

**RISK MANAGEMENT AS A TOOL TO ADDRESS THE
CHALLENGES OF MALADMINISTRATION IN
BUFFALO CITY METROPOLITAN MUNICIPALITY**

by

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(i) Abstract

The aim of this study is to explore the risk management function with reference to the challenges faced by the Buffalo City Metropolitan Municipality in the Eastern Cape.

(ii) Declaration

I, Peter Hlazo, hereby declare that this mini-dissertation for the Programme in Governance and Political Transformation at the University of the Free State (Bloemfontein) is my own original work and has not been submitted by me or any other individual at this or any other university for any other degree or qualification. I also declare that all references used for this study have been properly acknowledged.

.....

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(iii) Acknowledgements

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(iv)Table of contents

(i) Abstract.....(1)
(ii) Declaration of independent work.....(2)
(iii) Acknowledgements.....(3)
(iv) Table of contents.....(4)

TABLE OF CONTENTS

Page No.

CHAPTER 1: BACKGROUND AND MOTIVATION OF THE RESEARCH.....11

1.1 INTRODUCTION.....11

1.2 ACTUALITY/ MOTIVATION.....11

1.3 RESEARCH PROBLEM.....13

 1.3.1 Formulation of research problem.....13

 1.3.1.1 Sub-problems.....13

1.4 AIM AND OBJECTIVES OF THE STUDY.....13

1.4.1 Significance of the study.....14

1.5 METHODOLOGY.....14

 1.5.1 Research method.....14

 1.5.2 Literature review.....15

 1.5.3 Target group.....18

 1.5.4 Data collection procedure and sources.....18

 1.5.5 Data analysis.....19

1.6 RESEARCH DESIGN/LAYOUT.....19

 1.6.1 Limitations of the study.....19

 1.6.2 Layout of the chapters.....19

1.7 CONCLUSION.....21

 1.7.1 Accountability for outcomes.....21

 1.7.2 Prioritising in terms of cost-effectiveness at the level of activities.....21

CHAPTER 2

INTERNATIONAL PRINCIPLES AND GUIDELINES ON RISK MANAGEMENT AND THE LEGISLATIVE FRAMEWORK FOR RISK MANAGEMENT IN SOUTH AFRICAN MUNICIPALITIES.....22

2.1 INTRODUCTION.....22

2.2 A PERSPECTIVE ON THE OECD PRINCIPLES AND GUIDELINES.....22

2.2.1 Risk transparency and disclosure in the SOE Guidelines.....23

2.3 CORPORATE GOVERNANCE AND THE GLOBAL FINANCIAL CRISIS.....24

2.3.1 Corporate Governance and the Financial Crisis (OECD, 2010). Key findings and main messages: Effective implementation of risk management.....24

2.4 RISK MANAGEMENT PRACTICES IN LISTED COMPANIES.....26

2.4.1 General perspective.....26

2.4.2 Financial Stability Board Thematic Peer Review on Risk Governance (2013).....26

2.4.3 Risk management standards and codes.....27

2.4.4 Risk appetite and incentives.....29

2.4.5 Chief risk officer.....30

2.4.6 Board member qualification requirements.....30

2.4.7 Board Committees.....31

2.5 RISK MANAGEMENT PRACTICES IN STATE-OWNED ENTERPRISES.....32

2.5.1 SOEs versus listed companies.....	32
2.5.2 Mexican guidelines for internal control of SOEs.....	33
2.5.3 Risk appetite and incentives.....	34
2.5.4 Israeli ownership circular on risk management in SOEs.....	36
2.5.5 India-Risk management in the Guidelines on Corporate Governance for Central Public Sector Enterprises (DPE, 2010).....	37
2.5.6 Responsibilities at the board level.....	37
2.5.7 Owner’s risk.....	38
2.6 LEGISLATIVE PROVISION.....	40
2.6.1 The Constitution, 1996 (Act 108 of 1996).....	41
2.6.2 The Municipal Structures Act, 1998 (Act 117 of 1998).....	41
2.6.3 The Municipal Systems Act, 2000 (Act 32 of 2000).....	41
2.6.4 The Municipal Finance Management Act, 2003 (Act 56 of 2003 (MFMA).....	41
2.6.4.1 Financial management.....	41
2.6.4.2 Revenue management.....	42
2.6.4.3 Expenditure management.....	43
2.6.5 The role of the Auditor-General.....	43
2.6.6 The King Codes.....	45
2.7 CONCLUSION.....	45
CHAPTER 3: FUNDAMENTALS AND SPECTRUM OF RISK MANAGEMENT	48
3.1 INTRODUCTION.....	48

3.2 THE NATURE OF RISK MANAGEMENT	48
3.3 INTRODUCING RISK MANAGEMENT TOOLS AND TECHNIQUES	48
3.4 ENTERPRISE RISK MANAGEMENT	50
3.5 THE BENEFITS OF APPLYING ENTERPRISE RISK MANAGEMENT	50
3.6 GOOD GOVERNANCE IN GENERAL AND HOW CAN ENTERPRISE RISK BE MADE MORE EFFECTIVE	51
3.7 BACKGROUND	54
3.8 CORPORATE GOVERNANCE CODES GUIDANCE	56
3.8.1 All Codes.....	56
3.8.2 NYSE Code provisions.....	57
3.8.3 European Codes.....	58
3.8.4 Combined Codes.....	59
3.8.5 French Codes.....	59
3.8.6 The King Codes of South Africa.....	59
3.9 RISK MANAGEMENT GUIDANCE	60
3.9.1 Code provision.....	61
3.9.2 Sources of guidance.....	61
3.9.3 Turnbull guidance.....	63
3.9.4 Other guidance.....	63
3.10 PUBLIC ACCOUNTING AND EXTERNAL AUDIT STRETCHED TO BREAKING POINT	64
3.11 INTERNAL AUDIT STRUGGLING	64
3.12 LINKAGE OF RISK MANAGEMENT TO GOOD GOVERNANCE	65

3.12.1 Risk management.....	65
3.12.2 General benefits of effective risk management.....	65
3.12.3 Fundamental basis of good governance.....	65
3.12.3.1 Basic values and principles.....	65
3.12.3.2 Application.....	65
3.12.4 Develop a sound risk management system.....	65
3.13 CONCLUSION.....	66
CHAPTER 4: STRATEGIC RISK MANAGEMENT IN MUNICIPALITIES.....	68
4.1 INTRODUCTION.....	68
4.2 LOCATION OF THE BCMM.....	69
4.3 A NEW DUTY OF CARE.....	70
4.4 PROFESSIONALIZATION OF THE BOARD.....	72
4.4.1 Ethics and professionalism in risk management.....	72
4.4.2 The relevance of ethics to risk management.....	73
4.5 A risk framework.....	75
4.6 Risk intelligent organizations.....	77
4.7 Scope of risk management.....	79
4.7.1 Risk management.....	80
4.7.2 Risk assessment.....	80
4.8 The single voice of risk management.....	81
4.9 Granularity of risk management.....	81
4.10 Risk appetite.....	83

4.11 The importance of avoiding pitfalls.....	83
4.12 The extended enterprise.....	83
4.13 An assurance framework.....	86
4.14 Risk management and risk assurance framework.....	87
4.15 Documented assurance map.....	88
4.16 Risk management group.....	88
4.17 Barriers to team development.....	89
4.17.1 How to overcome these barriers.....	90
4.18 INTERNAL AUDIT.....	91
4.18.1 Functions of management.....	92
4.19 OTHER KEY ASSURANCE ROLE HOLDERS.....	93
4.19.1 External assurance.....	93
4.19.2 Chief Assurance Officer or Director of Risk Management and Assurance.....	93
4.19.3 Full time non-executive directors.....	94
4.19.4 Governance audits.....	94
4.20 CONCLUSION.....	95

**CHAPTER 5: SUMMARY OF THE CONCLUSIONS,
FINDINGS AND RECOMMENDATIONS.....96**

5.1 INTRODUCTION.....	96
5.2 CONCLUSIONS.....	96
5.3 FINDINGS.....	101

5.3.1 Lack of training.....	101
5.3.2 Legislation.....	101
5.3.3 The King Codes.....	101
5.4 RECOMMENDATIONS.....	101
5.4.1 Training.....	101
5.4.1.1 General financial functions according to the PFMA.....	101
5.4.1.2 Revenue management.....	102
5.4.1.3 Expenditure management.....	103
5.4.2 Risk and opportunity governance.....	103
5.4.3 Motivation.....	104
BIBLIOGRAPHY	105

CHAPTER 1

BACKGROUND AND MOTIVATION OF THE RESEARCH

1.1 INTRODUCTION

The state of municipal administration in South Africa has now reached critical proportions and the facts speak for themselves.

Many Audit Reports on the municipalities in South Africa indicate a lack of proper financial management and has led to recent disclaimers of audit opinions. As the result of this maladministration communities are suffering by not getting the service delivery they are entitled to. Service delivery protests reports and petitions were delivered to the municipalities that indicate dissatisfaction amongst the citizens with the administration of the municipalities. Newspaper reports in the local and national space refer to the maladministration that could have been avoided.

To address this problem this research project focuses on the Buffalo City Metropolitan Municipality's risk management system as a case study to mitigate the challenges of maladministration. Risk management is defined by National Treasury (2010:16) as "A systematic and formalised process to identify, assess, manage and monitor risks" so therefore if maladministration is regarded as a risk then a municipal-wide risk management mitigation system, should minimise the number of maladministration risks. Risks management are going to be investigated to determine the link with good governance and the Buffalo City Metropolitan Municipality (hereafter referred to as BCMM).

1.2 ACTUALITY/MOTIVATION

Over the past 17 years the state of local government has been transformed through various government legislative approaches transforming municipalities. In terms of section 12 notices of the Municipal Structures Act, 1998 (Act 117 of 1998), the municipalities are structured as follows:

Category A-Metropolitan Municipality:

A municipality with a mayoral executive system combined with both a sub-council and a ward participatory system.

Category B-Local Municipality:

A municipality with a mayoral executive system combined with ward participatory system.

Category C-District Municipality:

A municipality with a mayoral executive system.

Due to the cooperative governance arrangement each of these categories of municipalities is not required to account to one another. Section 41(g) of the Constitution of the Republic of South Africa, 1996 (Act 108 of 1996) does give guidelines on cooperative governance arrangements. In addressing the poor Auditor General's report findings the affected municipality must work together with the other spheres of government. These prevailing audit outcomes often result in community upheavals as there is no proper financial management provision to safeguard the allocated budget. A significant issue which has been highlighted in the Auditor General's report of 2010/11 is the substantial number of municipalities in the country that contravene Supply Chain Management (SCM) Regulations and Procedures (IMFO Journal: Volume12 Number 3: 2012:4). This indicates a lack of internal controls in the local sphere of government which make the risk of maladministration high (Auditor General Report: 2010/2011). However, the government is running programmes such as Operation Clean Audit (RSA: 2009) to enhance clean administration that should lead to the reduction of maladministration in the local sphere of government.

BCMM had since been upgraded to a Category A metropolitan municipality. Given this new status these problems of maladministration need to be addressed and therefore a more effective risk management system could address these challenges. The implementation of the institution's risk management policy should be guided by a strategy approved by the Accounting Officer. The focus is on the prevention of fraud and corruption, the elimination of unauthorised expenditure, fruitless and wasteful expenditure and irregular expenditure (Public Sector Risk Management Framework 2010).

1.3 RESEARCH PROBLEM

The South African Local Government system has limited trained officials in the area of financial management that leads to the high number of audit issues raised. Some of these problems are related to the levels of staff remuneration and inadequate capacity to provide services to the communities. This situation has been worsened by poor governance and oversight has led to high levels of maladministration and subsequent corruption. The consequence of corruption is that it defrauds the state of revenue, discourages potential investors and donor countries and hence undermines the ability of the state to meet social and development goals. This raises the question: Why is risk management not effectively addressing these things?

1.3.1 Formulation of research problem

In this study the unit of analysis is the BCMM risk management system. Such a system can be benchmarked against a standard, for example the King III CODE.

The research problem or research question is stated as follows: How can a more effective use of the risk management function reduce the maladministration level in BCMM? Risk management should always be considered as a tool that increases the institutions predictions of success through getting it right the first time and minimizes negative outcomes (RSA, 2013.1).

1.3.1.1 Sub-problems

- How effective do the senior management of the BCMM regard the risk management system in reducing maladministration in the BCMM?
- How do the senior management of the BCMM see the risk management system being made more effective to reduce maladministration?

1.4 AIM AND OBJECTIVES OF THE STUDY

The research can be dissected into two components, namely the process (search, inquiry, endeavour, scientific study and critical investigations) and the goal namely (discovery of new facts and principles) (Wessels 1999:363). Leedy (1993:8) agrees with the second part and states that the research has a prime goal namely discovery.

The aim for a solution to a specific problem is only the starting point from which the design of a quantifiable policy on which rational, defensible programmes of governance can be based.

The objectives of the study are to:

- Make recommendations to reduce or at least limit further maladministration in the BCMM; and
- Investigate the effectiveness of the risk management system of BCMM and make recommendations that can improve the effectiveness of the risk management system in mitigating maladministration.

1.4.1 Significance of the study

It is clear from the poor audit outcomes that there is a high level of maladministration or incapacity to deliver services.

The matters researched will deal with the administration in BCMM. Maladministration in the operational activities of a municipality increases incidence of corruption and fraud. Maladministration must therefore be regarded as an operational risk that needs to be reduced through risk mitigating strategies and plans. It can therefore be argued that an effective risk management system should reduce the level of maladministration. The reduction of maladministration through risk mitigating action should lower the incidents of corruption, fraud and theft and other actions or lack of actions defined as maladministration. The findings of this study, if adopted should increase the effectiveness of the present risk management system and reduce the incidence of maladministration.

1.5 METHODOLOGY

1.5.1 Research method

The research consists out of a literature study on risk management in general and specifically on risk management in municipalities. The objective is to find theoretical answers to the risk management challenge facing the BCMM in the Eastern Cape.

A research design is a plan or blueprint of how a researcher intends to conduct the research (Mouton 2001:55). Research design is the determination of available

research methodologies and criteria related to the identified problem. It is described as the clearly defined structures within which the study is implemented (Burns and Grove 2001:223). This research design follows the qualitative approach and is exploratory and descriptive by nature.

A method is the way to do something in a careful and logical way. A methodology is a set of methods used. The research should be grounded on well-designed methodologies making use of applicable techniques and scientific principles in the collection of suitable data.

1.5.2 Literature review

According to Botes (1995:26) Public Administration research includes a systematic investigation that has a purpose in the sense of behaviour, the processes and techniques in the administering of the public institutions to describe, explain and forecast specific phenomena regarding certain behaviour patterns, processes and techniques (Botes 1995:26).

Successful research depends on a well-planned and thorough review of relevant literature available and such review usually entails obtaining useful references or sources (Brynard and Hanekom 1997:31). The references will include the audit reports as well as available investigation reports on BCMM and other official documents on these matters.

The National Treasury has developed a Public Sector Risk Management Framework that provides an official guide on risk management and will be utilised during the research. The Eastern Cape Provincial Enterprise Risk Management Framework clearly sets out the directive to establish an effective risk management system across the entire organisation:

“Enterprise risk management is recognised as an integral part of responsible management. It is expected that all the public Institutions shall develop and implement institutional enterprise risk management practices, aligned to the Eastern Cape Provincial risk management norms. The public institutions shall work in a consistent and integrated manner with the National and Provincial Treasuries, with the overall objective of taking advantage of opportunities and managing risks better, as far as

reasonably possible, bearing in mind resources and time implications”(Eastern Cape Provincial Enterprise Risk Management Framework, 2013:4).

The following BCMM documents are to be utilised in this research process:

➤ Final Strategic Risk Assessment Report

One of the strategic objectives raised in the report is: “To encourage community participation in local government matters” which clearly indicates how wide risk management must be considered (Final Strategic Risk Assessment Report 2005:2).

➤ Draft Risk Management Framework

“Fraud and Corruption: These risks relate to illegal or improper acts by employees resulting in a loss of the institution’s assets or resources” (Draft Risk Management Framework 2009:184).

➤ Risk Management Policy

“The Risk Management Committee will undertake the roles and responsibilities of typical Risk Management and Fraud Prevention Committees, which are detailed below. The Risk Management Champion’s roles and responsibilities are also defined hereunder:

- Review the risks reported by the various departments and/ or programmes, and consider what action is required relative thereto.
- Evaluate the reports of the external and internal auditors.
- Obtain assurances (e.g. via Internal Audit) that the risk management framework and processes are being properly performed” (Buffalo City Metropolitan Municipality, Risk Management Policy, 2012:851).

➤ Integrated Development Plan 2012/13 Review

The BCMM had under the Good Governance and Public Participation indicator inserted the following: “Progress towards implementation of Risk, Fraud and Internal Audit Initiatives as evidenced by the formulation and implementation of mitigation strategies” (Buffalo City Metropolitan Municipality).

Integrated Development Plan Review, 2012/2013:143). This clearly indicates the intentions of the municipality to implement risk management initiatives.

Official documents such as the annual reports - including the Auditor-General reports will also be consulted. The minutes of the BCMM audit committee and risk management committees will be consulted. Secondary literature on risk management by various authors will also be consulted during the research process.

There will also be further research on how the private sector develops an organisation's risk culture with specific reference to:

- "Establishment of clear linkage between strategic planning and risk management
- Integration of risk management processes into an organisation's annual planning and budgeting processes" (Figo and Anderson 2011:8).

The above statements must be understood within the context of ensuring that management practically understand the Enterprise Risk Management.

Here reference is also made to the Enterprise Risk Management (ERM) and Decision Making processes which is explained as follows:

"ERM is not isolated from strategy, planning, or day-to-day decision making. Nor it is about compliance. ERM is part of an organisation's culture, just as making decisions to attain objectives is part of the organisation's culture" (Rittenburg and Martens 2012:1).

There is also another critical consideration that ERM should have. Ideally it should have its own line function in the Municipal Manager's office. Risk management should also stand separate from other functions. It should be the proverbial 'watch dog' that ensures and monitors effective Enterprise Risk Management implementation through all functions.

The municipality's approach to Enterprise Risk Management will also receive focused attention in the study.

1.5.3 Target group

The target group must be representative and it must reflect the image of the study (Mouton 1996:135). The researcher utilises sampling to select particular elements from the targeted population that will understand the topic and be representative of the group (McMillan and Schumacher 2001:175).

Purposeful sampling were adopted for this study. The target group for this study are the political office-bearers that is the members of the municipal councils and the municipal chief officials, which are: the departmental heads and their deputies where applicable. However, it is understood that the target population can be too big to make a meaningful and objective study for the purpose of a mini dissertation in the available time and attention will be given to this limitation.

The research will focus on both groups who are responsible for risk management (Budget & Treasury; Corporate Services; Develop and Spatial Planning; Infrastructure; Economic Development; and Special Projects (BCMM, IDP 2012/2013:194). The following municipal directorates will be consulted: Budget & Treasury; Corporate Services; Municipal Services; Development and Spatial Planning; Infrastructure; Economic Development (BCMM, IDP: 2012/2013:195).

1.5.4 Data collection procedure and sources

In this research, primary data will be gathered by focussing on information that has already been published (McNabb 2004:90). Primary data are collected for purposes of a specific problem and this will contribute to the purpose of the study.

The following primary methods were used to gather information to be able to provide the recommendations made in the final chapter of the dissertation.

A theoretical approach was followed, because data collections by way of questionnaires were unpractical due to long distances and disinterested interviewees.

A literature study of available texts such as published books and journals in the field of Municipal Public Administration, Management, Economic Sciences, Sociology, Strategic Public Management and Statistics were also utilised. The collection of data is a series of activities interrelated with the purpose at gathering information to provide

answers to research questions (Creswell 1998:110). In addition legislation, dictionaries, public documents and media articles were also used in the study.

1.5.5 Data analysis

Data analysis is the process of selecting, sorting, focusing and discarding data. These activities are performed to ensure the accuracy of the data and the conversion from a data form to a reduced form which is more appropriate for data analysis and interpretation.

The data were analysed using a narrative and content analysis approach and including biographical comparisons and other qualitative data analysis methods.

1.6 RESEARCH DESIGN/LAYOUT

1.6.1 Limitations of the study

Challenges may occur where the relevant needed information might not be easy available. Confidentiality might also play a part in the gathering of information. The availability of quality information is essential for the success of the study.

A further limiting factor of the study is that the findings may not be enforceable and readily available to the staff of the BCMM.

Due to the time constraints and the difficulties in gathering information there is a risk of not being able to submit the study on the planned date.

1.6.2 Layout of the Chapters

The layout of the Chapters is as follows:

CHAPTER 1: BACKGROUND AND MOTIVATION OF THE RESEARCH

Chapter one focuses on the prevention of fraud and corruption, the elimination of unauthorised expenditure, fruitless and wasteful expenditure, and irregular expenditure. The aim and objectives was to assess the risk management system of the BCMM and make recommendations on how to improve the effectiveness of its risk management system. The chapter also referred to the data collection process which was followed to obtain certain information.

CHAPTER 2: INTERNATIONAL PRINCIPLES AND GUIDELINES ON RISK MANAGEMENT AND THE LEGISLATIVE FRAMEWORK FOR RISK MANAGEMENT IN SOUTH AFRICAN MUNICIPALITIES

Firstly, international principles and guidelines on risk management were discussed in this chapter.

Secondly, and more important was the legislative framework for municipalities in South Africa investigated. The Municipal Finance Management Act, 2003 (Act 56 of 2003), the Local Government: Municipal Structures Act, 1998 (Act 117 of 1998) (as amended), the Local Government: Municipal Systems Act, 2000 (Act 32 of 2000) and chapter 7 of the Constitution which determines the structures, powers and functions of local government were noted.

CHAPTER 3: FUNDAMENTALS AND SPECTRUM OF RISK MANAGEMENT

In chapter three the nature of risk management, risk management tools and techniques in general were explained. The chapter also emphasises the benefits of applying effective risk management, and the relevance of external and internal audit.

CHAPTER 4: STRATEGIC RISK MANAGEMENT IN MUNICIPALITIES

Chapter 4 focuses on strategic risk management. Firstly, the location of the BCMM was put into perspective. Secondly, the reason of choosing this municipality is because of the BCMM's importance in the Eastern Cape and its essential basic services that affects so many people. Thirdly, Audit Reports were also investigated to try and find the real causes of poor risk management at the BCMM. This method was applied in an effort to substantiate the theoretical perspectives and legal determinations.

CHAPTER 5: SUMMARY OF THE CONCLUSIONS, FINDINGS AND RECOMMENDATIONS

The last chapter entails the conclusions, findings and recommendations of the research.

1.7 CONCLUSION

To conclude this chapter the following issues in the risk management process was emphasised:

1.7.1 Accountability for outcomes

Pauw *et al.* (2009) states that: "Somebody who is not willing to take risks is not suitable to take risks for the position of chief executive." When an activity comes up for prioritisation, the public manager must take note of the risks involved. Assuming that everything will run smoothly, they must also evaluate it in terms of its feasibility or probability of success, as measured by the 3E's: economy, efficiency and effectiveness.

1.7.2 Prioritising in terms of cost-effectiveness at the level of activities

The first step in the bottom up –up leg of the prioritising process is the identification of the outcomes that the executive desires. The political executive and the institution must then agree on the output to be achieved and on the priority of each desired output (Pauw *et al.* 2009).

In the next chapter international fundamentals of risk management and the legislative framework of risk management in South African municipalities received attention.

CHAPTER TWO

INTERNATIONAL PRINCIPLES AND GUIDELINES ON RISK MANAGEMENT AND THE LEGISLATIVE FRAMEWORK FOR RISK MANAGEMENT IN SOUTH AFRICAN MUNICIPALITIES

2.1 INTRODUCTION

Risk management will be firstly looked at from an international standard perspective.

Secondly, this chapter focuses on the legislative framework for municipal administration in South Africa. Companies and municipalities face both financial and non-financial risks. Financial risks are more solvable than non-financial risks specifically where human beings are involved.

2.2 A PERSPECTIVE PRINCIPLES AND GUIDELINES

The starting point for this review is Principle VI.D, which states that the board should fulfil certain key functions, including reviewing and guiding corporate risk policy as well as ensuring that appropriate systems for risk management are in place and comply with the law and relevant standards. The Annotations to the Principles add that *boards have an essential responsibility setting the risk policy by specifying the types and degree of risk that a company is willing to accept in pursuit of its goals.*

Complementary to this, the annotations to Principle VI.D.7 note that “ensuring the integrity of the essential reporting and monitoring systems will require the board to set and enforce clear lines of responsibility and accountability throughout the organisation”. The annotations further elaborate that the board will also need to ensure that there is appropriate oversight by senior management.

Chapter V.E of the *OECD Principles and Guidelines on Corporate Governance of State-Owned Enterprises* (hereafter “the Guidelines”) stipulates that SOEs should disclose material information on all matters described in the *OECD Principles of Corporate Governance* and in addition focus on areas of significant concern for the state as an owner and the general public. Material risk factors and measures taken to

manage such risks are one example of such information specifically mentioned in the Guidelines (see par.2.2.1).

2.2.1 Risk transparency and disclosure in the SOE Guidelines

This Annotation to the *OECD Guidelines* explicitly highlight risk governance issues for SOEs. Chapter V.E.3 notes the following:

Severe difficulties arise when SOEs undertake ambitious strategies without clearly identifying, assessing or duly reporting on the related risks. Disclosure of material risk factors is particularly important when SOEs operate in newly de-regulated and increasingly internationalised industries where they are facing a series of new risks, such as political, operational, or exchange rate risks.

Without adequate reporting of material risk factors, SOEs may give a false representation of their financial situation and overall performance. This in turn may lead to inappropriate strategic decisions and unexpected financial losses.

Appropriate disclosure by SOEs of the nature and extent of risk incurred in their operations requires the establishment of sound internal risk management systems to identify, manage, control and report on risks. SOEs should report according to new and evolving standards and disclose all off-balance-sheet assets and liabilities. When appropriate, such reporting could cover risk management strategies as well as systems put in place to implement them. Companies in extracting industries should disclose their reserves according to best practices in this regard, as this may be a key element of their value and risk profile.

Public Private Partnerships should also be adequately disclosed. Such ventures are often characterised by transfers of risks, resources and rewards between public and private partners for the provision of public services or public infrastructure and may consequently induce new and specific material risks.

(OECD. Principles for Public Governance of Public-Private Partnerships (www.oecd.org/governance/oecdprinciplesforpublicgovernanceofpublicprivatepartnerships.htm).

Chapter VI.E of the *Guidelines* further stipulates that, when necessary, SOE boards should set up specialised committees to support the full board in performing its

functions, particularly in respect of audit, risk management and remuneration. The annotations further note that the setting up of specialised board committees could be instrumental in reinforcing the competency of SOE boards and in underpinning their critical responsibility in matters such as risk management and audit.

2.3 CORPORATE GOVERNANCE AND THE GLOBAL FINANCIAL CRISIS

The OECD Corporate Governance Committee already completed several papers on risk management in the global context of its work on *Corporate Governance and the Financial Crisis* during 2009-10. Since then, additional work has been conducted in various institutions, including the Financial Stability Board. Boards reported to have increased their focus on risk in the last few years. Overall, however, the conclusions from the OECD's 2010 review, which are summarised in par. 2.3.1, appear to be still valid.

2.3.1 Corporate Governance and the Financial Crisis (OECD, 2010) Key findings and main messages: Effective implementation of risk management

- ❖ Perhaps one of the greatest shocks from the financial crisis has been the widespread failure of risk management. In many cases risk was not managed on an enterprise basis and not adjusted to corporate strategy. Risk managers were often separated from management and not regarded as an essential part of implementing the company's strategy. Most important of all, boards were in a number of cases ignorant of the risk facing the company.
- ❖ It should be fully understood by regulators and other standard setters that effective risk management is not about eliminating risk taking, which is a fundamental driving force in business and entrepreneurship. The aim is to ensure that risks are understood, managed and, when appropriate, communicated.
- ❖ Effective implementation of risk management requires an enterprise-wide approach rather than treating each business unit individually. It should be considered good practice to involve the board in both establishing and overseeing the risk management structure.
- ❖ The board should also review and provide guidance about the alignment of corporate strategy with risk-appetite and the internal risk management structure.

- ❖ To assist the board in its work, it should also be considered good practice that risk management and control functions be independent of profit centres and the “chief risk officer” or equivalent should report directly to the board of directors along the lines already advocated in the OECD Principles for internal control functions reporting to the audit committee or equivalent.
- ❖ The process of risk management and the results of risk assessments should be appropriately disclosed. Without revealing any trade secrets, the board should make sure that the firm communicates to the market material risk factors in a transparent and understandable fashion. Disclosure of risk factors should be focused on those identified as more relevant and/or should rank material risk factors in order of importance on the basis of a qualitative selection whose criteria should also be disclosed.
- ❖ With few exceptions, risk management is typically not covered, or is insufficiently covered, by existing corporate governance standards or codes. Corporate governance standard setters should be encouraged to include or improve references to risk management in order to raise awareness and improve implementation.

(OECD. 2010. Corporate Governance and the Financial Crisis – Conclusions and Emerging Good Practices to Enhance Implementation of the Principles, OECD, Paris, www.oecd.org/daf/ca/corporategovernanceprinciples/44679170.pdf.)

As the 2009/10 review noted, the financial crisis uncovered extremely deficient risk oversight and management practices even at highly sophisticated corporations. In many cases, risk was not managed on an enterprise wide basis and not adjusted to corporate strategy, as risk managers were often kept separate from management and not regarded as an essential part of implementing the company’s strategy. Moreover, boards were in a significant number of cases ignorant of the risk facing the company.

2.4 RISK MANAGEMENT PRACTICES IN LISTED COMPANIES

2.4.1 General perspective

Since the beginning of the financial crisis, many reports have focused on risk governance in financial institutions, including major reports by the Basel Committee on Banking Supervision, the Group of Thirty, the Institute of International Finance, and others. The most recent report has been the Financial Stability Board's Thematic Peer Review on Risk Governance, which is summarised in par.2.4.2. Relatively little work has been done, however, on risk governance in the non-financial sector, notably with regard to the lessons to be learned from risk management failures more generally.

2.4.2 Financial Stability Board Thematic Peer Review on Risk Governance (2013)

The Financial Stability Board's Thematic Peer Review on Risk Governance (2013) takes stock of risk governance practices at both national authorities and firms, notes progress made since the financial crisis, identifies sound practices and offers recommendations to support further improvements.

The recent global financial crisis exposed a number of risk governance weaknesses in major financial institutions, relating to the roles and responsibilities of corporate boards of directors (the "board"), the firm-wide risk management function, and the independent assessment of risk governance. Without the appropriate checks and balances provided by the board and these functions, a culture of excessive risk-taking and leverage was allowed to permeate in many of these firms.

The peer review found that, since the crisis, national authorities have taken several measures to improve regulatory and supervisory oversight of risk governance at financial institutions. These measures include developing or strengthening existing regulation or guidance, raising supervisory expectations for the risk management function, engaging more frequently with the board and management, and assessing the accuracy and usefulness of the information provided to the board to enable effective discharge of their responsibilities. Nonetheless, more work is necessary. In particular, national authorities need to better assess the effectiveness of a firm's risk governance framework, and more specifically its risk culture, to help ensure the sound

management of risk through the economic cycle. Supervisors will need to strengthen their assessment of risk governance frameworks to encompass an integrated view across all aspects of the framework.

Drawing from the findings of the review, the report identifies a list of sound risk governance practices (see Annex A to this report) that would help firms continue to improve their risk governance and national authorities to assess its effectiveness. The review also sets out several recommendations targeting areas where more substantial work is needed, in particular:

- National authorities should strengthen their regulatory and supervisory guidance for financial institutions and devote adequate resources to assess the effectiveness of risk governance frameworks.
- Standard setting bodies should review their principles for governance, taking into consideration the sound risk governance practices set out in the report.
- The FSB should explore ways to formally assess risk culture at financial institutions.
- The FSB should provide general guidance on the key elements that should be included in risk appetite frameworks and establish a common nomenclature for terms used in risk appetite statements.

(Financial Stability Board (FSB) (2013), *Thematic Review on Risk Governance*, www.financialstabilityboard.org/publications/r-130212.pdf).

The following sections highlight the main results from the international questionnaire responses, notably in the areas of: (1) risk management standards and codes; (2) risk appetite and incentives; (3) chief risk officers; (4) board member qualification requirements; and (5) board committees. Paragraph 2.5 then summarises the questionnaire responses relating to state owned enterprises.

2.4.3 Risk management standards and codes

In many jurisdictions, risk management issues are dealt with (in one way or another) in national corporate governance codes, as is the case with the New York Stock Exchange (NYSE) listed company rules, the UK's combined code and the French AFEP-MEDEF code. Internationally, professional institutes and associations also

offered their advice. In 1992, the Committee of Sponsoring Organisations of the Treadway Commission (COSO) published an internal control – integrated framework guide, 1 and in 2004 an enterprise risk management (ERM) – integrated framework guide. The report prepared for the OECD in 2010 concluded, however, “None of the existing guidance on risk management is adequate for the purpose. Most of the guidance is extremely high-level, is process-oriented and gives scant guidance how to create an effective risk management and assurance framework.”

More recently, COSO published guidance on risk assessments and on risk appetite (2012), which provides more specific guidance on certain issues. In 2009, the International Organisation for Standardisation issued its standard for implementation of risk management principles, ISO 31000, which has *de facto* become the world standard. The purpose of ISO 31000 is to provide principles and generic guidelines on risk management that could achieve convergence from a variety of standards, methodologies and procedures that differ between industries, subject matters, and countries.

The answers to the questionnaire for this review similarly highlight the inclusion of references to risk management in corporate governance codes (which in many countries operate on a comply-or-explain basis). Depending upon jurisdiction, references to risk management are also contained in listing rules or agreements (**India, UK, and US**), company laws (**Austria, Germany, 4 Turkey and Japan**), or stock exchange laws (**Mexico**), usually in connection with the audit or internal control functions. Additional guidance that is sometimes provided, such as the **UK's** “*Turnbull Guidance*”, also mainly refers to audit and internal controls. One exception is **Singapore's** Corporate Governance Council, which in May 2012 issued guidance specifically on the governance of risk management (“*Risk Governance Guidance for Listed Boards*”).

2.4.4 Risk appetite and incentives

Whereas it is generally accepted that boards should be responsible for setting a company's risk appetite or tolerance, little guidance is available on how boards can go about setting risk targets, considering the various types of risks that modern corporations may be subject to. Aggregating all the risks into one number appears

impossible, and even the existing models for aggregating financial risks (only) have largely been discredited during the financial crisis. Therefore, the only realistic option appears to be for boards to set risk appetite or tolerance with regard to each individual risk identified. At the same time, boards need to be aware of the possible interaction of different risk, notably the possibilities that they may reinforce each other (Source).

An important conclusion from the Committee's 2010 report on *Corporate Governance and the Financial Crisis* was that the board's responsibility for defining strategy and risk appetite needs to be extended to establishing and overseeing enterprise-wide risk management systems. The report noted that in some important cases the risk management system was not compatible with a company's strategy and risk appetite. Judging from the results of the present survey, there appear to be, at the national level, few rules regarding the risk appetite of (non-financial) companies. Board responsibilities do not generally extend to ensuring that the risk management system is compatible with company strategy and risk appetite. An exception is **Singapore's** Guidance, which specifically refers to financial, operational, compliance, information technology, and risk management systems.

In the context of the present global survey, only **Germany** and **India** highlighted special provisions for major risks threatening the existence of the company. **Germany's** stock company act requires the management board to introduce appropriate measures, in particular setting up a monitoring system, to ensure that any developments endangering the continued existence of the company may be identified and communicated to the management board early on. **India's** companies act requires, in the context of a statement on risk management, the identification of risk which may threaten the existence of the company. While it is not clear how effective such rules have been in practice, the absence of such rules in most jurisdictions suggests that the focus of risk management may often be more on the risks considered most likely to materialise rather than on those having the largest potential impact, even if considered unlikely to materialise.

2.4.5 Chief risk officer

Among the countries that responded to the global survey, **Argentina** and **Singapore** referred to guidance documents that suggest the appointment of a chief risk officer in

certain cases, and **India** reported that a rule requiring large listed companies to have a chief risk officer/manager is under consideration. Where (usually larger or financial sector) corporations have decided to appoint a chief risk officer, the trend is that the risk management function is separate from profit centres and, primarily in the financial sector, reports directly to the board, notably to non-executive directors. How sufficient such arrangements are in practice, depends upon many factors, most importantly perhaps the company's overall risk culture. The financial crisis certainly did not provide assurance that chief risk officers were effectively able to restrain excessive risk-taking. "From the standpoint of an institution, the existence of a risk manager has less to do with actual risk reduction than it has to do with the impression of risk reduction" (Taleb 2004).

In the financial sector, supervisors have therefore in many cases insisted that chief risk officer functions be upgraded, made more independent, better-resourced, and involved in decision-making. Whereas such sound risk governance practices for financial institutions will not be applicable or necessary for all types of companies, some may make sense also for larger companies, and/or those operating in high-risk sectors. The FSB, for example, considered it sound practice for risk management functions (at financial institutions), to have access to relevant affiliates, subsidiaries, and concise and complete risk information on a consolidated basis; for risk-bearing affiliates and subsidiaries to be captured by the firm-wide risk management system and be a part of the overall risk governance framework (Financial Stability Board, 2013).

2.4.6 Board member qualification requirements

Qualification requirements for board members typically apply only for financial institutions and in many countries also for members of audit committees. The EU's Statutory Audit Directive (2006/43/EC) for example states that "a natural person may be approved to carry out a statutory audit only after having attained university entrance or equivalent level, then completed a course of theoretical instruction, undergone practical training and passed an examination of professional competence of university final or equivalent examination level, organised or recognised by the member state concerned".

The Directive further requires that the test of theoretical knowledge cover the issues of risk management and internal control.

Some countries participating in the survey noted that new board members are offered training or participate in induction processes. It is unclear how far such programmes are able to transmit a sufficient degree of knowledge about risk management. They may help, but are unlikely to fully replace the knowledge that is gained through long-term industry experience.

2.4.7 Board Committees

The NYSE rules further comment that “while it is the job of the CEO and senior management to assess and manage the listed company’s exposure to risk, the audit committee must discuss guidelines and policies to govern the process by which this is handled. The audit committee should discuss the listed company’s major financial risk exposures and the steps management has taken to monitor and control such exposures. The audit committee is not required to be the sole body responsible for risk assessment and management, but, as stated above, the committee must discuss guidelines and policies to govern the process by which risk assessment and management is undertaken. Many companies, particularly financial companies, manage and assess their risk through mechanisms other than the audit committee.

The processes these companies have in place should be reviewed in a general manner by the audit committee, but they need not be replaced by the audit committee.”

The responsibility for establishing and overseeing the company’s enterprise-wide risk management system usually rests with the board of directors as a whole. In most cases, this responsibility is stated in company law and/or listing rules, except in a small number of jurisdictions where this is not clearly stated. In some jurisdictions, including the **US (NYSE)**, the responsibility rests with the audit committee. **Switzerland** recently abolished, due (among other things) to proportionality concerns for smaller companies, the requirement that risk management systems be reviewed by external auditors, and the **UK’s** Financial Reporting Council argues against mandating external auditor reviews of risk management systems.

2.5 RISK MANAGEMENT PRACTICES IN STATE-OWNED ENTERPRISES

When assessing risk-taking behaviour in the recent financial crisis, two types of institutions have stood out:

- (i) state-owned financial institutions considered as SOEs; and
- (ii) enterprises owned by the sub-national levels of government considered as SOEs.

2.5.1 SOEs versus listed companies

Almost all jurisdictions responded that there are no material differences between risk governance practices in non-listed SOEs and listed companies. This is despite the fact that, in many cases, this is not a requirement emanating from the legal or regulatory frameworks. What appears to underlie the responses is an issue of company size: some SOEs are very large, but most are small and have specific purposes. Governments therefore do not wish to mandate that all SOEs operate according to listed standards, but they expect their particularly large or particularly commercially-oriented SOEs to do so. Likewise, state owned financial institutions are normally expected – regardless of size – to operate according to similar risk management practices as listed private entities (although, as mentioned above, this expectation has not always been met).

At the opposite extreme, the Korean response indicated that “there surely are material differences between risk governance practices in unlisted SOEs and listed companies”, effectively arguing that risk management may be stronger in SOEs. Listed companies in **Korea**, it is argued, rely on their own internal governance and corporate culture for risk management, whereas there are externally mandated risk management frameworks in place in the SOEs. A second group does require non-listed SOEs to comply with the same risk governance standards as listed companies (**Finland**¹¹, **Italy** and **Sweden**). A third group of jurisdictions (**Argentina, Chile, India**¹², **Israel, Japan, Lithuania, Norway, Portugal** and **Switzerland**) set out specific standards for SOEs, but equivalence or mutual relationship between these standards and those for listed companies can hardly be assessed. One country (the **Netherlands**) makes it optional for SOEs whether to comply with listed company governance codes on a comply-or-explain basis.

Finally, a few countries (e.g. **Argentina**) observed that risk management is generally not well developed in SOEs. This may have to do with the way SOEs are perceived and positioned within the public sector. Other things equal one might expect that the more strongly a country's SOEs are corporatized the more fully will they have embraced private sector best practices in respect of risk management. The Mexican response par. 2.5.2 provides an example of a risk management culture that is particularly reliant on the involvement of the general government sector, and of the CEO as opposed to the board of directors.

2.5.2 Mexican guidelines for internal control of SOEs

The General Guidelines provide the mandatory creation in all SOEs, and under the direction of the CEO, of an Internal Institutional Control System, which allows the implementation of a systematic process to identify, assess, prioritise, manage and monitor the risks that may impede or prevent compliance with institutional goals and objectives, analysing internal and external factors that may increase the impact and likelihood of risks materialising, and defining strategies and actions to control them. This, by establishing and updating policies, procedures, mechanisms and actions required to manage risks, reasonably achieve institutional goals and objectives and comply with regulations applicable to public management.

The System's implementation begins with an annual self-assessment, whose results allow the establishment of a Risk Management methodology, which takes place in three stages: i) risk assessment; ii) assessment of controls; and iii) final assessment of risks relative to controls. The methodology produces the following:

- *Institutional Risk Map*. Allows prioritisation of risks based on their probability of occurrence and degree of impact; and
- *Strategies and Actions for risk administration*. The strategies are the options for managing the risk based on their assessment relative to controls in order to avoid, reduce, assume or transfer the risk, as a result of these actions, mechanisms are put in place for implementing the strategies, most relevant are optimisation of policies, programs, projects, processes, procedures and services, among others.

These documents, among others, and their updates, are presented at least annually to the board of directors. Risk management is under the direct responsibility of the CEO, who is aided by a Coordinator for Internal Control, responsible for submitting to the CEO's approval the risk management methodology and policies, as well as actions to implement them.

Source: Mexican response to OECD peer review questionnaire.

2.5.3 Risk appetite and incentives

Regarding managerial incentives, the respondents broadly agreed on the position that the variable element of managerial remuneration in SOEs is so relatively limited that it does not encourage managers to take excessive risk. Among the countries making specific reference to remuneration guidelines and practices to dis-incentivise excessive risk taking were the **Czech Republic, Norway and Switzerland**. The **Netherlands** informed that it is reconsidering the existing requirement that SOE board members receive variable remuneration.

As for mechanisms to limit risk taking, they fall into two broad categories, namely:

(i) Those that affect the general financial and operating environment of SOEs; and
(ii) Guidelines and instructions regarding the daily management of companies. In the first category, the approaches reported by various respondents in turn depend on the degree of corporatisation of SOEs and closeness between the SOEs and the general government sectors. In general, four overall approaches can be discerned:

- *Direct control.* Governments still exercise direct control over major transactions by SOEs, which may of course serve as the ultimate control instrument. In many jurisdictions this may be limited to large-scale acquisition and disposal of assets, but some governments go further. The **Indian** response indicates this as an important risk management tool.
- *Approval of SOE liabilities.* The most commonly cited way of controlling (financial) risk is the fact that SOEs in most jurisdictions are subject to an approvals procedure – typically involving the Ministry of Finance – if they wish to materially increase their liabilities. Among the respondents listing this as a risk limitation tool were **Chile, Japan, Mexico** and the **Netherlands**.

- *Extent of guarantees.* Most SOEs operate without government guarantees (although markets may in practice often perceive implicit guarantees), but those that are tasked with public policy objectives may still be explicitly state-backed. Some respondents (e.g. **Chile**, **Germany**, **Israel** and **New Zealand**¹⁴) list the explicit limitation of the extent of such guarantees as another risk control tool.
- *Sectoral regulation or legislation.* In some countries the scope of activities that any given SOE may engage in is stipulated in statutory rules or regulation. The responses from **Japan** and **Mexico** identify (for some sectors) this as a risk management tool.

At the same time, it must be recognised that, in many jurisdictions, the risk-taking of SOEs is considered mostly as an issue for the generally on-going surveillance by the government (often the Ministry of Finance). In most cases, this surveillance consists, however, to a large extent of quarterly or semi-annual reporting of financial results, in some cases supplemented by disclosure of risk assessments. As the financial crisis has demonstrated, such *ex post* reporting may frequently come too late to alert boards to excessive risk-taking. The same reservation applies to the widespread reliance on state audit bodies to monitor risk (in individual SOEs as well as the ownership function) to which many questionnaire responses made reference.

As noted earlier, a number of ownership functions or (other) ministries have issued guidelines on risk taking and risk managements to their SOEs. The arrangements can be more or less formal. The **New Zealand** response notes that the state “like any other shareholder, from time to time indicates its risk tolerance to the boards it appoints”. Where formal guidelines exist they may be either a stand-alone instrument, or imbedded in general governance codes for the SOE sector. In many cases, they cover both the risk management expectations to the companies and the specific responsibilities of the boards of directors (discussed in the following sub-section). One example of such guidelines was reported by **Israel**; it is reproduced in par. 2.5.4.

2.5.4 Israeli ownership circular on risk management in SOEs

According to a circular published in 2009 by the Government Companies Authority (ownership unit), all SOEs are required to establish a risk management policy and supervise its implementation. The control mechanisms include the following:

(a) The board is responsible to establish and approve the risk management policy and to supervise its implementation. Including, by means of internal reporting rules in the SOE approved by the board, the supervision of the board includes reviewing the performance of risk management, risks definition and grading, the organisation's functions and infrastructures, etc.

(b) The board can appoint a special committee designated to risk management function or perform this function itself.

(c) The SOE is required to appoint a designated management member responsible for risk management functions. In smaller SOEs (classified 6 or less), the board can decide that this function will be performed by outsourcing the services.

(d) Risk management of the SOE is part of the company's internal auditor yearly plan.

(Israeli response to OECD peer review questionnaire).

Other examples include **Lithuania**, where the Ministries of Finance and Economy issued financial risk management guidelines in 2012, detailing principles concerning: i) the management of SOE funds held with commercial banks; ii) investment strategies for SOE financial assets; iii) derivatives transactions. **India** (whose board-related practices are reported in par. 2.5.5 reports that SOEs are subject to stricter monitoring than listed companies with respect to risk taking, inter alia due to monitoring by a Central Vigilance Commission. The questionnaire response opines that this might actually contribute to disincentives to SOE risk-taking, making SOEs excessively risk-averse.

2.5.5 India – Risk management in the Guidelines on Corporate Governance for Central Public Sector Enterprises (DPE, 2010)

Section 7.3 of the Guidelines, which are established under the auspices of the Department of Public Enterprises (DPE) and mandatory for Indian SOEs, makes the following stipulations:

The company shall lay down procedures to inform board members about the risk assessment and minimisation procedures. These procedures shall be periodically reviewed to ensure that executive management controls risk through means of a properly defined framework. Procedure will be laid down for internal risk management also.

The board should implement policies and procedures which should include:

- (a) staff responsibilities in relation to fraud prevention and identification;
- (b) responsibility of fraud investigation once a fraud has been identified;
- (c) process of reporting on fraud related matters to management;
- (d) reporting and recording processes to be followed to record allegations of fraud;
- (e) requirements of training to be conducted on fraud prevention and identification.

(Department of Public Enterprises (DPE) (2010), Guidelines on Corporate Governance for Central Public Sector Enterprises, New Delhi, (India.bdpe.nic.in/sites/upload files/dpe/files/gcgcpse10.pdf.)

2.5.6 Responsibilities at the board level

The SOE Guidelines recommend that “when necessary” SOE boards should “set up specialised committees to support the full board in performing its functions, particularly with respect to [...] risk management” (Guideline VI.E). This clearly does not imply that every SOE should have a risk management committee, but that while the board as a whole would remain responsible for oversight of the risk management system, it could seek, where appropriate, the support of a committee dedicated to risk management issues.

The countries where a non-trivial number of SOE boards have established risk management committees include **Chile**, where government guidelines strongly recommend the establishment of a board-level committee responsible for risk management. Other countries where some of the larger SOEs have a risk management committee include **Germany, Israel** and **Korea**. In the **Netherlands, New Zealand, Norway** and **Switzerland** the large SOEs mostly have established board audit committees which are mandated to deal with risk management.

Among the countries that rely on the whole board of directors to manage risk (also including, among others, **Finland** and **Japan**), **India** provides an interesting example. The ownership co-ordination function (Department of Public Enterprises – DPE) has issued mandatory governance guidelines to SOEs which, among other things, stipulate how the boards must be informed of the companies' risk taking (Box 1.6). It appears that Indian regulators may be particularly concerned with the risks emanating from irregular corporate practices.

Finally, another matter of some concern arises from the fact that in most jurisdictions the questionnaire responses make no mention of mechanisms to ensure that the risk management system is tailored to the risks faced by SOEs. Apart from general requirements, governments do not usually define a specific risk management system, so that each SOE is required to define it on its own responsibility. Moreover, in countries with federal systems, the federal government may not have information on risk-taking by SOEs owned by sub-national levels of government.

2.5.7 Owner's risk

One exception from this general observation is provided by **Korea**. An extensive public reporting system disclosing the current status of the balance sheet of the consolidated SOE sector is in operation. Furthermore, as previously discussed by the Working Party, owing to the fluidity of the situation of a large number of public institutions in **Korea** (who may or may not qualify as SOEs according to the size of their commercial earnings – which either places them inside or outside the general government), the liability situation is monitored closely.

Notes

- The internal control guide provided a major conceptual development by describing internal control as part of a process, rather than bolted on activities, which had five main components:
 - (i) a control environment;
 - (ii) risk identification;
 - (iii) control activities;
 - (iv) information and
 - (v) communication and monitoring.Each part of this model was designed to support three key corporate objectives: the continuity of the business; timely and accurate financial reporting; and compliance with local laws and regulations. A final third dimension of the model was control activities that were expected to be carried out throughout the organisation.

- The ERM guide developed three additional components: objective setting, event identification; and risk response. The ERM framework comprises: (i) internal environment; (ii) objective setting; (iii) event identification; (iv) risk assessment; (v) risk response; (vi) control activities; (vii) information and communication; and (viii) monitoring.
- In the view of Anderson (2009), neither COSO nor Turnbull provides a helpful approach to the mechanics of creating an effective and lasting risk management and assurance framework over the long term. Missing elements include: risks are frequently not linked to strategy; risk definitions are often poorly expressed and have been reduced to the smallest number of words possible; the need for someone or something to make sure that the whole process takes place is not developed; not all involved stakeholders are considered and; only lip service is paid to important parts of the company's value chain that are outsourced, or where there is a dependence on key suppliers or joint venture partners.
- In Germany, the risk management rules, being part of the company law, apply to all stock companies, both listed and unlisted.
- More specific guidance and standards are also provided in Austria (Corporate Governance Code and ONR Standard 49000), and in South Africa (King III report).
- Whereas many countries require companies to promptly report on a major deterioration in their financial situation, notably in cases where their continuation on a going-concern basis is under threat, this (*ex post*) crisis management is not the same as (*ex ante*) risk management.
- Chief risk officers are usually required only for financial institutions.
- No such standards exist, however, in NASDAQ's listing rules, and some have expressed concerns that audit committees may not be the right body to be charged with risk oversight. See e.g. Choi (2013) and NYC Bar (www2.nycbar.org/pdf/report/uploads/20072409-NYSEListedCompanyRules.pdf).
- The same does not apply to NASDAQ.
- In a number of OECD countries the central government is to some degree prevented – e.g. constitutionally or via administrative law – from interfering in

the business activities of lower levels governments. In some countries, financial institutions are not technically considered as SOEs.

- In Finland, for example, it is clearly stated in the government policy that the corporate governance code is to be applied as a model for the governance of and reporting by unlisted SOEs.
- In India, for example, a specific guideline for the corporate governance of SOEs requires the establishment and periodical review of the procedure for informing the board about risk assessment and minimisation procedures.
- An exception is made for the particularly commercially oriented “navratnas” and “maharatnas” that operate at higher levels of autonomy.
- In the case of New Zealand, the fact that SOE debt is not subject to government guarantees must be explicitly stated when the liability is incurred.
- Again, this situation has been cited in the press as a factor believed to have contributed to a host of large losses at certain publicly owned enterprises in recent years.

2.6 LEGISLATIVE PROVISION

The local government sphere of government is regulated by the Public Sector, according to chapter 7 of the Constitution of the Republic of South Africa, 1996 (Act 108 of 1996). Flowing from the Constitution is the Municipal Finance Management Act, 2003 (Act 56 of 2003), the Local Government Structures Act, 1998 (Act 117 of 1998) and the Local Municipal Systems Act, 2000 (Act 32 of 2000). There are a wide range of risks such as changes in political mandates, skills shortage, high cost of capital, non-compliance with relevant regulations and laws. The Municipal Finance Management Act (MFMA), Section 166(1) states that each municipality and municipal entity must have an audit committee. Over and above the provisions of section 62(1) and 166(2) of the MFMA and other legislative provisions, BCMM has committed itself to good governance. This is also within the set of principles embodied in the King III Report on Corporative Governance which amongst others covers effective enterprise risk management.

2.6.1 The Constitution, 1996 (Act 108 of 1996)

Chapter 13 of the Constitution, determines the general financial matters of all three spheres of government. In addition Section 215 (1) of the Constitution requires that national, provincial and municipal budget processes must encourage transparency, accountability and effective financial management.

2.6.2 The Municipal Structures Act, 1998 (Act 117 of 1998)

The Municipal Structures Act, 1998 (Act 117 of 1998) states that each municipality must have a municipal council that comes together at least quarterly. The council is responsible to achieve the objectives set out in the Constitution.

Local government executives can be divided in two groups, namely the political – executives and the administrative officials (Boshoff 2011:34).

2.6.3 The Municipal Systems Act, 2000 (Act 32 of 2000)

The Municipal Systems Act, 2000 (Act 32 of 2000) provides for the core principles and processes that are necessary to enable municipalities to attend to social and economic challenges of local communities. The municipality must ensure general access to basic services that are affordable by all (Boshoff 2011:62).

2.6.4 The Municipal Finance Management Act, 2003 (Act 56 of 2003) (MFMA)

2.6.4.1 Financial management

With specific reference to financial management Section 62 of the MFMA refers to general financial management functions, which includes:

- (a) Resources of the municipality should be used effectively, efficiently and economically;
- (b) Records must be kept according to specific norms and standards;
- (c) The municipality must maintain an effective, efficient and transparent risk management and internal control system;
- (d) Unauthorised, irregular, fruitless, wasteful expenditure and other losses are prevented;
- (e) Disciplinary steps should be taken in case of any transgressions and/or acts of financial misconduct;

- (f) The municipality must implement a:
- (i) tariff policy;
 - (ii) rates policy;
 - (iii) credit control policy; and
 - (iv) supply chain management policy.

2.6.4.2 Revenue management

The accounting officer of a municipality is responsible for the management of the revenue of the municipality (Section 64(1) of the MFMA). According to section 64(2) of the MFMA the accounting officer must take reasonable steps to ensure that:

- the municipality has effective revenue collection procedures in place;
- revenue due to the municipality is calculated on a monthly basis;
- accounts for municipal taxes and charges are prepared on a monthly basis,
- all money received is deposited into the banking account of the municipality;
- the municipality has and maintains a management, accounting and information system which-
 - (i) recognises revenue;
 - (ii) accounts for debtors; and
 - (iii) accounts for receipts of revenue.
- the municipality has and maintains an internal control system;
- the municipality charges interest on arrears; and
- all revenue received is reconciled on a weekly basis.

2.6.4.3 Expenditure management

The accounting officer of a municipality is also responsible for the expenditure management of the municipality (Section 65 (1) of the MFMA). Section 65(2) of the

MFMA determines that the accounting officer must take all reasonable steps to ensure that-

- ❖ the municipality has and maintains an effective system of expenditure control;
- ❖ the municipality has and maintains an accounting and information system;
- ❖ the municipality maintains an internal control system of creditors and payments in place;
- ❖ payments are paid directly to the person due, either electronically or by way of non-transferable cheques
- ❖ all money due be paid within 30 days;
- ❖ the municipality complies with all statutory commitments;
- ❖ any disputes between organs of state concerning payments is disposed of in terms of regulating legislation;
- ❖ working capital is managed effectively and economically;
- ❖ the supply management policy is fair, equitable, transparent, competitive and cost-effective; and
- ❖ all financial accounts are reconciled and closed at the end of each month.

2.6.5 The role of the Auditor-General

Khalo, Mafunisa, Nsingo and Makondo (2007:45) states that the Auditor-General is an independent office which oversees finances on behalf of the legislatures. Section (4)(d) of the Auditor-General Act 12 of 1995 indicates that he/she must reasonably ensure that:

- ❖ Precautions have been taken to safeguard the proper collection of money;

- ❖ Precautions have been taken in connection with the receipt, custody and issue of, and accounting of property, equipment, stores and other assets;
- ❖ Receipts and payments are in accordance with applicable laws and instructions; and
- ❖ Satisfactory management measures have been taken to ensure that resources are applied economically, effectively and efficiently.

2.6.6 The King Codes

The first King Code was implemented in 1994 (Wixley and Everingham 2009:1). The second King Report was made public on 26 March 2002, the third in 2009 and the fourth in 2016. However, the application of the King Codes principles is not compulsory but voluntary. The King Codes are specific applicable to those companies who are registered on the JSE and other financial institutions such as banks, etc.

The King Codes is designed specifically for those companies registered on the JSE. However, the principles can be applied in any other company or municipality. Chapter 4 of King III (2009:27-32) contains inter alia 13 principles which refers to the strategies, policies and principles that should be applied in risk management. These principles are as follows:

- “Risk management is inseparable from the company’s strategic and business procedures;
- Management is responsible for the implementation of risk management processes;
- Risk management should be practiced by all staff in their day to day activities;
- The Board is responsible for the process of risk management;
- The Board should approve the company’s chosen risk philosophy;
- The Board should adopt a Risk Management Plan;
- The Board may delegate the responsibility of risk management to a risk committee;
- Risk assessments should be performed on an ongoing basis;
- The Board should approve key risk indicators and tolerance levels;
- Risk identification should be directed in the context of the company’s purpose;

- The company should ensure that key risks are quantified and are responded to appropriately;
- Internal audit should provide independent assurance on the risk management process; and
- The Board should report on the effectiveness of risk management.”

The fourth King Code (2016:47) refers to the committee for risk and opportunity governance:

“The governing body must consider a committee to support risk governance. The role of the committee is to:

- (i) Advise on the nature and extent of risks; and
- (ii) Oversee the implementation of a risk policy framework.

If the committee for risk and internal audit are separate the staff can be utilised in both committees for better functioning. If the roles are incorporated the meetings and agendas should be separate.

The risk committee should include at least 3 members of the governing body that have adequate skills, knowledge and experience in risk management.”

Principle 4.1 of King IV (2016:52-53) further states that the governing body should govern the risks in such a way that the organisation’s strategic objectives are met.

2.7 CONCLUSION

Companies and municipalities face both financial and non-financial risks. Financial risks are more solvable than non-financial risks specifically where humans are involved. The same risks that faces SOE’s also faces municipalities.

Lessons can be learned from the global Financial Crisis of 2010. The key findings and main messages of effective implementation of risk management includes:

- ❖ Perhaps one of the greatest shocks from the financial crisis has been the widespread failure of risk management. In many cases risk was not managed on an enterprise basis and not adjusted to corporate strategy. Risk managers were often separated from management and not regarded as an essential part

of implementing the company's strategy. Most important of all, boards were in a number of cases ignorant of the risk facing the company.

- ❖ It should be fully understood by regulators and other standard setters that effective risk management is not about eliminating risk taking, which is a fundamental driving force in business and entrepreneurship. The aim is to ensure that risks are understood, managed and, when appropriate, communicated.
- ❖ Effective implementation of risk management requires an enterprise-wide approach rather than treating each business unit individually.
- ❖ The board should also review and provide guidance about the alignment of corporate strategy with risk-appetite and the internal risk management structure.
- ❖ To assist the board in its work, it should also be considered good practice that risk management and control functions be independent of profit centres and the "chief risk officer" or equivalent should report directly to the board of directors.
- ❖ The process of risk management and the results of risk assessments should be appropriately disclosed. Without revealing any trade secrets, the board should make sure that the firm communicates to the market material risk factors in a transparent and understandable fashion.
- ❖ With few exceptions, risk management is typically not covered, or is insufficiently covered, by existing corporate governance standards or codes. Corporate governance standard setters should be encouraged to include or improve references to risk management in order to raise awareness and improve implementation of good risk management.

In Poland and in Sweden SOE's have risk committees. These committees' objectives are for "The Early Identification of Risks". In India direct control is an important risk management tool. In Israel the SOE is required to appoint a designated management member for the risk management functions. Switzerland also considers its SOEs as part of the government's overall risk management system.

Chief risk officers are usually required only for financial institutions.

The MFMA provide guidance on financial management, revenue management and expenditure management in municipalities, while the King Codes refers to strategies, policies and principles that should be applied in risk management in SOEs. These principles include:

- Risk management is inseparable from the municipality strategic and business procedures;
- Management is responsible for the implementation of risk management processes;
- The Board or Council is responsible for the process of risk management;
- The Council should approve the chosen risk philosophy;
- The Council should adopt a Risk Management Plan;
- The Council may delegate the function of risk management to a risk committee; and
- The Council should approve key indicators and tolerance levels.

Internal audit should provide independent assurance on the risk management process while the Council of the municipality should oversee the implementation of a risk policy framework.

In the next chapter the focus is on fundamentals and spectrum of risk management.

CHAPTER 3

FUNDAMENTALS AND SPECTRUM OF RISK MANAGEMENT

3.1 INTRODUCTION

This chapter will introduce the research problem of managing and mitigating maladministration and provide a broad description of the Buffalo City Metropolitan. The writer will attempt to refer to other sources as above to clarify some risk factors that may exist in other public institutions. The legislature appropriates large sums of public money to public institutions. This involves a certain amount of risk. Risks are the responsibility of those best able to control them, with reward commensurate with accepting risk responsibility. The latter principle is sometimes difficult to implement in the public sector, given the often risk non-responsive remuneration systems.

To discharge this responsibility, we need to understand risks and their related rewards and take appropriate measures to manage the probability and impact of those risks (Pauw *et al.* 2009).

3.2 THE NATURE OF RISK MANAGEMENT

Risk management is a scientific approach to the problem of dealing with the pure risks faced by the individuals and business. It is a function of management in the same style as marketing management, financial management, or personnel management. Risk management is somewhat narrower than the term implies, because organizations face a wide range of risks, some of which are beyond the control of the risk management function as it is used there. For example, a business may face a host of speculative risks: investment risk, risk from changes in interest rates, risk from improperly pricing its products, risks that its customers will be able to pay their debts and so on (Baxter 2009).

3.3 INTRODUCING RISK MANAGEMENT TOOLS AND TECHNIQUES

The top ten tools and techniques which are relevant to risk management professionals and to business/ project managers generally is:

1. Enterprise risk management. Starting with the big picture, how would you build a risk management framework to identify and manage the total risk to your business enterprise? Both quantitative and qualitative approaches are considered. All the remaining tools and techniques effectively fit into this framework.
2. Strategic risk management – It's no use managing the risk if your strategy is at risk so this should be the first point of focus.
3. Assumption analysis – Don't try to capture risks, analyse assumptions and approach risk management from a positive rather than a negative perspective.
4. Prioritisation–This is everything in any significant risk management process. If you fail to prioritise appropriately, you can't see the wood for the trees. Start by prioritising your projects and business processes and then prioritising your risks.
5. Risk Governance – Explains how the risk process is applied to ensure effective and efficient follow-through on risk management. Includes the use of risk reporting, effective risk planning and risk escalation.
6. Risk roles and responsibilities- defines the various risk related responsibilities that need to be implemented for effective risk management at the various levels in the organisation.
7. Risk trends- Measure the effectiveness of the risk process by analysing trends that will enable you to pinpoint and fix problems at a strategic rather than tactical level.
8. Risk metrics and behaviour- Set up metrics that drive appropriate behaviours in the stakeholder group and improve risk management performance overall.
9. Risk and groupthink- How to identify and manage the particular risks associated with decision making in groups.
10. Positive approaches to risk management – How to turn a 'negative' subject into a positive experience by focussing on opportunities, learning how to 'sell' risk management and doing risk management jointly and doing risk management with clients and suppliers" (Baxter 2010).

3.4 ENTERPRISE RISK MANAGEMENT

In business, as in life, your starting point is always to establish your objectives or strategy. Set risk management strategy against an enterprise risk management (ERM) framework. ERM is a process by which the total risk to the business is identified, prioritised and managed appropriately. In recent times, ERM has become a Holy Grail for organisations, i.e. if you can properly manage the total risk to the business then you should be able to sleep at night. In reality full ERM is often a valiant aim rather than an achievable reality for most businesses, and setting risk strategy is more about scoping what is and now and what is possible now and what is desirable in the future.

“It is important to define the enterprise in terms of your world. For example, perhaps the enterprise is the business area that you are responsible for or even just the one you own. However, it is always best to ‘shoot’ for the stars if you want to hit the moon or consider how full ERM can be established in business before defining and prioritising the various components” (Baxter 2010).

3.5 THE BENEFITS OF APPLYING ENTERPRISE RISK MANAGEMENT

The key benefits that should be realised from applying effective ERM are improving both short-term and long-term business profitability and performance by:

- avoiding costly mistakes- by capturing and managing risks to key projects and operational processes
- validating strategy-by checking that all key stakeholders are ‘on the same page with strategic priorities.
- Improving operational effectiveness – through the adoption of a systematic structured approach.
- building relationships by increasing the confidence of stakeholders/ clients.
- preserving reputation- by avoiding corporate disasters and associated publicity.
- anticipating market trends –by ensuring that key market assumption remain valid (Baxter 2010).

In all cases the benefits in ERM will massively outweigh the investment.

What are the challenges?

Full ERM is a very difficult state to attain. Why is this?

- Quantification is difficult or even impossible .Some risks (e.g. financial, contractual) are easy are easy to quantify whilst others are virtually impossible (e.g. quality, reputation, performance). Therefore when organisations attempt to quantify the total risk to the business they tend to mix ‘good quality ‘data with ‘poor quality’ data and thus dilute the real value of the final result.
- Objectives are not consistent across the enterprise. This leads to perceptions of risk that vary massively in different areas of the organisation. One area of the business may consider a particular risk to be ‘minor’ whilst another area considers the same risk to be a ‘showstopper’: for example operations may think that a change programme delay is a minor problem whereas delay the board may consider that any delay is a disaster.
- Risk processes are not consistent across teams. This leads to differing focus, analysis prioritisation and management approaches. Again this makes it impossible to build a consistent picture of risks across the enterprise.
- Risk tools are not supported by effective process. Very often, the use of software tools in the first attempt by an organisation to provide some consistency of risk management. However, if the tools can be one are not backed up by an effective risk process, the effect can be of GIGO (garbage in garbage out) as poor quality data is captured, analysed and then presented as a ‘high quality ’result.

The most common mistake, particularly to be found in financial institutions, is to integrate the various financial risk management measures (e.g. credit risk or market risk) (Baxter 2010).

3.6 GOOD GOVERNANCE IN GENERAL AND HOW CAN ENTERPRISE RISK BE MADE MORE EFFECTIVE

The chapter will review the relevant literature on Risk Management theory with good governance in general and its application with specific reference to Buffalo City Metropolitan Municipality and how enterprise risk management can be made more effective. Risk management approaches move along a spectrum from recognition of the concept to full implementation of a comprehensive risk management programme. At the lower ender of the spectrum, risk is seen as the negative factor that must be controlled. At the higher ender of the spectrum, risk is seen as an opportunity and

managed for realisation throughout the institution. In the private sector, risk management is a fundamental part of the corporate governance structure. It is also an integrated part of performance and measurement compensation schemes. Quantitative techniques should support the risk- reward decisions and measure performance on a risk-adjusted basis (Pauw *et al.* 2009).

The Financial Crisis portrays a picture of poor Corporate Governance in The United Kingdom, the United States of America and France in the banking sector. The extreme Financial Crisis that has seen household banking names run into trouble some to fail and others to be taken into various degrees of national ownership. Corporate Governance is stretched to the extent that it is distressed and has been unable to cope with the demands placed on it. The rationale for saying that it is stretched as follows:

- Corporate Governance is (almost) voluntarily;
- Investor pressures are fierce, leading many businesses to undertake risks that simply are not in the best long term interest of the organisation;
- Non-executive oversight is stretched in that directors only have a limited amount of time to devote to the organisation, but almost unlimited responsibilities;
- External audit is stretched to a point where the degree of reliance that is placed upon it is out of proportion to the amount of work that actually goes into it;
- Internal audit is struggling, largely because many internal auditors are not the beneficiaries of the regard that they are owed;
- Obtaining assurance from regulators, financial analysts and rating agencies cannot be comprehensive,
- Which leaves boards with dependence on management including the risk management team, and General Counsel (or the Company Secretary)

It is the opinion of the author that Corporate Governance alone is not the cause of the current Financial Crisis in SOEs like for example the SABC or SAA. However, Corporate Governance could have prevented some of the worst aspects of the crisis had effective governance operated throughout the period of time during which the problems were developing and before they crystallised. Furthermore, effective risk management could have helped to reduce the catastrophic impacts that the global and national economies are now suffering.

The main finding so far is that the balance between risk-taking (the life blood of the free market) and risk avoidance is no longer functioning. Similarly, the balance between remuneration (one of the principal drivers of the performance culture) and ethical behaviours no longer operates appropriately. The oversight over these two principal balancing acts, which should be exercised by the board, and in particular by the non-executive or independent directors does not function properly because the assurance functions are not given sufficient weight. Therefore as a matter of policy, in order to meet the local needs of society, there is a need for a significant rebalancing of boards and assurance functions in municipalities that are very important. Oversight by non-executive directors is sometimes too remote and distant and it is difficult, in global, complex organisations for this to be discharged effectively by part-time non-executive directors. Accordingly policy makers should consider whether more emphasis should be given to oversight by both the creation of full-time non-executive directors and the development of a broader concept of assurance.

While the focus has been on the financial services sector, and particularly on municipalities, many of the recommendations would equally be valid to other organisations which have a major societal impact, including for example public entities. Those that play a major part in the critical national and international infrastructure of the national and global economies. The re-balancing of responsibilities would help to ensure that such organisations remain focused on the needs of society as a whole rather than simply on the investor and executive management interests.

Effective risk management is an important prerequisite for the municipality to be successful. Most of the guidance is extremely high level, is process-oriented and gives scant guidance on how to create an effective risk management and assurance framework. A balanced approach to risk management that addresses the pitfalls is needed. A performance culture that encompasses the totality of the risk universe, is also important. Boards are encouraged to assess and manage the risk management culture, to achieve risk management maturity and to acknowledge the overall importance of ethics to the management of risk. Boards are also encouraged to take a more pro-active stance in overseeing the risk management framework as part of the development of the assurance framework.

In order to compensate for the extreme pressures on service delivery by the BCMM, it is advocated that a significant increase in the board's oversight of assurance across the municipality is needed. This would address the risk management group, the internal audit department and other internal assurance providers. Boards are encouraged to consider the appointment of a senior Chief Assurance Officer, or Director of Risk Management and Assurance to pull the whole picture together. Boards are also encouraged to consider the appointment of full time directors whose main responsibility is to ensure that sufficient attention is paid to the risk management and assurance framework, especially where there are significant societal responsibilities. Finally the paper advocates that boards should initiate independent governance audits.

Taken together, the recommendations in this paper would reinforce the overall risk management system of the BCMM, providing reassurance to external stakeholders that risks are taken care of. Reassuring also to the society as customers and as taxpayers.

The focus of this research is on the prevention of fraud and corruption, the elimination of unauthorised expenditure, fruitless and wasteful expenditure and irregular expenditure (Public Sector Risk Management Framework, 2010). For a better understanding of the challenge of the BBCM the following paragraph present more background on the subject. It need to be emphasised that public entities such as Eskom, the SABC and SAA are also confronted by poor risk management.

3.7 BACKGROUND

The Financial Crisis in South Africa needs no introduction. The banking industry of the world also collapsed across the globe and the ramifications for the rest of the global economy are well documented in many other places. The question that the cumulative collapse of shareholder value around the world begs is whether the failure is one of risk management or not. This is not simply a semantic question: following the examples of Enron, WorldCom and others in the United States, the Sarbanes-Oxley Act introduced some major changes to US Corporate Governance. On the other hand, in response to more isolated examples elsewhere, such as the collapse of Marconi in 2001 in the UK, leading commentators argued that this should not be seen as a failure of Corporate Governance since the failure was principally due to a misguided strategy,

rather than a collective board failure. Following this logic, one might well argue that the Financial Crisis was not so much a failure of Corporate Governance but rather a “Perfect Storm” within the global banking industry, which boards could neither be expected to foresee or to react to swiftly enough to make a substantial difference.

Good corporate governance should contribute to better municipality performance by helping a board discharge its duties in the best interests of communities; if it is ignored, the consequence may well be vulnerability of poor performance. Good governance should facilitate efficient, effective and entrepreneurial management that can deliver quality services over the longer term (FRC, Combined Code, and June 2008).

This view is underpinned by the preamble to the OECD’s Principles of Corporate Governance, which sets out clearly the importance of effective Corporate Governance in the following statement:

“The presence of an effective corporate governance system, within an individual company and across an economy as a whole, helps to provide a degree of confidence that necessary for the proper functioning of a market economy. As a result, the cost of capital is lower and firms are encouraged to use resources more efficiently, thereby underpinning growth.” (OECD Principles of Corporate Governance, 2004).

At the same time as Corporate Governance promotes a positive system which is beneficial for the economy as a whole, there is also a strand which looks at the need for boards to have a role in ensuring that there are effective “detective” controls (in other words, controls that help to identify shortcomings and failures) and overall monitoring of corporate activities.

The second, countervailing arguments would run as follows:

Boards have a responsibility to identify and understand the conditions within which their organisations are operating, to ensure that there is alignment between long and short term strategy, to ensure that remuneration policies are appropriate so as to identify potential issues as soon as possible. Irrespective of the Perfect Storm, boards should have been trimming their sails to match the developing conditions and should have been cognisant of their responsibilities to a broader concept of society.

3.8 CORPORATE GOVERNANCE CODES GUIDANCE

There is an enormous array of source material when considering the strength or otherwise of any given code of Corporate Governance. Local laws, customs and cultures dictate approaches to Corporate Governance and colour the manner in which it is received by boards of directors, investors and other stakeholders.

3.8.1 All codes

Each of the three codes reviewed includes sections on the following topics:

- **Independent or non-executive directors:** all three codes envisage either a majority of non-executive directors or a balance of non-executive and executive directors. This is no longer a controversial issue. Each code either has material in it, or there is supporting material prepared by others that provides clarity on the meaning of independent.
- **Executive sessions:** all three of the codes envisage a need for non-executive directors to meet alone without the presence of executive directors, normally with access to such managers in the organisation as they require.
- **Nominations Committee:** all three codes require nomination committees for the appointment of new directors. The main purpose is to ensure that there is a transparent appointment process which is not under the control of management alone, and to ensure that the right balance of skills and experience is brought to the board table. In practice the search for new directors is often outsourced to head-hunters with the consequence that the appearance of transparency is somewhat reduced by the typical reluctance of head-hunters to consider shortlisting anyone who has previously undertaken a given role. Consequently this can significantly reduce one of the objectives of the Higgs review in the UK which was specifically to encourage drawing potential board candidates from a broader population than hitherto.
- **Compensation Committee:** there is a requirement in each code for a compensation or remuneration committee. These are principally designed to deal with the remuneration of directors, and especially executive directors. In the case of the United States this includes the CEO and Executive Officers. Given the experience of the Financial Crisis, there is a good argument to be

made that the scope of the remuneration of senior managers throughout the organisation, especially where there is a high contingent of conditional remuneration (bonuses) which has the potential significantly to influence the nature of risk-taking organisation.

- **Audit Committee:** each code requires an audit committee of the board. There are similar requirements for the skills and expertise, although they have varying forces of law behind them.
- **Internal Audit:** all corporations are required to have internal audit under the NYSE code, are required to consider the need for internal audit on an annual basis under the Combined Code and Audit Committees are required to oversee internal audit under the French code.
- **Evaluation of board and committees:** all codes envisage the need for boards to conduct some form of evaluation of the boards and their committees. The Combined Code also requires an evaluation of individual board member performance.

3.8.2 NYSE Code provisions

The NYSE Code has three unique components, being:

- **Code of Business Conduct and Ethics:** each company must develop and publish an appropriate Code of Business Conduct and Ethics. This is not absence may be explained by a presumption of high levels of business conduct and ethics. Revelations in the British and French press suggested that this presumption might be inappropriate. Accordingly, this type of provision should be incorporated in the codes where it is lacking.
- **Certification:** both the Combined Code and the French Code require companies to either comply or explain why they are not complying with their respective codes. The NYSE Code requires directors to certify that they are complying. Certification has an implication of a stronger requirement to comply with the provisions of Corporate Governance. Policy makers should consider the benefits (to society at large) of good corporate governance and therefore why corporate governance is not relevant to them.

3.8.3 European Codes

European Codes of Corporate Governance have recently been subjected to European requirements. Several facets that are found in both the Combined Code and the French Code, but which are not in the NYSE code are:

- **Comply or explain:** as discussed above, the European codes require the boards to disclose the extent of their non-compliance with their respective codes and to explain why they have not complied. Evidence suggests that some of the disclosures under the Combined Code are mechanistic and remain unchanged from year to year. The purpose behind the concept of “Comply or Explain” is clear enough. However, the evidence of the Financial Crisis is that this is now an inadequate compliance regime, especially for companies which have a great societal impact, and policy makers should consider whether compliance should now be required unless compliance is not in the best interest of society, rather than the preferences of the directors themselves.
- **Separation of role of Chairman and CEO:** Both the French and Combined Codes require the separation of the Chairman and the CEO. This paper is recommending a re-balancing of the management and assurance roles of boards, and therefore it should be a requirement enshrined in all codes for the separation of the roles of Chairman and CEO, especially in companies where there is significant societal interest.
- **Availability of information:** both of the European Codes discuss the importance of information for the directors. Getting the balance right between inundating directors and starving them of information is of critical importance. Accordingly it should be the Chairman’s role to ensure that this balance is struck correctly, and to facilitate, and to facilitate any additional information that directors should request in the pursuance of their duties.
- **Periodic elections:** in Europe all directors are to be subject to periodic election. This is not covered in the NYSE code.
- **Reporting to the market:** Both European Codes have provisions concerning the need to report to the market.

3.8.4 Combined Codes

There are two particular provisions in the Combined Code which do not appear in the other two codes considered:

- **Role of institutional investors:** the Combined Code has a section on the role of institutional investors. Evidence suggests that the role of institutional investors in the proper discharge of corporate governance is immensely important. It may be that this would be more appropriately addressed in a code for institutional investors, rather than in the Combined Code which is more appropriately addressed to the board of directors. Policy makers should consider whether or not they should develop codes of practice or mandatory requirements for the involvement of institutional investors in the effective structuring and discharge of corporate governance in their investments.

3.8.5 French Codes

The French Code enshrines a provision requiring that directors represent all shareholders rather than specific segments interest groups. While it can be argued that this is the essence of “independent” directors, being explicit about the requirement is beneficial in the context of the current Financial Crisis.

3.8.6 The King Codes of South Africa

In South Africa King Code I, II, III and IV was implemented to improve corporate governance.

3.9 RISK MANAGEMENT GUIDANCE

Risk management appears in each of the three codes to varying extents: in the NYSE code the requirement is for the Audit Committee to “Discuss policies with respect to risk assessment and risk management”. This is explained further in the commentary as follows:

While it is the job of the CEO and senior management to assess and manage the listed company’s exposure to risk, the audit committee must discuss guidelines and policies to govern the process by which this is handled. The audit committee should discuss the listed company’s major financial risk exposures and the steps management has

taken to monitor and control such exposures. The audit committee is not required to be the sole body responsible for risk assessment and management, but as stated above, the committee must discuss guidelines and policies to govern the process by which risk assessment and management is undertaken. Many companies, particularly financial companies, manage and assess their risk through mechanisms other than the audit committee. The processes these companies have in place should be reviewed in a general manner by the audit committee, but they need not be replaced by the audit committee (NYSE Listed Company Manual, Corporate Governance Standards, s303.A.07 (D)).

The interesting aspects of this are that the expectation is that it is the job of the CEO and senior management to assess and manage the listed company's exposure to risk. The Audit Committee's requirements are in respect of "financial risk exposures". There is no explicit requirement for the board to consider the risk management processes and framework as a whole.

The French Code deals with risk management in section 2.2 on off balance sheet items and corporate risks as follows:

Each listed company must be equipped with reliable procedures for the identification and assessment of its commitments and risks, and provide shareholders and investors with relevant information in this area.

For such purposes:

- The annual report should specify the internal procedures set up to identify and monitor off-balance-sheet-commitments, and to evaluate the corporation's material risks;
- Each company must develop and clarify the information provided to shareholders and investors regarding off-balance-sheet-commitments and material risks, and disclose the company's ratings by financial rating agencies as well as any changes occurred during the financial year (Corporate Governance Code for Listed Companies, produced by AFEP and MEDEF, s 2.2).

There is no further explicit guidance on risk management in the French Code.

The Combined Code deals with risk management in Part C on Accountability and Audit and read as follows:

The board should maintain a sound system of internal control to safeguard shareholders' investment and the company's assets.

3.9.1 Code provision

The board should, at least annually, conduct a review of the effectiveness of the group's system of internal controls and should report to shareholders that they have done so. The review should cover all material controls, including financial, operational and compliance controls and risk management systems and risk management systems in relation to the financial reporting process (The Combined Code on Corporate Governance, published by the Financial Reporting Council, s C).

3.9.2 Sources of guidance

COSO is derived from the Committee of Sponsoring Organisations of the Treadway Commission, has produced two major works on risk management:

- Internal Control- Integrated Framework (1992); and
- Enterprise Risk Management- Integrated Framework (2004).

The first was a key part of the development of risk management, although it approached this from an internal control perspective. This was a major conceptual development which has underpinned a lot of current thinking on risk management. It described internal control as part of a process, rather than bolted on activities, and which had five main components:

- **A control environment:** without a good control environment there could be no effective internal control;
- **Risk identification:** this was the first time that control was seen as being truly a response to risk, which is an empowering concept because it also allowed people to identify wasteful control procedures;
- **Control activities:** these were the responses to risks, and they could either be preventive or detective controls; and

- **Information and communication:** these were the glue that bound the whole internal control process together.

Each part of this model was designed to support three key corporate objectives:

- The continuity of the business;
- Timely and accurate financial reporting; and
- Compliance with local laws and regulations.

Finally, the third dimension of this model was the control activities, in pursuit of these objectives was expected to be carried out throughout the organisation, whether at the head office, or manufacturing or distribution units throughout the organisation. The three dimensions of the COSO model are often shown graphically represented by a cube.

The second COSO report, Enterprise Risk Management, developed the front face of the cube by adding three additional components:

- Objective setting;
- Event identification; and
- Risk response

It is questionable whether these additions add greatly to the model, since they were all inherently in the front face anyway.

3.9.3 Turnbull guidance

Neither COSO nor Turnbull provides effective guidance on how to implement their high level models into the reality of a complicated business. COSO retains a high level of following in the US, and Turnbull is widely recognised in the UK. Neither provides a helpful approach to the mechanics of creating an effective and lasting risk management and assurance framework over the long term.

3.9.4 Other guidance

Some common risk management problems are set out below.

- **Risk are frequently not linked to strategy:** Are risks linked to strategy? Is the strategy clearly articulated? Does the strategy set out how it will impact on the

key value drivers? Aligning risks to the strategy is key to ensuring that risk management has a focus on the business context.

- **Risk definitions are often poorly expressed:** Are risk definitions capable of being interpreted by anyone (with appropriate local knowledge) who picks up the risk register? Better risk definitions (context, event, consequence) are contrary to a lot of current thinking in risk management which has been to abbreviate risk descriptions to the smallest number of words possible- that really does not work.
- **Can the organisation develop intelligent responses to risks:** Lots of risk registers dump everything into responding to risks? In fact there are five key dimensions to consider. **Strategy:** by which we mean do you want to prevent a risk from happening or allow it to happen and deal with consequences, by, for example devising an appropriate contingency or disaster recovery plan. **People:** by which we mean do you want the risk to be managed by specific individuals, or is it something that needs to be managed throughout the organisation. **Detail:** by which we mean do you want to manage general risks or specific risks. **Tasks:** by which we mean the activities of gathering information, devising plans, procedures or approaches to managing the risk and then the actions, including implementing the plans, and looking for assurance that the proposed actions has been taken. **Drivers:** by which we are referring to the need for someone or something to make sure that the whole process takes place. These drivers include managers in the organisation, outside regulators or the culture of the organisation.
- **Do boards take into account stakeholders and guardians in detailing responses to risk:** Does the risk management approach recognise the importance of people who are not directly involved in the management of a given risk, but who might be impacted if there is a change in the way it is addressed? For the size and complexity of their business
 - Principle 7- Risk management process: requires that banks have in place a comprehensive risk management process.
 - Principle 8,12,14,15 and 16 all address specific categories of risk.

- Principle 17- Internal control and audit: requires that banks should have in place internal controls that are adequate for the size and complexity of their business.

3.10 PUBLIC ACCOUNTING AND EXTERNAL AUDIT STRETCHED TO BREAKING POINT

This is exacerbated by the comparative rarity of issuing a qualified audit report, which in itself has the potential to be the final demonstration of frailty that could bring a Metro down. It might make sense for the municipality, in conjunction with the regulators, to explore whether a much more gradated approach to audit reports could be developed which would be less binary in its application, but which could signal more subtle differences between municipalities without catastrophically undermining the one in question.

3.11 INTERNAL AUDIT STRUGGLING

In many organisations internal audit has moved from being an extension of financial control, focussing on financial accounts and the operation of routine internal financial controls to becoming a function which perceives it has a role in assurance and internal consultancy, in relation to all risks, but especially those that have an impact at a strategic level, and which has a reporting line directly to the chair of the Audit Committee. In practice however, the identification of risks is weak in many organisations and the role of internal audit in running risk identification processes is hotly debated. Internal auditors frequently lament that they are not asked more questions by audit Committees and feel that they are not used to their full potential.

The ambition of internal auditors is both to provide assurance and to be a catalyst for improvement. In practice, given the relative numbers of internal auditors to staff, it is unreasonable to expect them to operate and apply controls (which is what some people still think of them doing). Therefore the only practical way for internal audit to add value is to look at the whole-how does the system of internal control operate to manage the risks to the objectives of the organisations? It is also worth noting that internal audit does not usually view itself as an extra as an extra level of risk management- there are not enough internal auditors to identify risks, but they do have

a role to champion the management of risk, to challenge and get to the truth and to catalyse the change.

Whether one can learn from global surveys across all industries is not clear. However, the risk remains that internal audit in many institutions may be no more highly regarded by the board than is the norm across the business world.

Where does assurance come from?

This therefore begs the question as to where assurance can possibly be drawn from. If:

- Audit Committee members are overstretched;
- The relevance of external audit is being over emphasised ; and
- Internal audit is not what it should be.

Then where can board members draw comfort in respect of their responsibilities for assurance. They can of course:

- Seek the views of the regulators. For example, what is the opinion of the Auditor-General? One can also ask the question what is the opinion of the clients or the public.
- Seek the views of financial analysts. Except of course, in many cases the financial analysts are part of the pressure imposed by the investor community.
- Seek the views of the rating agencies. However, the views of the rating agencies may well be coloured by the commercial pressures that they have faced in assessing credit ratings for the increasing number of investment vehicles.

Internally, the board members of the municipal council can seek assurance from other members of the management team, including the Risk Management division. Although in a sense the current organisation of risk management has been about the nuts and bolts of risk and spreadsheets, rather than a coherent assessment of the full range of risks that the municipality faces. Therefore if the risk management group is not looking at a particular type of risk, there will not be any focus on it for the purposes of the council seeking assurance.

The board can also seek additional assistance from the municipal council or municipal's secretary, or from other managers in the municipality. But this all takes much more time than the already heavy workload of the average director would allow. (Anderson rc.anderson@tiscali.co.uk).

3.12 LINKAGE OF EFFECTIVE RISK MANAGEMENT TO GOOD GOVERNANCE

3.12.1 Risk management

Risk management is a systematic and ongoing process to identify and assess potential events (risks) that may affect an institutions' objectives and also promotes the implementation of corrective measures to minimize the impact of the risk.

Risk management can be linked to "disaster management". The latter occurs when a natural hazard has an impact on a human population, infrastructure and/or economic assets. Examples include tornados, floods, earthquakes, droughts, etc. although it must be emphasised that "hazards" forms not part of this study and falls under the South African Disaster Management Act, 2002 (Act 57 of 2002).

3.12.2 General benefits of effective risk management

Benefits of effective risk management include the following:

- Effective risk management enables the institution to achieve its objectives with greater certainty.
- A robust and affective risk management process aims at increasing awareness, transparent evaluations and sound mitigation of risks facing the institution.
- An integrated risk management framework assist in achieving objectives more efficiently.
- Risk management as a management tool also promotes effective an efficient resource utilisation.

It is the responsibility of the risk management unit to investigate both internal and external fraud, corruption and maladministration in an institution (Republic of South Africa. 2013. Risk Management: Department of Labour).

3.12.3 Fundamental basis of good governance

3.12.3.1 Basic values and principles

According to the Constitution (RSA 1996:83) the basic values and principles of good governance include the following democratic values and principles:

- (a) Professional ethical standards must be promoted and maintained.
- (b) Efficient, economic and effective use of resources must be promoted.
- (c) Governance must be development orientated.
- (d) Services must be provided, fairly, equitable and without bias.
- (e) People's needs must be addressed.
- (f) Governance should be accountable.
- (g) Transparency must be encouraged by providing the public within timely, accessible and accurate information.
- (h) Good human – resource management must be cultivated.
- (i) Governance must be representative of all South African people.

3.12.3.2 Application

The above values and principles apply to –

- (a) Administration in every sphere of government;
- (b) Organs of state; and
- (c) Public enterprises.

3.12.4 Develop a sound risk management system

Wixley and Everingham (2009:85) asserts that uncertainty surround us and it is essential for successful governance to develop a sound risk management system.

The key steps in a sound risk management system include the following:

- Identify risks early and continuously.
- Understood risks, their courses and consequences.
- Determine how to avoid or reduce risks.
- Implement sound internal control systems to “mitigate” the risks.
- Monitor performance of controls and ensure timely reporting.

3.13 CONCLUSION

Risk management is a scientific approach to the problem of dealing with the pure risks faced by the municipalities. It is a function of management in the same style as marketing management, financial management, or personnel management. Risk management is somewhat narrower than the term implies, because municipalities and organizations face a wide range of risks, some of which are beyond the control of the risk management function as it is used.

Risk management can be linked directly to good governance. Effective risk management is a systematic and ongoing process that supports top management to achieve the objectives of the institution more successfully. Risk management can also promote the implementation of corrective measures to minimize the impact of such losses. With a good risk management unit in place some losses can also be foreseen and avoided.

To conclude this chapter the top ten tools and techniques which are relevant to risk management professionals and to municipal officials were emphasised. These include:

- ✓ Risk management. Starting with the big picture, how would you build a risk management framework to identify and manage the total risk to your institution? Both quantitative and qualitative approaches are considered. All the remaining tools and techniques effectively fit into this framework.
- ✓ Strategic risk management.
- ✓ Assumption analysis;
- ✓ Prioritisation;
- ✓ Risk Governance;
- ✓ Risk roles and responsibilities;
- ✓ Risk trends;
- ✓ Risk metrics and behaviour;
- ✓ Risk and groupthink; and
- ✓ Positive approaches to risk management.

To conclude this chapter the benefits of applying risk management is stipulated below:

- ❖ Avoiding costly mistakes;

- ❖ Checking that all key stakeholders are “on the same page” with strategic priorities;
- ❖ Improving operational effectiveness;
- ❖ Building relationships by increasing the confidence of the clients;
- ❖ Building a positive reputation by avoiding disasters; and
- ❖ Anticipating to client expectations.

In the next chapter strategic risk management in municipalities and other fundamentals of managing risks were presented.

CHAPTER 4

STRATEGIC RISK MANAGEMENT IN MUNICIPALITIES

4.1 INTRODUCTION

In this chapter ethics and professionalism as well as risk assessment will receive attention. The barriers to team development and how to overcome these barriers will also be highlighted.

There are theories applicable to the risk management environment and assisting to the code of good governance. "Corruption is rooted in our apartheid past, but also it is a problem of the present. Many of those who are new in government are corrupt as those before them. Corruption affects all areas of society." (Stewart 2004:83). In taking this notion further governance is not just the responsibility of the state. Rather it is a function that can be performed by a wide variety of public and private state and non-state, national and international institutions and practices. The governing powers, international, national and regional need to be "secured" together into a relatively well integrated system (Hurst and Thomson 1966:183-4) and (2008:272).

This chapter will introduce strategic risk management in managing and mitigating maladministration and provide also the location of the Buffalo City Metropolitan. The writer will attempt to refer to other sources as above to clarify some strategic risk management factors that may exist in other public institutions. The legislature appropriates large sums of public money to public institutions. This involves a certain amount of risk. Risks are the responsibility of those best be able to control them, with reward commensurate with accepting risk responsibility. The latter principle is sometimes difficult to implement in the public sector, given the often risk non-responsive remuneration systems.

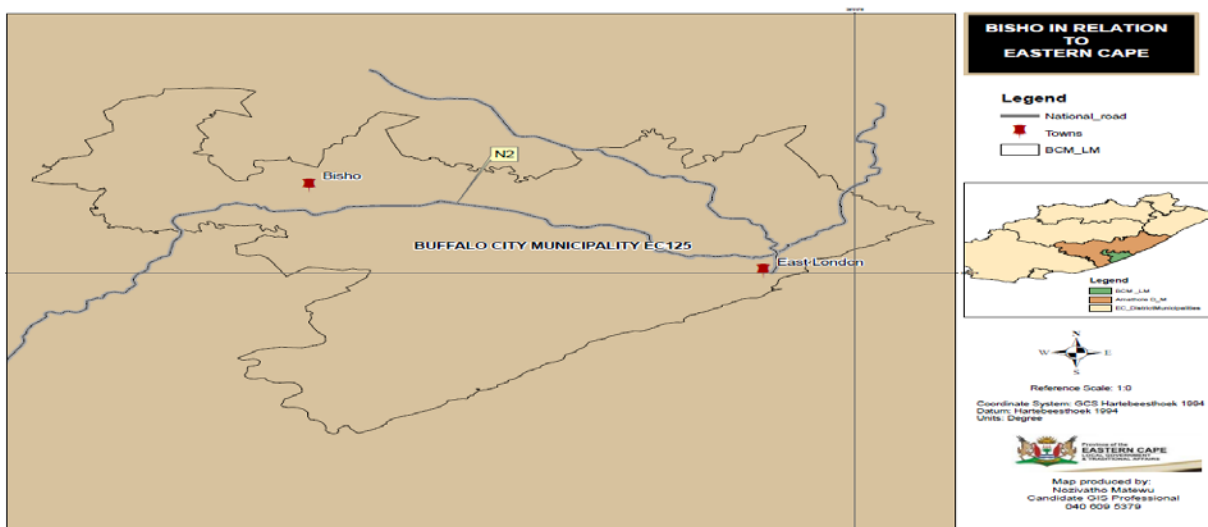
To discharge this responsibility, we need to understand risks and their related rewards and to take appropriate measures to manage the probability and impact of those risks (Pauw *et al.* 2009).

4.2 LOCATION OF THE BCMM

The Buffalo City Metropolitan Municipality is situated in the Province of the Eastern Cape with its seat in East London. The Provincial Legislature and several Provincial Government Departments are headquartered in the Metro. East London is 300 kilometres away from Port Elizabeth and 65 kilometres from Bisho. The main areas of the Metro includes East London, Mdantsane, Zwelitsha and the surrounding rural areas. There is a river that runs through the Metro named Buffalo River after which the Metro was named.

The Province of the Eastern Cape is one of nine provinces created in 1994, when the new Provincial Government system came into being with a new constitutional dispensation, embodied in the *Constitution of the Republic of South Africa, 1996*, as amended.

The following map will indicate the location of the Buffalo City Metropolitan Municipality in relation to the Province of the Eastern Cape. The smaller map indicates the described area in relation to the remainder of the Province of the Eastern Cape and the bigger map indicates the described areas in this research.



4.3 A NEW DUTY OF CARE

It is not the purpose of this paper to generate a lawyers' charter or to create a new bureaucracy. However, having identified that Corporate Governance has struggled, and indeed failed, to cope with the Financial Crisis, it is incumbent on us to explore how we might address the shortcomings. One of the major issues is the need to persuade boards and individual directors that they need to take their Corporate Governance role seriously, and to provide the investment in time which it requires. In many cases this is anathema to boards where directors often see themselves as providing strategic oversight and contributing personal expertise gained in other roles.

Corporate Governance is not a question of ticking the boxes of relevant codes, but rather it is as much about the board's role in providing risk oversight as it is about supporting management in implementing its strategy. Most non-executive directors dislike the increasing role of Corporate Policeman that seems to be foisted upon them. However, it is clear that some part of the board's responsibility is to act as a counter-weight to the often risk-laden growth aspirations of some management teams.

CEO's might be dominant, persuasive individuals who are used to getting their own way within their organisations. Some have been described as "imperial", others have been described as "bullying". The exact terminology is unimportant; the implications of their behaviours are the important focus. However, there is no question but that investor pressures on these individuals to perform and to grow their organisations are very great. Failure to grow in line with market aspirations and expectations can and will cut short the tenure of the incumbents. This focuses the mind and necessarily the demands that the CEO's in turn place on their entire organisations. Spurred on by an engrained culture of aggressive growth and encouraged by the promise of exorbitant bonuses, departmental managers prepare budgets and plans that their people are expected to achieve almost by whatever means possible. Unsatisfactory budgets and plans from business units are rejected and failure to meet targets is punished by reduced remuneration or even the loss of jobs. This tends to lead to an excessively short-term approach, rather than long term, sustainable value creation.

One can make the argument persuasively that this is the life-blood of market capitalism. However, what this approach fails to do is to protect the interests of those who have no financial impact on the short term result, but who can disproportionately

prejudiced by the decisions of the short-term oriented CEO or corporation. In the case of banks, society at large has deemed that deposit-taking institutions have been afforded a level of protection vastly in excess of national deposit protection schemes. In effect some Banks have been deemed “too big to fail” and either have been shepherded into mergers, have been acquired by the state, or have the totality of their deposits guaranteed. The banking institutions that have been allowed to fail have not on the whole had direct dealings with the public, although the knocking-on effect have been catastrophic to trust in the banking system.

This level of protection makes the banks (and some insurance corporations different to most other organisations (with perhaps the exception of the car industry in the US and the UK).

The relevant banking supervisors or regulators should conduct a periodic assessment of the manner in which directors and officers discharge this duty, both as individuals and as a board. While details would need to be worked out, the duty would address:

- The normal areas of Corporate Governance as already set out in the relevant codes (see chapter 3 for a comparison of existing codes). However, it might be worth exploring whether there is scope for greater harmonization of the codes.
- An enhanced role addressing risk oversight and assurance (see the next two paragraphs of this paper for more detail).

What are not discussed in this paper are the exact mechanisms or responsibilities that would be owed under this duty. This would need to be addressed at an international level. In addition there would to be some form of “Safe Harbour” provision for those who have undertaken their individual responsibilities with due and diligent care, but who nevertheless find their organization to be failing.

4.4 PROFESSIONALIZATION OF THE BOARD

In support of this initiative, it might be appropriate to consider the “professionalization” of boards and the “C-suite”. The UK Treasury Select Committee suggested in response to the collapse of Northern Rock that board directors should have a “banking” qualification. It seems highly unlikely that a first or second degree, or a

professional qualification taken immediately after graduation, would have a great deal of impact on a role taken on some thirty or more years later. However, there is an argument to suggest that an individual's "license to operate" should be subject to review in the event of inappropriate behaviours.

This would imply a licensing regime, perhaps akin to that effectively operated by professional bodies such as the ICAEW or the ABA, which would be earned either by experience or by examination, and subsequently maintained by Continuing Professional Development. One might argue that in the current environment that this would be entirely irrelevant since none of the key board members of failed institutions is likely to be employed again in a similar role. However, there is some evidence to suggest that members of professional bodies such as those referred to, have a sense of professional duty that is owed to society at large, and outside of their current employers, based upon the retention of their license to operate. Examples such as the Institute of Directors' professional qualification may prove to be a fertile ground for further development.

4.4.1 Ethics and professionalism in risk management

- ✓ Ethics refers to those principles of behaviour that differentiate between "good", "bad", "right" and "wrong".
- ✓ The purpose of a code of ethics is to enable team members to make choices between alternative behaviour.
- ✓ The importance of ethics increases in direct proportion to the consequences of the outcome of an action (Donnelly *et al.* 1987:663 in Van der Waldt, Van Niekerk, Burger and Nell, 2002:215-216).
- ✓ Example, during the 1990's a project team solved a problem of escaping from holding cells by installing brick walls. Brick walls were also cost-effective.
- ✓ The group leader can make decisions that are good for them but bad for the community.
- ✓ In the example human rights considerations policy came under attack by human rights groups in the area.

- ✓ This example indicates that group leaders must be ethically responsible when they make decisions.
- ✓ Ethical considerations are an integral part of the decision-making process.
- ✓ The best possible decision should be seen as being the best economically, technically, behaviourally and ethically (Pinto *et al.* 1998:140 in Knipe *et al.* 2002:216).
- ✓ It is important to note that ethical standards differ from individual to individual.
- ✓ Society sets certain criteria for socially acceptable behaviour. For example, gifts for good work might be seen by the community as bribery, even if the official claim that it did not have an impact on the objectivity in decision-making.
- ✓ Some institutions might view business lunches as impacting on the ability to criticise objectively. It might differ between institutions (Knipe *et al.* 2002:215-216).

4.4.2 The relevance of ethics to risk management

This paper has addressed extensively the risk culture of an organisation. Without a guiding sense of purpose, it is likely that the pressures from investors and the opportunities for breathtaking rewards will lead to increasingly morally questionable behaviours. While laws may or may not be broken, ethics come into play when considering behaviours that are not governed by laws, but where “guidrails” are needed to assist in interactions between members of staff, with suppliers, customers and the public at large.

Ethics programs are much more common in the US, probably encouraged by the US Federal Sentencing Guidelines which set out a framework for organizations which will be taken into account should a corporation be subject to criminal prosecution. By following the guidance of the Sentencing Guidelines, it is possible for companies to reduce the potential penalties in criminal prosecutions by as much as 95%.

What is interesting about the Federal Sentencing Guidelines is that, unlike many US rules, where we are used to black letter prescription, the Guidelines are just that: guidelines. They do not set out rules, they rather set out the sorts of things that you should do. The benefits are two-fold: (i) more lenient sentencing, should a matter get

to that stage; but (ii) more importantly, preferential treatment afforded by Department of Justice (the “DoJ”) in deciding whether or not to prosecute on a given set of facts.

In essence the Guidelines set out to encourage ethical corporate behaviour and reward those companies that take active steps to develop an ethical compliance program and punish those that disregard the ethics of their business activities. So two companies that commit the same violation of the same law, the first has implemented an effective ethical program and the second has not. The first may benefit from the leniency often applied by the DoJ in practice using the “effective” compliance program Sentencing Guidelines approach, the second runs the real risk of having the full weight of the law thrown at them.

In a society that prides itself on its “ethical” approach to life (the inventors of cricket and the Marquis of Queensbury Rules for boxing) it is a strange contrast, in the UK, that ethical policies tend to be set by the legislative process and potentially by purchasing practices in the public sector. For example, most large companies now have an equality or diversity policy, they are increasingly developing anti-bullying programs and so on. These are largely driven by societal changes dictated at national level, rather than by a preference to act in a morally or ethically appropriate manner.

However, this area is important. Surveys in the US have shown that a significant proportion of staff, when questioned, have seen acts or behaviours that are inappropriate within the organization, and which, were they disclosed to the public could result in material damage to the reputation of the organization. However, on further questioning, approximately 50% of those staff would not do anything about it, either because the organization simply would not take the accusation seriously, or because it could actively harm their career. Equally, a significant proportion of staff would not bother to tell management about improvements that could be made to activities, products or processes on the basis that they would be stepping on someone’s toes in a much more senior role and therefore they would suffer severe detrimental consequences in their careers.

It is not difficult intellectually to extrapolate from the ethics of the question to the risk management ramifications. Ethics needs to be more than simple legal compliance with local laws and regulations (as presupposed in the first COSO framework on internal

control). It also needs to be about the moral compass that guides each member of staff in the context of the organization's business.

It is worth noting that anthropologists argue that there is a maximum size of unit for effective communications. While the exact size is debated, the upper limit is somewhere in the region of 150 people. Given the size and complexity of the global banks, it is important that boards of directors take responsibility for ensuring that there are appropriate communication lines for the purposes of engendering a deeply held sense of ethical behavior in the organization.

4.5 A risk framework

This study focuses on risk management as a tool to address the challenges of maladministration in the BCMM.

One of the most startling aspects of the global Financial Crisis was that virtually nobody saw it in the making, and those that did were ignored. Investors were pushing for growth right up until the last minute. Bankers were, in Chuck Prince's words, dancing. Regulators and Central Banks did not put the brakes on banking activities, and politicians were, on the whole, continuing to work closely with the grain of the financial services markets.

Unethical and possibly illegal loans were being marketed in the United States, 125% mortgages were being made available in the UK, and credit was being fueled by "cheap" liquidity. New financial instruments which were meant to spread the risk were being created and then rated by the rating agencies. Institutional investors were demanding ever greater leverage, more efficient use of capital and better returns. Work by the FSA in the background to nudge organisations like HBOS and Northern Rock to better operating and risk models appears to have had little effect.

This despite the fact that all of the banks had senior risk managers and supposedly comprehensive risk programs. Many were moving towards or had achieved AMA status for Operational Risk under Basel II. Many of the larger banks had very sophisticated credit and market risk programs and conducted extreme stress testing as periodically required by their banking regulators. The banks considered themselves to be risk experts: where car companies had a core competence in designing, manufacturing and marketing cars, banks had a core competence in identifying,

leveraging, transforming and spreading risk: hence their perceived status as masters of their risk universe.

Despite their risk programs boards did not foresee the Financial Crisis. In part this might have been because of a failure by individual directors to understand the nature of the risks that their banks were assuming. This point was reinforced by the evidence of former Chairmen and Chief Executives to the Treasury Select Committee which is looking into the lessons to be learned from the Financial Crisis.

It has become apparent that there is a disconnection between different aspects of risk. On the one hand, what John McFall (Chairman of the Treasury Select Committee) refers to as “clever young men”, were creating new instruments for disseminating risk, others were exploring credit and market risk and yet others were looking at operational risk. And yet, in discussion with a senior risk manager at one of the large banks, it became apparent that their “enterprise risk management” approach was still at a very early stage. This implies that there was not yet a joined up approach to risk management across the bank.

Based on above mentioned the interviews for this exercise, it is clear that:

- Bank risk processes are very focused on operational (as opposed to strategic) risks;
- There is comparatively little emphasis on developing a risk aware culture; and
- The remuneration culture has skewed risk taking towards potentially dangerous risk profiles.

As a senior member of the FSA said, it is not difficult to envisage a bank that has twin objectives of AA+ credit rating and 25% per annum growth finding those objectives soon come into conflict. It is not clear that many banking organizations would have explicitly considered the conflicting nature of their major objectives and accordingly they would not have been able to express their risk appetite, let alone tie the operational risks that emerge from their risk models into their strategic impact.

It is worth noting that prior to its demise, Rick Buy, the risk manager at Enron Corporation was seeking, in his own words:

“...to condense all the risks of Enron Corporation into a single metric. This would

comprise operational, market and credit risk and incorporate risk-adjusted return on capital (RAROC), value-at-risk (VaR) and extreme value theory into what Buy calls a single 'pseudo capital-at-risk figure' that can be shown to the Enron board of directors." (E-Risk, February 2001).

It is not proposed that any banking institution should seek to reduce its risk reporting to a single figure: that clearly is not feasible or desirable. However, there needs to be a recognition that risk taking needs to be balanced with avoiding value destroying events (pitfalls) and equally takes into account the conflicting pressures from the performance culture (and more particularly in the banking sector, short term cash bonuses that are not aligned to the long term strategic objectives or the risk profile of the bank) and the corporate ethics and behaviours which their societal impact demands from the banking sector.

This recommendation will require a significant change of culture in order to embed a "risk intelligent" approach to business within these organizations. Some areas where further consideration should be given to encouraging banking institutions to developing aspects of their risk management are set out in the paragraphs below.

4.6 Risk intelligent organizations

Many organizations see the corporate governance aspects of risk management as a paper pushing exercise that adds little value. It is clear that risk management needs to move beyond the mundane processes and needs to become part of the culture of organizations. In other words risk management needs to be about bringing a perspective to the management of complicated issues in complex organizations. It should be about the management (and not the avoidance) of risk. It should help to prioritize work in a fast moving context with an approach that is better than simple intuition and which facilitates communication between people. Risk management needs to become a style of thought, and should definitely not be a mere paper chase. Developing a risk intelligent organization requires boards to understand the maturity of their risk management activities right across the organization.

The Institute of Internal Auditors in the UK and Ireland (the "IIA UK") encourages organizations to look at their risk management maturity. IIA UK focuses predominantly

on risk processes. In addition, boards should consider four aspects that need to be assessed on a regular basis:

- **Manager and staff attitudes to risk, control and governance:** based on the experience of working with a multitude of different clients in different sectors, attitudes to risk, control and governance are perceived differently in different parts of any organization. It is clear that the board of BCMM should have an overall understanding of these attitudes so that it can assess what further steps are required to develop the overall culture of effective risk management.
- **Whether the organization is prone to disasters:** there is plenty of material in the risk management literature to identify signs of the disaster-prone companies. Banks might well have been able to hold a mirror up to themselves and identify many of the symptoms of such companies (for example excessive complexity, blame cultures, over-confidence, following the herd and so on). The board of BCMM need to undertake this exercise round all parts of the business to identify whether any remedial action needs to be taken.
- **Attitudes to corporate ethics and behaviours:** many organizations pay little more than lip-service to corporate ethics. Surveys have shown that a high proportion of staff have seen potentially illegal or inappropriate behaviours in other organisations that they in turn are not prepared to report to top management. Facilitating appropriate corporate ethics with a focus on open and frank disclosure is important for the board of BCMM to follow an effective approach to risk management.
- **Identify how staff will react in times of pressure:** many risk management systems assume a normal pace of life for the business. These systems then crash when excessive pressure is applied because managers and staff move into a different paradigm of management, which results in the need for what might be described as Fast Clock speed Risk Management. Part of this assessment is also about understanding the heuristics that managers and staff of the BCMM must use to manage risk. Most informal risk management

is done by means of the “unwritten rules of the game” – identifying and understanding the ramifications of those unwritten rules are both vital.

4.7 Scope of risk management

At the moment, risk and risk management mean different things to different people. In the course of one day of its deliberations the Treasury Select Committee identified risk in:

- Acquisitions (RBS’s acquisition of ABN Amro);
- Financial instruments;
- The sales culture (the FSA’s comments on HBOS sales culture, as reflected also by the former Head of Group Regulatory Risk at HBOS); and
- Dependency on wholesale funding.

In addition the well documented problems of unauthorized trading at Société Générale represent a further manifestation of risk, as do the sub-prime lending problems in the US and the total destruction of trust following the collapse of Lehman Brothers which led to the drying up of inter-bank lending.

This diversity of risk leads to considerable difficulties in bringing all of the risk elements together, and all organizations, not just banks, tends to obsess about some elements of risk management and to omit others from its group thinking about risk. One possible way of thinking about the scope of risk management and ensuring that all aspects are considered is to present it in a quadrant. Turnbull concentrated on the top right hand quadrant, without understanding the component parts, and Sarbanes-Oxley on the bottom left hand quadrant, without looking at the bigger picture. Nightmare risks are often those that move rapidly from the bottom of the scale to the top and become big ticket issues – for example funding operations from the wholesale market at HBOS probably started as an operating risk, but developed into a major strategic issue which ultimately brought the bank to its knees. Many organizations fail to see these changing risks coming at them because they are culturally attuned to an on-going level of activity that provides false comfort. A good risk management framework will address all of these areas.

4.7.1 Risk management

Institutional survival in today's world is achieved by pursuing opportunities within a spectrum of uncertainty, and programmes/projects are typically launched to take advantage of these opportunities.

Therefore, the whole point of risk management is to achieve something new, to venture and to take chances – thus, risk has always been part of team work.

In today's markets with heavy competition, advanced technology and tough economic conditions, risk has assumed significantly greater proportions.

Identifying hazards and risk exposures is probably the most important step in the risk management process (Head & Horn, 1991:83 in Knipe *et al.* 2002:333).

The goals of risk management are to identify organisational risks and to develop strategies to reduce them or avoid them altogether (downside risk).

Steps should also be taken to maximise success and opportunities (Knipe *et al.* 2002:333).

4.7.2 Risk assessment

Since it is virtually impossible to eradicate risk totally in a program or a project, it is paramount that the influence of these risks on the outcome be reduced (Baguley, 1995:22 in Knipe *et al.* 2002: 338).

Risk assessment involves identifying and evaluating risks and risk interactions to assess the range of possible outcomes.

It is primarily concerned with determining which risk events warrant a response.

It is complicated by a number of factors including, but not limited to:

- Strengths and weaknesses that can identify clear sources of risk.
- Opportunities and threats that can interact in unanticipated ways, for example schedule delays may force consideration of a new strategy that reduces overall delivery duration.
- A single risk event that can cause multiple effects, such as late delivery of a key component that produces cost overruns, schedule delays, penalty payments and a lower-quality product.
- Opportunities for one stakeholder (reduced cost) that may be threats to another (reduced profits).

- The mathematical techniques used can create a false impression of precision and reliability (Knipe *et al.* 2002:338).

4.8 The single voice of risk management

As indicated above, it is not uncommon for risk management to mean different things in different parts of an organization. Typically there is a different meaning of risk management for each of governance, risk departments and internal audit. This can lead to considerable confusion, to people failing to understand differing responsibilities, believing that they are being discharged elsewhere and to important risk issues falling between organizational gaps and between risk silos.

4.9 Granularity of risk management

Financial and management reporting have been focused for centuries on currency based reporting. From the 14th Century innovation of double entry bookkeeping by an Italian monk, money has been the cornerstone of reporting and decision making. In the latter half of the 20th Century and up to the current time, more difficult and subjective areas of accounting (such as valuation of investments in a trading book, deferred taxation, revenue recognition) where there is scope for manipulation of the results or balance sheet values have been subjected to normative accounting rules.

The benefit of accounting in monetary terms is clear: the unit of currency is recognized, and most transactions are reflected in monetary terms. Organizations capture accounting data at a very low level of granularity. At one of the author's former clients, the group financial controller used to allocate his lunch across five different cost centres so that all bore their fair share of the costs associated with his travel and subsistence expenses. This is clearly excessive, however, it illustrates the point that as a consequence of the level of granularity and based upon the rules, it is possible for any company to state unequivocally its revenues, or its profit after taxation, or the amortized value of its fixed assets. The relative sizes are clear, that they are made up of lots of sub-accounts is well understood and the systems for recording transactions are commonplace.

This is not the case with risk management. When John McFall or Sir Tom McKillop talk about the risk associated with the acquisition of ABN Amro by RBS, they are in fact talking about a multitude of different risks, which might include exposure to toxic assets, variable quality credit risk processes, unknown operational risk procedures,

the culture of risk taking and so on. The exact taxonomy of risks involved in such an acquisition would differ for each transaction and depending on who was undertaking the acquisition: for example, had a risk due diligence exercise been carried out by Barclays when they first mooted a takeover of ABN Amro, it would no doubt have looked very different to a similar task undertaken for RBS and its acquisition partners. To a large extent the differences would be valid: they would relate to different new holding companies, and to different corporate objectives. However, some of the differences would simply be because two different sets of individuals were carrying out the analysis.

At the moment there is no single recognized way for organizations to link high level aggregate risks to low level transactional risks. As a consequence, those who are analyzing risks, for example of individual CDO instruments, might not have been able to attach them effectively to the high level of aggregation which is necessarily involved in board discussions. While some risk experts talk about a “golden thread” linking from the top to the bottom, others seek a more rigid alignment between objectives, risks and controls (sometimes referred to as ORCA – objective, risk and control alignment). In any event it is unequivocally the case that there is no single direct line from top to bottom: there are one-to-many, many-to-one and many-to-many relationships between risks and between risks and controls.

While IT systems have been developed to address many of these issues, there are more important definitional issues to be ironed out before they can be used effectively. It would also require a very significant investment of time and effort to capture the risks and relevant responses throughout a major bank. However, without this level of data, it is hard to envisage how more comprehensive risk programs might operate to the maximum potential benefit of the organizations and society as a whole. The level of granularity that would be required would also be a subjective matter in that while there might be an appropriate response to a high level risk, there may well be sub-risks that require a different response.

4.10 Risk appetite

There has been a lot of discussion in the literature sources, and also in the press about risk appetite. The more this issue is probed, the harder it is to get to grips with it.

However, what is clear is that for different types of risk at different levels of the organization, there are different risk appetites. There is a different risk appetite for risks that a company wishes to engage with, compared to the risk appetite for risks that represent pitfalls. While it might be possible to determine a risk appetite for certain types of risk that are subject to quantitative measurement, or for clear cut issues (for example the death of employees through accidents at work would be intolerable for all banks) it is clear that there are other types of risk for which it is almost impossible to set an appetite.

It might be possible to begin to disaggregate risk appetite by looking at two of the principal components of risk appetite which are:

- The propensity to take risk; and
- The propensity of the organization to exercise control.

In turn these two elements will be informed as much by the culture and processes of risk management and internal control as they will by explicit policies and statements of risk appetite. They will also be determined to a large extent by the organization's performance culture (often significantly driven by its remuneration policies) and its corporate ethics and behaviours.

It is also worth noting that the risk appetite for one risk might be at variance with the risk appetite for another risk. Until there is greater clarity of the taxonomy and aggregation of risks referred to above, it is unlikely that we will be able to arrive at a sensible body of guidance on the issue of risk appetite.

4.11 The importance of avoiding pitfalls

As already discussed, the prime motivating factors in determining the BCMM's approach to risk appear to be the nature of the industry, pressures from investors and the way in which the "irrational exuberance" of the markets can encourage all institutions to seek ever more levels of risky instruments (without always recognizing the level of risk being assumed), or engage in more audacious acquisitions. The susceptibility of many municipalities' risks to quantitative techniques also allows for the illusion of measuring residual downside risk. In practice it appears that banks probably have not spent sufficient time exploring the nature and management of

downside risks, which can have a significant potential to destroy shareholder value (referred to elsewhere in this paper as pitfalls).

It is naturally difficult to persuade bankers in the midst of a long run bull market to stop, pause and think about the downsides of their actions. However, those organizations that do not assess the pitfalls that can pull the organization up short are likely to suffer dire consequences. In a culture where growth, risk taking and aggressive tactics are applauded, being the individual who stops the organization in its tracks can be very unpopular, as demonstrated by the HBOS whistle-blower, and his former colleague, both of whom have made much of a culture that did not like to hear bad news.

The resources indicated that, while banks pay lip-service to downside risk management and avoiding pitfalls, there is a sentiment that the capital cushion will protect them. With the past Financial Crisis, we have seen that this is not necessarily the case. Whereas regulators may well encourage organizations to undertake scenario stress testing, this should be extended to cover a wide range of strategic and other risks which might not be traditionally examined under normal stress testing.

4.12 The extended enterprise

Risk management is complicated even when looked at simply within the boundaries of an organization. The efficiency of risk management in a traditional economic unit, an enterprise, is dependent on the skills of management in fostering and managing the risk management program. However, where traditional boundaries become semi-permeable through alliances, joint ventures and outsourcing, the relationship between objective, risk and response is broken where a third party takes on responsibility for a part of the risk management chain.

It is often assumed that outsourcing exports risks. Outsourcing can, however, frequently produce risk importing through risk dependency. Where the linkages are broken and Company A is responsible for the objective, but Company B manages the likelihood and timing of achieving those objectives (because it manages the risks or the risk responses), then this gives rise to the dependency risk conundrum: who is managing what? For whom? And why? And how?

Exactly the same issues arise whether we are talking about alliances, joint ventures or outsourcing: the complicating factor is the number of parties to the relationship. The more there are, the harder it becomes to exercise control. Traditional responses, many

of which remain valid, even in today's world of virtual and real joint ventures and alliances include:

- Good definition of the scope of the JV, respective responsibilities, and appropriate management;
- Good legal documentation; and
- Appropriate insurance cover.

But these all have shortcomings: the management route is orders of magnitude more difficult to pursue. Needless to say, legal documentation should only be relied upon as a last resort: where the objectives of a JV and its operation have broken down. Insurance is a “sticking plaster” approach to management in that it deals with the symptoms of problems, but not the root causes. Consequently there are new approaches that need to be called on in order to ensure that the extended enterprise can work:

- Build trust – both internally and externally;
- Share risk management data – between participants to the relationship; and
- Create a partnership of risk intelligent organizations.

Essentially, the answer is to create a risk intelligent partnership, which implies the creative collaboration of two or more risk intelligent organizations, supported by the flow of risk data in a format that can be digested and utilized by all parties.

Historically joint ventures have often been used in the belief that risks are being mitigated. However, the world is littered with failed joint ventures. This is in part because managers are often blind to dependency risk and because they settle for a reactive approach to risk management. The solution is to work with a new resolve towards the creation of “risk intelligent partnerships”. The hallmarks of a risk intelligent partnership are:

- Trust, both between partners and also between the joint venture and the customer;
- Achievement of objectives; and
- Better satisfied customers.

Given the complexities of modern global financial services, there is an increasing use of alliances; accordingly, this area of the extended enterprise is important. Equally, as we have seen through the current Financial Crisis, irrespective of the more formal alliance relationships, banks are entirely dependent upon one another for liquidity. It is therefore in the interests of the Banking Regulators and Supervisors to ensure that shared risks are properly managed across organizational boundaries.

4.13 An assurance framework

Section IV describes a distressed model of Corporate Governance. To recap:

- Corporate Governance is (almost) voluntary;
- Investor pressures are fierce, leading many businesses to undertake risks that simply are not in the best interests of the organization;
- Non-executive oversight is stretched in that directors only have a limited amount of time to devote to the organization, but almost unlimited responsibilities;
- External audit is stretched to a point where the degree of reliance that is placed upon it is out of proportion to the amount of work that actually goes into it;
- Internal audit is struggling, largely because many internal auditors are not the beneficiaries of the regard that they are owed;
- Obtaining assurance from regulators, financial analysts and rating agencies cannot be comprehensive; and
- Which leaves boards with dependence on management including the risk management team, and General Counsel (or the Company Secretary).

Section V outlines proposals for a new duty for boards to discharge their Corporate Governance responsibilities with due and diligent care. This would help to enforce a change of culture that is engrained in the Banking industry, (and in others) an industry which contributes significantly to the proper functioning of our economic system.

Section VI describes a balanced approach to risk management that addresses the pitfalls and the ethics as much as the risk taking and the performance culture; that encompasses the totality of the risk universe, both within the organizational boundaries and across semi-permeable boundaries.

All of this requires an oversight, or assurance approach that can act as a counter-balance to the naturally entrepreneurial inclinations of the CEO and management. This is not to act as a bureaucracy or serve to chill the essential entrepreneurial spirit of management. Rather it is in recognition of the major societal impact that these major financial institutions have when they face problems such as those that have emerged in the current Financial Crisis. These banking institutions owe a responsibility to society that is greater than that of most other organizations. They are so important to our societies and to the global economy at large that they cannot be allowed to fail: they are “too big to fail”.

With this in mind, it is worth cautioning that there is no “one-size-fits-all” approach to improving the assurance received by, and dispensed by boards. Accordingly, this section sets out a range of possible improvements that could be made to board assurance processes.

4.14 Risk management and risk assurance framework

Section VI sets out a vision for a comprehensive risk management framework which would address the totality of the risk universe (down to an appropriate level of granularity) both inside and outside the organization. This envisages that management should operate within that risk management framework, and that a properly funded and staffed group should act as guardians of the risk management framework. While the internal audit group should continue to carry out its function to review the operation of the risk management framework, including the effectiveness of reporting to the highest levels, and the continuing operation of appropriate risk responses. The internal auditors should work with the risk management group to ensure that there is a single view of risk management.

4.15 Documented assurance map

At the moment, there is a sense in which assurance simply happens. It is not a planned activity in the way in which parts of it are executed: for example most internal audit departments normally prepare an annual plan which is presented to and discussed with the Audit Committee. However, there is rarely an overall, documented plan for the totality of assurance that is required at board level and which the board needs to provide to other stakeholders.

In order to assess the requirements for resources and funding for assurance purposes, the board should annually prepare or update an assurance map which should as a minimum:

- Document the people to whom assurance is required to be provided (e.g. regulators, investors, customers and so on), the nature of the assurance, how that assurance is to be provided and how the board is going to satisfy itself that the assurance that is being provided is truthful, correct and appropriate in all the circumstances.
- Document the manner in which the board will seek and obtain assurance that what they are told is happening in respect of the business is indeed happening in order to discharge the assurance aspects of their Corporate Governance duties to exercise risk management oversight.
- Document the way in which the board is assessing, monitoring and managing the risk management culture, and progress towards becoming a risk intelligent.

4.16 Risk management group

The risk management group should have unfettered access directly to the board, reporting either to the Chairman (if the roles of Chairman and CEO are split) or to the Chair of the Audit or Risk Committee (if the CEO and Chairman roles are not split). The budget for the group should be set by the board member responsible for the direct report, not by the CEO or the CFO. The sponsoring board member should be responsible for senior recruitment decisions and for terminating employment. Any decision to terminate the employment should be accompanied by a letter from the role holder to the board stating whether or not there are any circumstances that the individual wishes to bring to the attention of the board.

The head of the risk management group should not be remunerated by reference to the financial success or otherwise of the organization, but rather should be remunerated by reference to objectives agreed between the role holder and the sponsoring board member.

The risk management group should be tasked with determining risk management policy, in conjunction with the board, assessing and reviewing the risk management culture and the risk maturity of the organization. They should provide the mechanisms

for identifying, assessing, managing and recording risks and the necessary IT infrastructure.

There is no reason why the risk management group should not be a good career development route for people in other parts of the business. However, it might also be some individuals' preference to remain entirely within a risk management group.

The head of the risk management group should report to the board on a regular basis, and have the absolute freedom to seek access to any member of management and any non-executive member of the board. Going to the Chairman should not be seen as the "nuclear" option.

4.17 Barriers to team development

These barriers include for example:

- Different outlooks, priorities and interests
- Role conflicts
- Unclear outcomes or objectives
- Dynamic work environments
- Competition over team leadership
- Lack of team definition and structure
- Team personnel selection
- Creditability of leader or supervisor
- Lack of team member commitment
- Communication problems
- Lack of top management support (Knipe *et al.* 2002: 201-204).

4.17.1 How to overcome these barriers

- ❖ The supervisor must attempt to find out conflicting differences as early as possible. He/she must explain the scope of risk management and rewards of the prevention of risks. Team members' responsibility should also be explained.
- ❖ As early as possible the leader should obtain input from team members to see where they fit in. Subsystems and sub-tasks should be determined (through a

WBS or RAM). Roles should be allocated. The leader must control role conflicts throughout the financial year.

- ❖ The leader should assure all team members and other stakeholders of the overall objective and outcomes of risk management. Clear communication is vital.
- ❖ The leader is faced with the challenge of stabilising the external influences on the delivery of services. The staff should “sell” the services to all stakeholders involved. To cope contingency plans should be developed.
- ❖ Top management should assist to establish the role of each staff member. The supervisor must fulfil the leadership role. He/she must accept his responsibility and in doing so can reduce competition over leadership.
- ❖ Staff need to sell the team concept to top management and to the division itself. Regular meetings can be held to address the different roles and responsibilities. The team concept can also be strengthened through visible communication, for example in memoranda and other written media.
- ❖ The team should try to negotiate the task assignment with other team members. If the team members are still not interested than consider replacing them.
- ❖ The group leader must be credible in the eyes of the team. Credibility increases where the group leader is seen as a good decision maker. Other good relationships can also enhance the credibility of the group leader.
- ❖ The group leader should attempt to determine any lack of team member commitment early in the financial year. Insecurity is often the reason for lack of commitment. Conflicts amongst team members can be a reason for lack of commitment. Other interests can also be a reason for lack of commitment. In all these scenarios the group leader needs to be creative.
- ❖ A great part of the group leader’s time is spent on communication with team members. Tools for improving communication includes status meetings, reviews, schedules and reporting systems. Communication with the community and top management should be regular and thorough. “What is not written down has not been said” is true for the entire financial year.
- ❖ The support of top management is an absolute necessity for dealing effectively with interface groups and resource commitment. The group leader must inform top management of the resources needed. The group leader must keep top

management committed to the outcomes and objectives (Knipe *et al.* 2002:201-204).

These guidelines can also be followed when the municipality undertakes a project.

4.18 INTERNAL AUDIT

This dissertation does not propose any significant change to the role of internal audit. What follows would probably be familiar to most heads of internal audit. However, it is set out here for the sake of completeness.

Internal audit's primary responsibility should be to ensure that the risk management approach is being followed throughout the group, and that appropriate internal controls are in place and are operating effectively. They should work on a risk-based audit plan that seeks to deliver assurance to the board as to the efficacy and efficiency of the risk management approaches adopted, including of the framework as a whole.

In common with the risk management group, the internal audit group should have unfettered access directly to the board, reporting either to the Chairman (if the roles of Chairman and CEO are split) or to the Chair of the Audit Committee (if the CEO and Chairman roles are not split). The budget for the group should be set by the board member responsible for the direct report, not by the CEO or the CFO. The sponsoring board member should be responsible for senior recruitment decisions and for terminating employment. Any decision to terminate the employment should be accompanied by a letter from the role holder to the board stating whether or not there are any circumstances that the individual wishes to bring to the attention of the board.

The head of internal audit should not be remunerated by reference to the financial success or otherwise of the organization, but rather should be remunerated by reference to objectives agreed between the role holder and the sponsoring board member.

There is no reason why the internal audit group should not be a good career development route for people in other parts of the business. However, it might also be some individuals' preference to remain entirely within an internal audit group.

The head of internal audit should report to the board on a regular basis, and have the absolute freedom to seek access to any member of management and any non-executive member of the board. Going to the Chairman should not be seen as the

“nuclear” option. The head of internal audit and the sponsoring board member should share a responsibility to build a real and effective relationship between the head of audit and the board to create trust and understanding.

4.18.1 Functions of management

The role and functions of modern public managers differ from more traditional concepts of public administration. Van der Waldt (2016) asserts that public managers need to be competent, knowledgeable, creative and skilled to manage a highly turbulent and rapidly changing public sector. They have to do more with less financial resources. A trained and experienced management corps is needed to convert objectives into activities.

Basic management functions include:

- Planning;
- Organizing;
- Leading;
- Control;
- Coordination; and the
- Function of policy-making.

Knowledge of these functions are essential to deliver the much needed services to the community.

4.19 OTHER KEY ASSURANCE ROLE HOLDERS

The board should ensure that they have unfettered access to any other key assurance providers as needed: for example compliance officers, ethics officers and other similar assurance providers. The board should ensure that they have the full details of reporting lines, that they monitor budgets for these role holders and are kept informed of any changes in the role holders.

4.19.1 External assurance

To the extent that the assurance map determines that the board will have to place reliance on outside suppliers (for example the external auditors, or outsourced internal

audit providers), they should ensure that the providers are independent, are appointed by them and have a direct reporting line without interference from executive management.

4.19.2 Chief Assurance Officer or Director of Risk Management and Assurance

Many of the resources is of the opinion that it would be appropriate to have a very senior individual overseeing the risk management and assurance framework. Where there is a mix of executive and non-executive members of the board (the UK and French model) then it would be appropriate for that individual to be on the board.

Where there is a predominantly non-executive board (the US model) then it might be sufficient for the CAO to be a member of the “C-Suite”, although there would be an expectation that the individual would regularly be in attendance at board meetings.

Any individual filling the role of CAO or Director of Risk Management and Assurance would have to be independent of mind, sometimes referred to as “objectivity of thinking”. Their independence would be supported by the appointments process and the reporting lines. They would be appointed by the board as a whole (perhaps through the nominations committee, or under the auspices of the Audit Committee) and any termination of their employment would be a matter for the entire board, with the same requirement to circulate a letter confirming whether or not there were any matters they wished to bring to the attention of the board on termination of their employment.

In common with the head of risk management and the head of internal audit, remuneration should be based not on the financial success or otherwise of the organization, but rather by reference to objectives agreed between the individual and the Audit Committee.

4.19.3 Full time non-executive directors

Especially where there is either no CAO (or equivalent), or the role holder is not on the board, the board should consider the appointment of one or more full time non-executive directors to oversee the risk management and assurance framework. The work of audit committee members is already onerous and hard to discharge as a part time role, and this would only be more so in the context of the work that would be involved in establishing a fully functioning risk management and assurance framework as envisaged by this paper.

Some might argue that full time non-executive directors become de facto members of the management team. Their purpose would be to ensure that all aspects of the risk management and assurance framework operate effectively. They would have to develop a proper and effective working relationship with the CEO and other executive officers, but they would report to the Chairman of the Board (where the roles of Chairman and CEO are split) or to the Chairman of the Audit Committee. Their remuneration should be based not on the financial success or otherwise of the organization, but rather by reference to objectives agreed between the individual directors and the Remuneration Committee.

4.19.4 Governance audits

Boards should seek independent reviews of their governance arrangements, in particular they should:

- Obtain independent reviews of the board's and board committees' performance, rather than conducting the reviews themselves;
- Commission a periodic (at least once every other year) review of their risk management and assurance framework and of their assurance map. The review should focus on the scope and coverage of the framework, the review of the risk culture and the scope and nature of the work of the risk management group, internal audit and other assurance providers.
- Commission a periodic (at least once every other year) review of the other corporate governance arrangements, to ensure that they remain fit for purpose and consistent with best practice in the industry.

These reviews should be commissioned by and report to the independent non-executive directors.

4.20 CONCLUSION

This study focuses on risk management as a tool to address the challenges of maladministration in the BCMM. The risk management framework received attention with specific reference to professionalism and ethics in program/project management.

This chapter included the location of the Buffalo City Metropolitan. This chapter also introduced the barriers to team development to manage risks effectively and how to overcome them. The fundamentals of strategic municipal risk management were

highlighted as well as the internal control function and other key assurance role-holders.

A trained and experienced management corps is needed to achieve certain objectives, primarily providing services and/or products to improve the general welfare of the public. Basic management functions that they should know is the following:

Planning;

Organising;

Leading;

Control;

Coordination; and

Policy-making. In the next chapter the summary of the conclusions, findings and recommendations were presented.

CHAPTER 5

SUMMARY OF THE CONCLUSIONS, FINDINGS AND RECOMMENDATIONS

5.1 INTRODUCTION

In this chapter the conclusions, findings and recommendations are presented.

5.2 CONCLUSIONS

CHAPTER 1

The research problem was explained in chapter one. Poor governance and maladministration was identified as some of the problems of poor risk management. The aim and objectives of the study was to make recommendations how to reduce maladministration and to improve effectiveness of a risk management system.

The following issues in the risk management process were also emphasised:

- **Accountability for outcomes**

Pauw et al. (2009) states that: "Somebody who is not willing to take risks is not suitable to take risks for the position of chief executive.". When an activity comes up for prioritisation, the public manager must take note of the risks involved. Assuming that everything will run smoothly, they must also evaluate it in terms of its feasibility or probability of success, as measured by the 3E's: economy, efficiency and effectiveness.

- **Prioritising in terms of cost-effectiveness at the level of activities**

The first step in the bottom up –up leg of the prioritising process is the identification of the outcomes that the executive desires. The political executive and the institution must then agree on the output to be achieved and on the priority of each desired output (Pauw *et al.* 2009).

CHAPTER 2

Companies and municipalities face both financial and non-financial risks. Financial risks are more solvable than non-financial risks specifically where humans are involved. The same risks that faces SOE's also faces municipalities.

Lessons can be learned from the global Financial Crisis of 2008. The key findings and main messages of effective implementation of risk management includes:

- ❖ Perhaps one of the greatest shocks from the financial crisis has been the widespread failure of risk management. In many cases risk was not managed on an enterprise basis and not adjusted to corporate strategy. Risk managers were often separated from management and not regarded as an essential part of implementing the company's strategy. Most important of all, boards were in a number of cases ignorant of the risk facing the company.
- ❖ It should be fully understood by regulators and other standard setters that effective risk management is not about eliminating risk taking, which is a fundamental driving force in business and entrepreneurship. The aim is to ensure that risks are understood, managed and, when appropriate, communicated.
- ❖ Effective implementation of risk management requires an enterprise-wide approach rather than treating each business unit individually.
- ❖ The board should also review and provide guidance about the alignment of corporate strategy with risk-appetite and the internal risk management structure.
- ❖ To assist the board in its work, it should also be considered good practice that risk management and control functions be independent of profit centres and the "chief risk officer" or equivalent should report directly to the board of directors.
- ❖ The process of risk management and the results of risk assessments should be appropriately disclosed. Without revealing any trade secrets, the board should make sure that the firm communicates to the market material risk factors in a transparent and understandable fashion.
- ❖ With few exceptions, risk management is typically not covered, or is insufficiently covered, by existing corporate governance standards or codes.

Corporate governance standard setters should be encouraged to include or improve references to risk management in order to raise awareness and improve implementation of good risk management.

In Poland and in Sweden SOE's have risk committees. These committees' objectives are for "The Early Identification of Risks". In India direct control is an important risk management tool. In Israel the SOE is required to appoint a designated management member for the risk management functions. Switzerland also considers its SOEs as part of the government's overall risk management system.

Chief risk officers are usually required only for financial institutions.

The MFMA provide guidance on financial management, revenue management and expenditure management, while the King Codes refers to strategies, policies and principles that should be applied in risk management. These principles include:

- Risk management is inseparable from the municipality strategic and business procedures;
- Management is responsible for the implementation of risk management processes;
- The Board or Council is responsible for the process of risk management;
- The Council should approve the chosen risk philosophy;
- The Council should adopt a Risk Management Plan;
- The Council may delegate the function of risk management to a risk committee; and
- The Council should approve key indicators and tolerance levels.

Internal audit should provide independent assurance on the risk management process while the Council of the municipality should oversee the implementation of a risk policy framework.

CHAPTER 3

Risk management is a scientific approach to the problem of dealing with the pure risks faced by the municipalities. It is a function of management in the same style as marketing management, financial management, or personnel management. Risk

management is somewhat narrower than the term implies, because municipalities and organizations face a wide range of risks, some of which are beyond the control of the risk management function as it is used.

Risk management can be linked directly to good governance. Effective risk management is a systematic and ongoing process that supports top management to achieve the objectives of the institution more successfully. Risk management can also promote the implementation of corrective measures to minimize the impact of such losses. With a good risk management unit in place some losses can also be foreseen and avoided.

To conclude chapter three the top ten tools and techniques which are relevant to risk management professionals and to municipal officials were emphasised. These tools and techniques include:

- ✓ Risk management. Starting with the big picture, how would you build a risk management framework to identify and manage the total risk to your institution? Both quantitative and qualitative approaches are considered. All the remaining tools and techniques effectively fit into this framework.
- ✓ Strategic risk management;
- ✓ Assumption analysis;
- ✓ Prioritisation;
- ✓ Risk Governance;
- ✓ Risk roles and responsibilities;
- ✓ Risk trends;
- ✓ Risk metrics and behaviour;
- ✓ Risk and groupthink; and
- ✓ Positive approaches to risk management.

To conclude this chapter the benefits of applying risk management is stipulated below:

- ❖ Avoiding costly mistakes;
- ❖ Checking that all key stakeholders are “on the same page” with strategic priorities;
- ❖ Improving operational effectiveness;
- ❖ Building relationships by increasing the confidence of the clients;

- ❖ Building a positive reputation by avoiding disasters; and
- ❖ Anticipating to client expectations.

CHAPTER 4

This study focuses on risk management as a tool to address the challenges of maladministration in the BCMM. The risk management framework received attention with specific reference to professionalism and ethics in program/project management.

This chapter included the location of the Buffalo City Metropolitan. This chapter also introduced the barriers to team development to manage risks effectively and how to overcome them. The fundamentals of strategic municipal risk management were highlighted as well as the internal control function and other key assurance role-holders.

A trained and experienced management corps is needed to achieve certain objectives, primarily providing services and/or products to improve the general welfare of the public. Basic management functions that they should know is the following:

Planning;

Organising;

Leading;

Control;

Coordination; and

Policy-making.

The writer attempted to refer to other sources to clarify some risk factors that may exist in other public institutions. The legislature appropriates large sums of public money to public institutions. This involves a certain amount of risk. Risks are the responsibility of those best able to control them, with reward commensurate with accepting risk responsibility. The latter principle is sometimes difficult to implement in the public sector, given the often risk non-responsive remuneration systems.

To discharge this responsibility, we need to understand risks and their related rewards and take appropriate measures to manage the probability and impact of those risks

In this chapter the fundamentals of strategic risk management were highlighted.

5.3 FINDINGS

5.3.1 Lack of training

As was discussed in chapter 2 and 3 it is essential for the municipality to realise that untrained staff in risk management is unacceptable and that in-house training is needed to avoid unnecessary losses due to unforeseen circumstances. This can also be linked to disaster management.

5.3.2 Legislation

It can also be stated that all staff must know the basic principles of the applicable acts such as the MFMA, the Municipal Structures Act and the Municipal Systems Act to be able deliver successful services in the communities.

5.3.3 The King Codes

The MFMA provide guidance on financial management, revenue management and expenditure management, while the King Codes refers to strategies, policies and principles that should be applied in risk management.

5.4 RECOMMENDATIONS

Avoiding risks is not an easy process. Somewhere down the line something will go wrong. When it happens management must be well prepared to handle the risk situation. Here are some suggestions on how to improve risk management:

5.4.1 Training

The first recommendation by the researcher is that the municipality must start to train all staff in the general financial management functions, revenue management and expenditure management functions [Municipal Finance Management Act, 2003 (Act No. 56 of 2003)].

Training at universities is also recommended by the researcher.

5.4.1.1 General financial functions according to the MFMA

Training and knowledge of these general financial functions is recommended by the researcher. They include:

- Resources of the municipality must be used effectively, efficiently and economically.
- Proper records of the financial affairs of the municipality must be kept.
- That the municipality has and maintains effective, efficient and transparent systems-
 - (i) of financial and risk management and internal control; and
 - (ii) of internal audit operating in accordance with any prescribed norms and standards.
- That unauthorised, irregular or fruitless and wasteful expenditure and other losses are prevented.
- That disciplinary or, when appropriate, criminal proceedings are instituted against any official of the municipality who has allegedly committed an act of financial misconduct or an offence in terms of chapter 15 ; and
- That the municipality has and implements-
 - (i) A tariff policy.
 - (ii) A rates policy as may be required in terms of any applicable national legislation.
 - (iii) A credit control and debt collection policy referred to in section 96 (b) of the Municipal Systems Act.
 - (iv) A supply chain management policy in accordance with chapter 11.

5.4.1.2 Revenue management

The accounting officer of a municipality is responsible for the management of the revenue of the municipality. Training of revenue management according to the MFMA is also recommended by the researcher. They include:

- That the municipality has effective revenue collection systems in place.
- That revenue due to the municipality is calculated on a monthly basis.
- That accounts for municipal tax and charges for municipal services are prepared on a monthly basis.

- That all money received is promptly deposited in accordance with the MFMA.
- That the municipality has and maintains a management, accounting and information system.
- That the municipality has and maintains a system of internal control in respect of debtors and revenue, as may be prescribed.
- That the municipality charges interest on arrears.
- That all revenue received by the municipality, including revenue received by collecting agents, is reconciled on a weekly basis.

5.4.1.3 Expenditure management

The accounting officer of a municipality is also responsible for the management of the expenditure of the municipality. Training of expenditure management according to the MFMA is also recommended by the researcher. They include:

- That the municipality has and maintains an effective system of expenditure control.
- That the municipality has and maintains a management, accounting and information system.
- That the municipality has and maintains a system of internal control in respect of creditors and payments.
- That payments by the municipality are made-
 - (i) Directly to the person to whom it is due, unless agreed otherwise.
 - (ii) Either electronical or by way of non-transferable cheques.
- All money owing by the municipality is paid within 30 days.
- That the municipality complies with its tax, levy, duty, pension, medical aid, audit fees and other commitments.
- That disputes concerning payments are disposed of in terms of legislation.
- That the working capital is managed effectively and economically.
- That the supply chain management policy is fair, transparent, competitive and cost-effective.
- That all financial accounts of the municipality are closed at the end of each month.

5.4.2 Risk and opportunity governance

Management and all staff of BCMM should also take notice of the recommendations of the King III Code of 2009 and King IV Code of 2016.

The recommended practices of the King III (2009:27) include that:

- ❖ Management is responsible for the implementation of risk management processes;
- ❖ Risk management should be practiced by all staff in their day to day activities;
- ❖ The board of BCMM should adopt a Risk Management Plan;
- ❖ Internal audit should provide independent assurance on the risk management process; and
- ❖ The board should report on the effectiveness of risk management.

The recommended practices of the King IV Code (2016:52) includes that:

- The governing body should provide clear strategic direction for the taking and managing of risks and opportunity.
- Consideration of risk and opportunity should be integrated in the decision-making duties and processes.
- The governing body should approve the nature and extent of the risks and opportunities that the organisation should be willing to take.
- Standards should be adopted.
- The governing body should delegate responsibility for implementing policy.
- The governing body should oversee the adequacy and effectiveness of risk and opportunity management.

5.4.3 Motivation

The researcher recommends that all staff of BCMM should be motivated to enhance effective risk management. A code of conduct should be in place. Good ethical behaviour should be rewarded. Misconduct should be handled according to a Code of Conduct and unsuitable directors and staff should be removed or transferred.

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