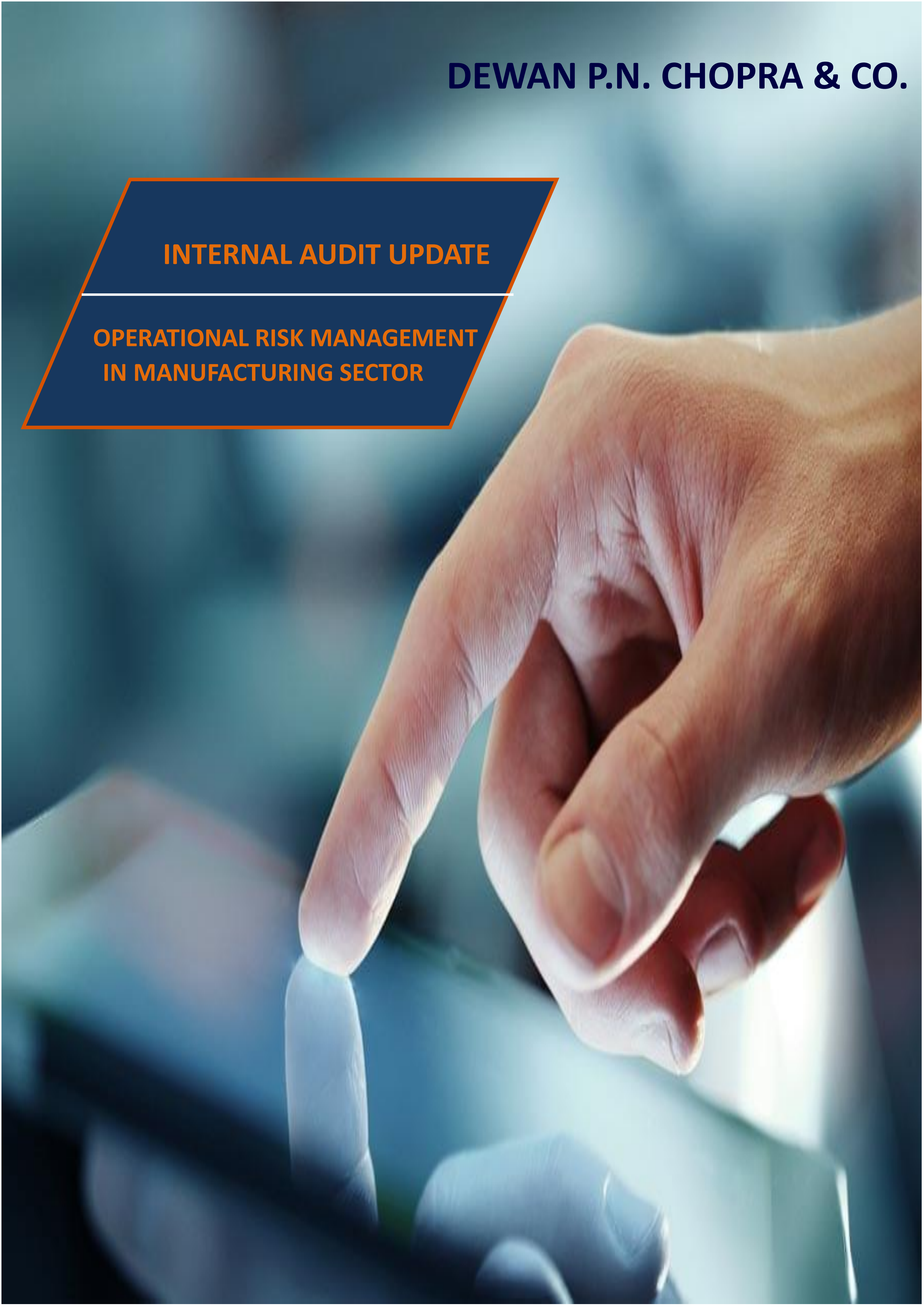
DEWAN P.N. CHOPRA & CO.

INTERNAL AUDIT UPDATE

OPERATIONAL RISK MANAGEMENT IN MANUFACTURING SECTOR



Operational Risk Management in Manufacturing Sector

A. What are the type of operational risks faced by the manufacturing sector?

Most common operational risks faced by any manufacturing concern includes risks from employee conduct, third parties, data breach, risk of loss resulting from failed or inadequate internal processes and controls. Some risks are inherent like cultural, moral, and ethical risks and on the top are technology risks—which are magnified as organizations embrace new technologies like automation, robotics, and artificial intelligence.

The broad categories of risks associated with business and operation risk relate to:

- Business interruption
- Errors and omissions by employees
- Product failure Risks
- Health and safety of employees
- Failure of IT system
- Fraud Risks
- Loss of key management personnel
- Long ongoing Litigation

When considering the impact of operational risk there are three primary areas that affect the business activity.

Property exposures – these relate to the physical assets belonging to or in possession with the business.

Personnel exposures – these relate to the risks faced by all those who work for and with the business, including customers, suppliers and contractors.

Financial exposures – these relate to all aspects of the company's ability to remain in business, whether profitable or not. Financial exposures also include intellectual property, goodwill and patents.

B. Why to manage operational risk?

In the nutshell, operational risk is the risk of doing business. Small control failures and operation ineffectiveness, if remain unnoticed, can lead to greater risk materialization and enterprise-wide failures.

There are numerous **potential benefits** derived from a well-structured and efficiently run operational risk management approach, including:

- **Freeing up capital:** Capital is a scarce resource, Capital determines the organization's earnings capacity, since each risk taken requires a cushion of capital. The more organized an institution is from an operational risk perspective, the more capital it can allocate to income-earning activities.

- **Better decision making**; with all data in hand regarding risks and its potential impact, it becomes lot easier for the organization to take inclusive decision.

- **Lower operating costs:** Improved controls and monitoring tools can help organizations identify potential risk events before they cause losses.

- **Increased customer and staff satisfaction:** It is generally understood that customers and employees prefer to work with/for a financial institution with a low error rate and a reputation for high quality. Losing customers means losing their contribution to margin, and the cost of finding new customers is often higher than the cost of keeping existing customers.

- **Better regulatory compliance:** Regulatory compliance is an indispensable part of doing business and can be a source of competitive advantage. The operational risk management function has an important role in helping to assure regulatory compliance

C. What is the risk management framework to manage such operational risks?

A complete risk management framework has multiple and complex risk capabilities and in its most simple form risk management framework would look something like the following:

- Risk Identification
- Risk Quantification
- Risk Prioritization
- Risk Mitigation

D. How can manufacturing enterprises manage such operational risks?

Operational risks are generally within the control of the organization through risk assessment and risk management and risk mitigation practices, including internal control and insurance.

Risk evaluation is used to make decisions about the significance of the risks, impact of the same in the organization and whether each specific risk should be accepted or treated. When looking at operational risk management, it is important to align it with the organization's risk appetite. Once the severity of the risk has been established, one or more of the following methods of controlling risk can be applied:

- Accepting the risk
- Sharing or transferring the risk
- Risk reduction
- Risk avoidance

A lack of strong risk mitigation strategies results in various operational failures, leading to crises in organizations.

There are steps one can take as one approach new ways to manage operational risk management, including:

1. **Adopt technology that fits with people and processes:** While any new approach will require some degree of training, make it easy to integrate technology with the current processes in the organization.

2. **Standardize risk assessment all across enterprise:** This removes the subjective analysis of an event and helps the entire organization understand the severity of various risk levels and take actions to minimize the risk prevailing in the organization.

3. **Align operational inconsistencies with financial impact:** one can't remain profitable if one doesn't understand the financial, impact of operational issues. So it is very important to align the risk impact into financial terms so as to understand the gravity if impact the operational inconsistency can lead to.

4. **Segregation of duties:** Effective segregation of tasks and duties reduces internal theft, collusion and risks related to fraud. This prevents one individual from taking advantage of the numerous aspects of transactions and business processes or

practices. It should be documented and should be available with employees at every level so that there is no dispute regarding the responsibilities.

5. **Establish contingency policies and escalation procedures:** As an ongoing process to document and prevent risk, manufacturers must have a contingency plan that everyone in the company understands and can execute when an adverse event takes place.

6. **Periodic risk assessment**: Timely and periodically assessments of all aspects of operational risks bring more relief to organizational management. It is imperative to be risk-ready by ascertaining regulatory obligations, IT assets, skills, competencies, processes and business decisions.

7. **Keep intact organizational ethics**: Creating a strong ethical environment within the organization is highly effective in mitigating operational risks management.

Conclusion:-

The idea is to use more quantitative tools to evaluate how to operate the business. ORM enables to measure outcomes and understand the inputs to the business processes, then assess the risks before making any significant decisions.

Effective and efficient operational risk management relies upon having a clear-cut understanding of the strategy, products and processes of the business enterprise. This can enable the operational risk management function to identify the real risk issues, properly assess identified risks, and add value by giving practical advice.