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ENTERPRISE RISK MANAGEMENT PRACTICES; BENEFITS AND CHALLENGES

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ABSTRACT: ***This study discusses the enterprise risk management principles and practices in the business environment using relevant case studies. Bringing out the importance and benefits derivable to a business, the impact of effective enterprise risk management to business organization; the challenges and cost of risk management the risk manager need to take into account while allocating the firm's resources. The reason being that every organization has its key objectives, corporate goals and risk profiles; therefore need different risk management methods to achieve the best results.***

Keywords: Enterprise Risk Management, Benefits, Corporate Governance, Financial Implication

INTRODUCTION

Risk management is regarded as all the activities, methods and strategies put in place to control, influence or manage the future outcomes that can bring about loss or benefit to the organisation. It is all about taking advantage of the opportunities open to the organisation as well as preventing threats (Aven 2014, Aven 2012). Enterprise risk management has gone beyond this by coordinating/integrating different risk types and different risk management tools that add value to the organisation. It identifies all types of risks specific to the organisation as well as assessing their dependence/correlation (Morgan 2005, Kaplain and Mike 2012) and applying a holistic or integrated approach to handling all risks according to the organisation's risk profile and appetite in order to achieve its corporate goals (Gordon et al 2009, Chew 2008).

A firm's specific risk or commercial or unsystemic risk can be defined as the probability of the occurrence of any negative or positive outcome unique to the organisation which can be influenced or controlled by the risk manager (Servaes et al…2009, Aven 2010, Aven 2012). The firm's specific risks are those risks that can be managed through diversification, hedging, insurance or ART (Smithson et al..2007).These is internal sources of risk that are associated with the firm's profit or losses or opportunities or threats which are within the control of the management. In this respect, it is possible to say that risks are related to the future of an organisation so need to be managed. The purpose of this study is to discuss the benefits and rationale behind enterprise risk management practices in business organisations, to consider how different types of industries vary in terms of taking management decisions towards managing specific risks.

Having identified enterprise risk management and firm's specific risk, we should consider how this can impact on the organisation that practices it, and how risk managers can align their decisions with the organisation's risk profile and appetite with the available resources. The risk manager should bear in mind how the organisation stands to benefit when spending resources on risk management, because it is important to know the costs and benefits (derivable) before making any decision. In this section, the study discusses the business benefits open to the organisation and the implication of management decisions in relation to real life cases.

Benefits of Risk Management

Risk management helps an organisation to put in place tools that can direct (risk-related decision making) their activities towards achieving their corporate objectives and goals (Beneplanc and Rochet 2011). An effective risk management strategy usually assists in implementing policies and evaluating the risks associated with any business plan or activity before any execution is made (Morgan 2005).

In this respect, therefore, an organisation that maintains an effective and flexible risk management function will be able to effectively take decisions on which investment to undertake (investment policy)(Morgan 2005); how much of the risk to retain or transfer and with what tools (risk management policy); how much of the company's capital makes up equity, shares, retained earnings and what proportion of it should be used (financing policy); how much working capital/economic capital (buffer) needs to be maintained to meet unexpected losses as well as short and long term investments(cash management policy) (Beneplanc and Rochet 2011, Chew 2008). Additionally, organisations that practise effective risk management will have direction in their day to day activities. Besides assisting companies to implement their policies, the other benefits an organisations stands to gain in managing risk will be discussed below.

Financial Benefits of Risk Management

Risk management can minimise financial distress/bankruptcy costs, improve operational and financial flexibility. Financial distress arises when an organisation fails to meet its financial obligations to its stakeholders. There are direct or indirect costs associated with financial distress such as the cost of a key employee leaving the organisation for a competitor; denial of credit by suppliers; low patronage from customers. These all lower the organisation's ability to compete, which can have a negative impact. With effective risk management practices, an organisation can reduce any negative impact that can affect the business by effectively allocating resources to all departments as well as ensuring that cash is made available to meet its obligations (Georgia 2002, Hatchett et al…2010, Seavaes et al 2009, Fehne and Tsyplokov 2005, Chew 2008).

When an organisation becomes financially distressed, this might lead to bankruptcy if not managed properly. For instance, an organisation that has failed to repay interest and capital borrowed can be forced by creditor/banks to declare bankruptcy so that they can get back their cash. So, in the winding up process, the organisation will spend money to pay liquidators and court fees, hire lawyers and assessors, as well as going out of business. A case study could be Lehman Brothers who went bankrupt due to poor risk management and communication (asymmetric information). The CFO O'Meara refused to pass risk-related information to the board of directors, and instead reported edited standard chart for meetings, so there was poor risk culture/communication because the board was unaware the organisation was taking excessive risks (Pirson and Turnbull 2011).

Integrated risk management can also make policies and operations more flexible in an organisation. This is because risk management tools are used to deal with uncertainties in the future. In this sense, there is the possibility of reacting quickly to competitive challenges and price fluctuations by reducing the operating leverage or insurance or ART or using hedging activities to stabilize future prices. To illustrate this point, take for example, Microsoft which introduced an operational policy to reduce its leverage to meet unexpected shocks (changes) in demand, technology and regulation. They also decided to use temporary workers which created more room for financial and operational flexibility. These policies (no leverage and the use of temporary employees) helped reduce their overall fixed costs levels, increased flexible finance and reduced the total risk. However, this may be very dangerous and may not be applicable in other industries such as the financial, pharmaceutical, oil and gas and the mining industries which take substantial risks to earn strategic returns (Kplain and Mike 2012).

Internal Benefits of Risk Management

Risk management can reduce the problem of underinvestment, reduce risk, reduce taxation and also generate internal funds. When the cost of borrowing external finance is high, financially troubled companies cut back or delay new investment opportunities with positive NPV because they lack the internally generated funds, so they can preserve some internal funds to meet costs. If there is an effective risk management program, it can ensure that sufficient funds and access to capital market is always maintained to carry out new business opportunities (Akintoye and MacLeod 1997, Fatami and Luft 2002).

This is due to the fact that risk management assists in strictly monitoring and reporting outcomes that can limit the company from the underinvestment problem. If effective integrated risk management is in place, an organisation will be able to identify, assess, quantify, rank, benchmark all types of exposures as well as applying appropriate tools to reduce their likelihood and severity (Panaretou et al 2013,).

In this case it will facilitate decisions concerning profitability measures(sensitivity analysis), capital structure (Opler et al 1997) and allocation of resources as well as designing performance systems and job descriptions that focus on actualising the overall objectives of the firm, thereby reducing the organisations exposure (Hatchett et al 2010). A case study of an empirical evidence of Insurance companies and US Bank Holding companies indicates that banks with stronger independent internal risk controls fared better during the GFC 2007-2008 than others that failed to identify their exposure. This was salient but very significant during the crisis period; banks with stronger risk controls had lower tail risks, a smaller fraction of non-performing loans, better operating performance and higher annual returns (Cohen et al...2014, Ellull and Yerrimiller, Eckles et al 2014, Beasley et al 2005)

Risk management assists in the organisation's efficiency which can lead to reductions in operating costs and as well generating additional funds. If resources are managed efficiently by investing in profitable and value enhancing projects, the organisation will have steady cash flows to finance new business opportunities instead of issuing shares or debts externally (Chew 2008). Although this can be beneficial to organisations, in reality highly profitable companies may want to raise external capital to avoid the discipline of outside review. In addition, larger corporations with growth opportunities would want to minimise information asymmetry due to greater coverage by raising external finance. This may be more important for smaller and more specialised firms in the real world. Again if a company pays progressive tax, stabilising income means the company will perform better in the future. Therefore, when a company tries to avoid negative earnings, it will, as a result, lower taxation costs since positive earnings will help maintain the progressive tax bracket (Chew 20008, Guay and Kothari 2003, Smithson and Simkins 2007).

An effective risk management can keep track of activities by monitoring and risk reporting which as a result aids communication, provides transparency, reduces uncertainty and recommends better strategy to handle losses, exposures and risk to the board directly. Risk blindness, according to Bruce (2014), can lead to greater destruction. Risk identification is the first step in risk management:- unidentified risks means they cannot be managed or accepted. Therefore, risk managers need to understand the corporate strategic objectives of the organisation in questions, because this depends on the industry and the size/complexity of the firm (Arena et al 2010).

Firms with higher foreign sales are more likely to use FX derivatives instruments to reduce exchange rate risks (Kevin and Sonhke 2010, Bartram 2000), but can have some side effects when not used properly (Weiying and Jian 2010, Li et al 2013, Weinying and Boafeng 2008) because the size can also have negative effect on the firm. Again, risk management in construction is difficult in international and joint venture projects with foreign co-operation (Aleshin 2001). In reality, financially constrained firms and companies with information problems hedge less or not at all. For example the fuel prices in airline; more constrained airlines may hedge less compare to their counterparts in same business (Rampini et al 2014).

External Benefits of Risk Management

Risk management can minimise free option, damage to reputation, negative externalities, asymmetric information, monitoring cost, risk faced by key employees, and increase shareholders value, corporate debt as well as facilitating of stockholders risk management. Managers are more informed about the firm than the shareholders and this has been a problem in business. In managing risks with compensation plans related to risk, investors are given more confidence in the organisation. In addition, the commodity prices movement and the statutory risk factor disclosure, FX investors can get information on the company's performance (Cassidy et al 1990, Chavas 2004, Seavaes et al.. 2009).

In countries where the government provides incentives for corporations to issue debt, through interest tax-deductibles, debtholders who are bound to lose in case the company makes losses, but will not gain from its profit. With an effective risk management strategy, it can strengthen the corporation; as a result help to expand its debt capacity by creating trust and credibility. Thus, the organisation can increase the tax benefits of debt financing as well as greater efficiency in cash holdings, because the cost of debt is reduced (Andrade et al 2014, Huberman 1997).

Again Organisations enter contractual relationships with suppliers or customer prices in foreign currency for a given period of time, or sometimes in agreements to finance a project in the future. In the absence of proper risk management tools in terms of their prices and currencies, the company can end up giving free options to their customers or suppliers unknowingly (Seavaes et al 2009).

Effective and flexible risk management can improve and restore a company's reputation after a disaster. When the volatility and negative earnings are reduced, it will improve credit rating and will create intangible assets such as goodwill. If any negative event occurs, an effective and quick positive response can protect the reputation of the company (Hatchett et al. 2010, Smithson and Simkins 2007). A good example of such is the damage to the reputation of SeaWorld Parks and Entertainment after the release of a movie titled Blackfish. The documentary revolves around the alleged mistreatment of the amusement park's orcas, and the death of several of the animals' trainers. This movie led to the reduction of its share price by 40 % and the resignation of CEO Jim Atchison. But in the case of Johnson and Johnson's; when its Tylenol capsules killed seven people; a follow up public announcement was made about the product dangers, product was recalled from selves, emergency communication lines provide to keep in touch with public and product was re-launch without damaging the company's reputation

Negative externalities occur when a product or decision costs the society more than its private cost. It is generally viewed as a failure of the market, because the level of consumption or production of the product is higher than what the society requires. A good case study is the Deep Water accidental spill of British Petroleum due to lack of risk monitoring and communication, which affected people directly and indirectly. The indirect costs on the society cannot all be accounted for by British Petroleum. With integrated risk management strategy, an organisation can anticipate and communicate some level of uncertainty that might adversely affect their business activities (Aleshin 2001), and can avoid, reduce and mitigate possible future outcomes

Integrated risk management can give managers opportunity to understand the firm's exposures better than its investors. Due to the fact that investors (shareholders) have less information about the organisation's activities (Fauver and Naranjo 2010), corporate-level risk management creates more value for investors than they could have achieved on their own (Chew 2008), because equity based compensation plans (a risk management method) align the interests of managers and stockholders. For instance, Tesco introduced compensation plans help influenced both the key employees and other staffs. This stabilizes stockholders earning as well as employee turnover (Woods 2011). Risk management practices assist in reducing the wealth of managers who have majority of their investments in the organisation's stock and stock options, because they have no ability to diversify their holdings. Their wealth fluctuates alongside that of the company's equity to encourage risk taking behaviour (Tufano 1996, Jenson 2010, Jenson and Meckling 1976), so risk management can help reduce the risk faced by managers (Campbell and Kracaw 1990), by stabilizing fluctuations and reducing the overall risk through hedging, insurance or Alternative Risk Transfer methods. Although, industries that have cash flows with high variances such as the mining industry, may hedge less even if they face high financial distress, just to minimize asymmetric information (Zhoa 2004). According to Morgan (2005), derivative usage can be more suitable in the energy and the finance sector, but might not be appropriate for oil and gas sector because they face more commodity risk. And therefore, needs other risk management tools like investments in lots of tangible/fixed assets, insurance or ART.

Investors, creditors, customers and corporate board of directors always want to evaluate and monitor the performance of an organisation, which can be costly. When an organisation has set risk appetite, or total risk limits (benchmark), it can facilitate monitoring because an organisation gives details of its risk and operations through corporate disclosure which is more informative so can reduce the cost of monitoring the organisation's activities for investors, creditors, customers as well as the board (Chew 2008). Enterprise risk management creates opportunities for senior management to map, assess/measure, rank and manage risk-return trade off (O'Donnell 2005). This can be done through accessing the capital markets to raise resources needed for its corporate business strategies and plans. In managing the total risks of the organisation, deadweight costs that can also affect diversified shareholders if commodity prices or currency changes occur unexpectedly can be reduced (Tufano 1996). Proper risk management culture and tools can be used to reduce or limit the probability of large cash losses that can result to value destroying investments as well as limiting activities that can have negative impact. A case study of HSBC that was fined to pay $1.9 billion US dollars for money laundering, which may have negative effect on the company in the future if not properly managed. A more positive example is Starbucks; they hedged their coffee prices when there is a forecasted price increase in the future just to ensure fluctuations are stabilized. This can create more value for the shareholders.

Challenges in Implementing integrated Risk Management

Besides these benefits above risk management still have some challenges. Enterprise wide risk management as identified by Meulbroek (2002); is not widespread, it is often difficult to identify, assess and measure risk in terms of frequency and severity due to lack of reliable data, which can affect the firm value. Since enterprise wide risk management requires co-ordination of all independent units, strategic approach and understanding of all operation

(Stokes, 2004). Senior management must determine what level of risk/risks are acceptable or not (risk appetite). The size of a firm, its complexity and type of industry makes it unique in its risk and potential reward; this can make it more difficult in achieving the desired risk management results in organisation (Tummala et al 1997, Ward and Chapman 2003). So, risk management need to be headed by the Treasurer who can take a corporate wide view and has a key understanding of overall strategy instead of a Chief Risk Officer in order to prevent failure. Additionally, enterprise wide risk management needs adequate resources, full support from senior management, adequate education of line managers, specialist expertise skills and IT software. Therefore, too little resources, limited support from senior management, inadequately educated line managers, insufficient specialist expertise and IT software can lead to risk management failure.

Risk management also incurs some costs because hedging strategies involves the combination of a downside protection and an upside reward. The right combination of derivatives completely eliminates any exposure, but this strategy involves giving up the upside potential to pay for downside protection. Thus, the loss of the upside if not a fair one can be costly to the investor who's fluctuations are highly significant. Communication challenges may also arise, in exploring hedging losses can be costly to top management due to the fact that it is hard to have a best designed hedging program to explain acceptable hedging losses.

An effective integrated risk management needs the services of technical experts to handle the risk management functions. The amount spent on hiring such personnel; training of staffs on risk management activities and buying of Information Technology design to monitor risk is a cost to the business. It is even a risk to use short term instruments to hedge long term cash fluctuations (Bauer and Ryser 2004). Product cost can arise in trying to implement risk management. This is because when investors want to protect against potential losses, they will purchase put options in the market or buy insurance and pay premiums. These premiums paid are costs to the investors.

CONCLUSION

This paper has discussed the importance and benefits of risk management practices to business, the impact of effective enterprise risk management on the organisations, the challenges and costs associated with risk management and what organisational risk managers need to consider when allocating resources to risk management activities. This is because organisations have different key objectives, corporate goals and risk profiles, and therefore need different risk management strategies for better results.

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