Enterprise Risk Management - An Overview

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Abstract
Enterprise risk management has emerged as a new paradigm for managing the portfolio of risks that organizations are vulnerable to, as policy makers continue to focus on mechanisms to improve corporate governance and risk management. The nature of risk management has undergone a rapid and remarkable transformation over the past few decades, from a primitive defensive approach to the cotemporary strategic and dynamic approach.

Enterprise risk management encompasses an overall risk management approach to business risks. The term succeeds earlier approaches to risk management like corporate risk management, business risk management, holistic risk management, strategic risk management and integrated risk management. Although these terms differ in their focus to a small extent, the general concepts are quite similar. The emergence of Enterprise Risk Management can be attributed to i) the enhanced scope of corporate governance that covered all risks that a firm takes following many high profile corporate failures and ii) the focus of modern strategic planning on shareholder value concepts derived from finance theory, where risk plays a prominent role. The present paper discusses enterprise risk management and its relevance in the present context.

Keywords: Enterprise Risk Management, Corporate Governance, Risk Management

INTRODUCTION

The Risk Environment
In the modern competitive business environment, business entities are exposed to greater risks along with opportunities in their quest for value creation. The global crises and the resulting competitive environment have compelled businesses to take up many measures for survival and growth. These measures varied from employee lay-offs, office shutdowns etc. These have led managers and investors in recent times to pay more attention to managing the risks inherent and emerging in their businesses. It is therefore imperative for businesses to take advantage of making appropriate strategic decisions on uncertain outcomes for reducing losses and enhance profitability. Uncertainties and risks present both risks and opportunities, with potential to erode or enhance value.

A Risk Management survey carried-out by the Aon Corporation presents its findings in four key components - Top ten risks, Overall risk preparedness, Business losses related to risk, and key business topics/functions.

The top ten risks identified were as follows: 1. Economic slowdown 2. Regulatory/legislative changes 3. Business interruption 4. Increasing competition (new addition to top ten since 2007 report) 5. Commodity price risk (new addition to top ten since 2007 report) 6. Damage to reputation 7. Cash flow/liquidity risk 8. Distribution or supply chain failure (new addition to top ten since 2007 report) 9. Third party liability and 10. Failure to attract or retain top talent.

Need for Enterprise Risk Management
The recession has forced businesses to place more focus on the management of risks relating to all aspects of their businesses. Such management is broadly defined as "Enterprise Risk Management" ERM, which describes the set of activities that businesses undertake to deal with all the diverse risks that face it in a

holistic/strategic/integrated method. These risks include financial, strategic, operational, hazardous, and compliance risks, spanning through the organization. Many of such risks have significant impact on the profitability, effectiveness, and reputation of business enterprises. In the 21st century, there are several critical factors that have considerably driven the need for enterprise risk management, which today is referred to as drivers of ERM, this includes increase in the following:

- Greater transparency through better Corporate Governance
- Financial disclosures with strict reporting and control requirement
- Security and technology issues
- Business continuity and disaster preparedness
- Focus from rating agencies
- Regulatory compliance (laws and regulations)
- Globalization in a continuously competitive environment

UNDERSTANDING ENTERPRISE RISK MANAGEMENT

The renowned father of modern management, Peter Drucker quotes "a decision that does not involve risk, probably is not a decision". Thomas Stewart says, "Risk – let's get this straight up front – is good. The point of risk management isn't to eliminate it; that would eliminate reward. The point is to manage it – that is, to choose where to place bets, and where to avoid betting altogether" We see the same school of thought in the words of Dan Borge, former director of Bankers Trust; "Many people think that the goal of risk management is to eliminate risk – to be as cautious as possible, not so. The goal of risk management is to achieve the best possible balance of opportunity and risk. Sometimes, achieving this balance means exposing yourself to new risks in order to take advantage of attractive opportunities." Again, Peter Drucker makes it clear what an attempt to eliminate risk completely would lead to; "A business has to minimize risk. But if its behaviour is governed by the attempt to escape risk, it will end up taking the greatest and least rational risk of all: the risk of doing nothing." Dr Vedpuriswar adds that risk can neither be avoided nor eliminated completely. The theme of risk management is clearly highlighted as the minimization of risk in a bid to keep it within controllable limits, as well as the acceptance of risk in other to gain reward – the definition of a risk appetite. Uncertainty in business and life in general is said to exist due to the futuristic nature of outcomes. The outcomes of business operations are to be reached at sometime in the future after the tasks have been performed. G. Monahan agrees to this in his work stating that businesses face risk due to the uncertainty of possible outcomes of the actions taken in the course of doing their business. And even in situation where a high level of certainty exists towards the achievement of positive outcomes, a sudden disastrous event may occur to change this fate. Barton T. L. et. al. sheds light on the „risk" debacles which the business community has witnessed that have resulted in considerable decrease in shareholder value, financial loss, damage of company reputation, so on. They point out that such events may include environmental disaster, mergers destroying shareholder value, organisations trading in complex derivative instruments without the understanding of the risks involved, traders lacking oversight and have inadequate controls for the enormous risks they assume, etcetera, while placing emphasis on the attention and handling of such risks. G. Monahan argues on the notion that risk is the same as uncertainty, by defining risk as anything that produces a distribution of various probabilities for various outcomes. COSO on the other hand, defines uncertainty as that which presents both risk and opportunities, with potentials to erode or enhance value. Risk is the possibility that the occurrence of an event will adversely affect the achievement of objectives, and opportunity is the possibility that an event will occur and positively affect the achievement of objective.

What is Enterprise Risk? Currently, the need for corporate governance, internal control (as well as the compliance to rules and regulations) and risk management have been of critical concern to businesses as experts call for the integration of all three with a single management approach referred to as the integrated GRC. However, the solution came as „Enterprise Risk Management", as it emphasizes on all three aspects within its process of application. Experts point at the recent financial crisis and the related economic downturn, and the failure of risk management to help the situation as further backing for the reevaluation of the discipline for a change to a more co-ordinated (wider scoped) risk management approach that recognizes the interdependencies of risks. Again, Enterprise Risk Management is described as the solution to this challenge. Enterprise risk is the aggregate of all functional and process risks a business entity faces in the course of carrying out its business activities. Such risks would include the types described by Casualty Actuarial Society listed below: 1. Hazard risk 2. Financial risk 3. Operational risk 4. Strategic risk Enterprise Risk Management (ERM) approach is a first attempt to recognize the interdependencies among risks and the treatment of risks across all business operations. About Enterprise Risk Management (ERM) The holistic approach that characterizes the present trend of risk management, referred to in some text as enterprise-wide risk management, enterprise risk management (ERM), strategic risk management, or integrated risk management, is aimed at dealing with uncertainty for the organisation. The rationale behind this approach is that value is maximized when the decision-makers sets strategy and objectives to strike an optimal balance between growth and return goals, and the related risks, and efficiently and effectively allocate resources in pursuit of the entity‟s objectives. Barton et. al. stated that the goal of this new approach is to create, protect, and enhance shareholder value by managing uncertainties that could influence the achievement of organisational objectives. Enterprise Risk Management is clearly distinguished from risk management and financial risk management in the RIMS Executive Report, 2009. While risk management is described as a broad term for the business discipline that is concerned with the protection of the assets and profits of an organisation by either reducing the potential before it occurs, mitigating the impact of a loss if it occurs, and the execution of a swift recovery after a loss occurs; Financial risk management is the term often used by non-financial institution to describe the mitigation process for their financial exposure; Enterprise Risk Management on the other hand, is said to represent a revolutionary change in the risk management discipline that broadens the scope of risk management behaviours. By definition and contrast, ERM is seen as the new paradigm in risk management; while the old paradigm in characterized by avoiding losses within a limited scope, separated by function, and terminates at the end of the task (or project), this new approach covers all risks, both internal and external, integrates and views all risks from a board, creating awareness organisation-wide, with the goal of creating, protecting, and enhancing shareholder value by mitigating risks and seizing opportunities in a continuous process. The authorities and expert of this emerging discipline have defined ERM in a number of ways that depicts their perception and the way they practice it. The CAS committee definition is stated below: “ERM is the discipline, by which an organisation in any industry assesses, controls, exploits, finances, and monitors risks from all sources for the purpose of increasing the organisations short and long term value to its stakeholders”.

The committee places emphasis on the following five parts of the definition:
1. ERM is a discipline
2. ERM applies to all industry
3. ERM exploits (value creating) as well as mitigate (manage) risk.
4. ERM consider all sources of risks
5. ERM consider all stakeholders of the enterprise

The COSO committee describes ERM as one that deals with risk and opportunities, and defines ERM as follows: “Enterprise risk management is a process, affected by an entity’s board of directors and other personal, applied in strategy setting and across the enterprise, designed to identify potential events that may affect the entity, and manage risk to be within its risk appetite, to provide reasonable assurance regarding the achievement of entity objectives.” As before, the COSO committee also breaks the definition in to simple bits, it seems to be the most elaborate definition of the concept; 1. ERM is a process; it is ongoing and following through an entity. 2. ERM is affected by people at every level of an organization. 3. ERM is applied in strategy setting.

4. ERM is applied across the enterprise, at every level and every unit, and includes entity-level portfolio view of risk. 5. ERM is designed to identify potential events that, in the event of their occurrence, will affect the entity and to manage the risk within its risk appetite. 6. ERM is able to provide reasonable assurance to the management and board of directors of an entity. 7. ERM is general towards the achievement of objectives in one or more separate but overlapping categories. Managing Enterprise Risks According to Lexicon Systems, LLC, this new, strategic imperative has grown momentum, and in a single paragraph summarizes the activities of ERM which will take organisations years and years to accomplish, stating that:

organisation can support ERM solutions when they reach a certain level of business and information maturity. When this occurs, they establish a “risk culture” and then gather risk intelligence. The adoption of a process focused on GRC as against the “siloed” issue-by-issue style follow. In addition to these, they suggest that the organisations establish a risk and compliance architecture that considers the business processes, the people and the information technology. And finally, the organisation commits and trains the members consistently on corporate policies and procedures. The CAS committee states that this involves continual scanning of the risk environment and evaluating the performance of the risk management strategies, and the feedback into the context setting step of the process and the cycle repeats again and again, continuously. The ERM process in a generic sense is a reiterative process in which certain sequential activities are carried out starting with establishing a context, and then identifying events, analyzing and quantifying risks, integrating risks, assessing and prioritizing risks, and finally treating risks/exploiting opportunities. The monitoring and reviewing activities are continuous and concurrent with these other activities.

The Limitations of ERM

The COSO committee clears the air by stating the observed limitations, discussing the misguided notion that with embedded internal controls, the organisation will achieve its objectives. In the viewpoint of COSO, there are three distinct concepts that must be regarded: 1. Risk relates to the future, which is described as being inherently uncertain. 2. ERM can only provide reasonable assurance, and does not provide that the objectives must be met. 3. ERM cannot provide absolute assurance of outcomes with respect to any one of the objectives.

Conclusion

ERM provides guidance for the leaders of organizations to identify, assess, and manage risk while at the same time growing the business. Because the risks in the global economy constantly change and evolve, ERM is a never-ending journey. ERM requires strong commitment from C-level executives and an effective process tailored to each organization’s unique culture. A company’s implementation can benefit from the ERM knowledge that Certified Management Accountants (CMAs) and other finance professionals can bring to the process. In their quest to “drive business performance,” businesses should exploit the true potential of ERM.

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