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249

IMPACT OF ENTERPRISE RISK MANAGEMENT (ERM) ON FIRM PERFORMANCE: THE CASE OF MALAYSIAN LISTED FIRMS

Noraznira Abd Razak[1], Zuriah Abdul Rahman[1] and Halimahton Borhan[2]

University Technology MARA (UiTM), Malaysia

Abstract

Purpose: The various financial crises occurring globally gave rise to the proliferation of different risk management frameworks. This paper focuses on the enterprise risk management (ERM) practice within an organization and its impact on firm specific factor and firm performance relationship by adopting the structure-process-outcome theory.

Design/methodology/approach: The study employs a survey approach with a self-administered questionnaire distributed to companies listed under Malaysian Bourse.

Findings: The results propose a conceptual strategic risk management framework focusing on the development and sustainability of corporate performance in the context of listed companies in Malaysia.

Originality/value: The novelty of this study is the contribution to the body of knowledge through the development of new findings on enterprise risk management (ERM) studies in Malaysia.

Keywords: Risk culture, Enterprise risk management, Firm resources, Firm performance, Strategic risk management

Paper type: Conceptual paper

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[1] Arsyad Ayub Graduate Business School, University Technology MARA (UiTM), 40450 Shah Alam, MALAYSIA, Email: noraznira@melaka.uitm.edu.my

[2] Faculty of Business Management, University Technology MARA (UiTM), 110 Off Jalan Hang Tuah, 75300 Malacca, MALAYSIA

INTRODUCTION

Organizations face a variety of risks and any one of them could threaten growth and success. An event like the currency crises in Europe in 1992–93 and in Mexico in 1994–95, the Russian and Asian financial crises of 1997–98, the Argentinian crisis of 2001–2002 and most recently the Global Financial Crisis in 2008–2009 will affect the execution of the strategies and achievements of the firm. The various economic events gave rise to the proliferation of various frameworks in risk management. Milestones of this effort include the Turnbull report in the United Kingdom (its requirements for risk disclosure incorporated directly into the Stock Exchange listing rules) which Malaysia has also adopted into its Stock Exchange listing rules (see Malaysian Code of Corporate Governance, 2007).

Various studies have already focused on determinants that lead and affect firm performance, especially for a large corporation. The corporate sector in Malaysia in the early 90s claimed to be highly active and confident at capturing various potential chances and highly skilful at optimising whatever relevant opportunities come their way. Hence, the investment level was boosted and created a truly impressive record.

However, Claessens (2000) emphasized that the high rates of return registered by firms in Malaysia were relatively insufficient for the degree of risk already undertaken during that time. The logic behind the statement presumed that before the crisis, firms in an already frail condition functioning with a high degree of risk were not being controlled adequately through competition and monitoring by shareholders and creditors (foreign and domestic).

In other words, poor performers were not straining to alter and lift up their rates of returns suitably to counter balance investors for the risk obtained. Hence, susceptibility in corporate financial structures which was perceived to be the main factor of the crisis in the late 90s, has actually been subsisted since the early 90s. Although the financial fragility of the corporate sector during the 90s may not have triggered the crisis, it did contribute to its depth and severity.

ENTERPRISE RISK MANAGEMENT (ERM)

In various literature, the term enterprise risk management (ERM) has a variety of different definitions (British Standard BS31100). However, the operational definition from the Committee of Sponsoring Organization of the Treadway Commission (COSO) in 2004, Australia/New Zealand (AS/NZ4360 2004), the Casualty Actuarial Society (CAS) in 2003 and several other established associations was commonly adopted by various empirical findings such as Gates (2006), Beasley *et al.* (2005, 2006) O'Donnell (2005), Banham (2004) and many others.

Lam (2000) defined ERM as an integrated framework for managing credit risk, market risk, operational risk, economic capital and risk transfer in order to maximize firm value. CAS (2003) defined ERM as disciplines by which an organization in any industry assesses, controls, exploits, finances and monitors risks from all sources for the purposes of increasing the organization's short- and long-term value to its stakeholders. Australia/New Zealand AS/NZ4360 (2004) defined risk management as a holistic management process applicable in all kinds of organizations at all levels and to individuals. The definition of risk management by ISO 31000, also an adaptation of AS/NZS 4360 2004, quoted ERM as "coordinated activities to direct and control an organization with regard to risk" (i.e. culture, processes, structures) as did AS/NZS 4360.

On the other hand, the Committee of Sponsoring Organization of the Treadway Commission (COSO) (2004) defined ERM as a process, effected by an entity's board of directors, management and other personnel, 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.

The increasing interest in ERM started in the 1990s, when several corporate disasters occurred globally (Mikes and Kaplan, 2013). As such, nurturing a strong risk culture within an organization is crucial in order to ensure that the corporate sector is not repeatedly being faced with vulnerability to contagion risks and spill-over effects. Hence, prioritizing and vigilance is necessary to ensure all potential risks are taken into consideration, and comprehensive risk management measures are adopted (Abdul Manab, 2010). The increasing interest in the practice of ERM has been caused by numerous factors. One of these is the change in the competitive environment, with a tendency towards greater turbulence and complexity (Chapman, 2003; Floricel and Miller, 2001; Giddens *et al*., 2006; Miller *et al*., 1998; Rahman and Kumaraswamy, 2002; Rasmussen, 1997). Although ERM practices is on the rise, not all organizations are adopting it (Daud and Yazid, 2009).

Lam (2000), on the other hand, emphasized that risk may exist from daily business operation, therefore firms need to integrate all possible risk in a systematic manner hence, ERM helps firms manage better outcomes (Jablonowski and Kleit, 2006). The adoption of ERM practice does not come cheap. Firms have to have sufficient resources to ensure that the task of adoption and implementation can materialize in the first place.

FIRM RESOURCES – FIRM PERFORMANCE RELATIONSHIP

Firm resources are resources or capabilities specific to a particular firm, which are also known as firm specific factors. These resources may be finance, unique technology, knowledge, human and other assets (Barney, 1991). The resource-based view (RBV) offers an explanation for the firm effects on strategies and the performance outcomes of the firm. Performance differences across the firm can be attributed to the variance in the firm's resources and capabilities (Hitt *et al.*, 2001).

The empirical study of Galbreath (2005) defined resources as a firm specific factor that has potential to contribute to various benefits, such as performance. The RBV theory holds that performance is driven by internal, not external factors and describes firms as bundles of tangible and intangible resources, while strategy selection is based on the careful evaluation of these resources (Barney, 1991). The strategic goal of the firm, then, is to develop and deploy a combination of resources that competitors cannot imitate or directly purchase in the markets (Barney, 1991) hence, performance advantages are subsequently built and sustained. According to the studies of many resource-based scholars, performance is ultimately dependent on the unique assets owned and controlled by the firm, whereby the line of reasoning is that there are differences in firm profitability stemming from the acquisition and deployment of valuable firm resources (Caloghirou *et al.*, 2004). The work of Gu and Guan (2009) also supports the finding of the above study, which emphasizes that a firm's resources are influential in determining their firm performance, which leads to the sustaining of competitive advantage. Therefore, this research hypothesized:

H1: There is a significant relationship between firm resources and firm performance

THE MEDIATING EFFECT OF ERM ON FIRM RESOURCES - FIRM PERFORMANCE RELATIONSHIP

Much has been written on the subject of ERM by regulators, consultants, professional associations, academics and government agencies (e.g. Kumar and Persaud, 2002; Gai and Vause, 2004; Barfield 2007). There are various empirical findings that emphasize the relationship between firm resources and ERM, including Yazid, Wan Daud and Hussin (2008), Abdul Manab *et al.* (2010), Pagach and Warr (2010) and Hoyt and Liebenberg (2008).

On the other hand, there are also empirical finding on the impact of ERM practices on firm value and firm performance, such as Hoyt and Liebenberg (2008), Mohd and Razali, 2011 and Gordon *et al.* (2009) as far as related previous studies are concerned. The academic literature on enterprise risk management has focused more on the level of adoption of ERM practice within a firm and its determinants (which clearly falls on various types of resources such as cash, fixed assets, skilled workers etc), but it is unclear which of the resources within a firm actually play pivotal roles in the implementation of the practice (Paape and Spekle, 2011). The same views are also supported by the most current studies, including Monda and Giorgino (2013).

This research follows the four steps of Baron and Kenny (1986) in determining the mediating variable in the firm resources – firm performance relationship. The hypotheses below reflect the theoretical gap of this research, where ERM has never been treated as a mediator variable between the firm resources and firm performance relationship. Accordingly, the following hypotheses were formulated:

H2: There is a significant relationship between firm resources and enterprise risk management (ERM)

H3: There is a significant relationship between enterprise risk management (ERM) and firm performance

H4: Enterprise risk management mediates the relationship between firm resources and firm performance.

PROPOSED FRAMEWORK AND METHODOLOGY

The conceptual framework is developed to help postulate and test the relationship, and thus enhance the understanding of the situation involved. The proposed framework for the research is shown in Figure 1.

From the proposed framework, this study suggest that there is a triad relationship between the three variable construct, as per Figure 1. As such, the theory of structure-process-outcome by Donabedian (1966) would be best suited to support and strengthen the framework further. Company structures, processes, strategic orientations and their interaction are relevant subjects for further research (Jantunen, 2005). Hence, the justification for this research to adopt and adapt the structure-process-outcome theory from Avedis Donabedian (1966) is established.

This study will adopt a quantitative approach and data will be gathered via survey using a self-administered questionnaire. The study population for this research consists of companies listed on the main board of Bursa Malaysia by using a random sampling technique. The analysis will be carried out using PLS-SEM.

CONCLUSION

It is crucial to conduct an empirical study to examine the significance of the ERM process in influencing the relationship between firm resources and firm performance in the context of Malaysian public listed companies.

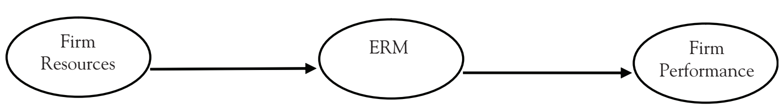

Figure 1. Proposed framework

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ABOUT THE AUTHORS

Noraznira Abd Razak is a risk management and insurance lecturer at the Faculty of Business and Management, University Technology MARA, Melaka, Malaysia. She has more than ten years experience as a practitioner in risk management and the insurance industry and became an academician in 2006. She is currently pursuing a PhD in risk management, and her expertise is in any fields related to risk management and insurance.

Professor Zuriah Abdul Rahman is a Professor of Risk Management & Insurance at Arshad Ayub Graduate Business School, Universiti Teknologi MARA (UiTM), Malaysia. She holds a BSc in Business Administration in Insurance and an MBA from Bowling Green State University, Ohio, USA. She also has a PhD from Universiti Utara Malaysia/University of Memphis, USA, where she conducted research on risk management. Professor Zuriah is an Associate of the Chartered Insurance Institute, UK, a Chartered Insurance Practitioner, UK and a Visiting Scholar at Durham University, UK. She is also engaged in

teaching, research, consultancy and training in risk management, safety management, insurance and Islamic insurance/takaful areas. She has authored and published several books and journals and is currently serving as a Panel Expert for the Malaysian Qualifications Agency, and as a Council Member for the National Council for Vocational Training, JPPK, Ministry of Human Resources, Malaysia.

Dr Halimahton Borhan is a senior lecturer in economics at the Faculty of Business and Management, University Technology Mara, Melaka, Malaysia. She has presented many papers at national and international level. Her papers have been awarded "Best Paper" at international level and have been published in many refereed journals. Her expertise is in economics-related fields, such as environmental, finance, sustainable development and quality of life.