

A Conceptual Framework For The Adoption of Enterprise Risk Management in Government-Linked Companies

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The aim of this paper is to propose a conceptual framework in order to study the level of ERM adoption by government-linked companies. The level of adoption of ERM would depend on the extent of companies' involvement in ERM. Clearly the framework suggests that the Quality of Chief Risk Officer (QCRO) would influence status of ERM adoption. In addition, the Quality of Board of Directors (QBODs) also signifies companies' involvement in ERM. Finally, the Quality of Internal Audit Support (QIAS) would be considered as a moderating factor in the adoption of ERM. From the review of literatures, hypotheses are developed to suggest relationship between the level of ERM adoption with the Quality of CRO, Quality of BODs and Quality of IAS that could be empirically proved for future research.

Field of Research: Enterprise Risk Management

1.0 Introduction

Recent years have seen heightened concern and focus on risk management, and it became increasingly clear that a need for a robust framework to effectively identify, assess and manage risk (Flaherty, 2004). Moreover, in this century, companies face with a lot of risky events. Those events involved in various types of risks such as physical risk, interest rate risk, political risk and investment risk. Wrong approach in taking those risks could create a severe financial impact to

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the companies. For example, during the financial crisis in 1997 Malaysian Airline System (MAS) and Tenaga Nasional Berhad (TNB) suffered huge foreign exchange losses due to their failure to manage the risk (Yazid, 2001). Therefore, the proper management of risk is critical to ensure companies achieve their vital objective in maximizing shareholders' value.

Current literatures have paid increasing attention to Enterprise Risk Management (ERM) (Liebenberg & Hoyt, 2003). Furthermore, Pagach & Warr (2008) postulated that ERM is a holistic method of managing both operational and strategic risks across an organization. In addition, ERM provides a process by which a company integrates all of its risk management functions (Pagach & Warr, 2007). As the consequence, those firms which adopted ERM experience a reduction in stock price volatility, increased asset opacity, a decreased market to book ratio and decreased earnings volatility besides increased the boards and senior management's ability to oversee the portfolio of risks facing an organisation (Beasley et al., 2006 and Pagach & Warr, 2008).

In Malaysia, many companies are looking forward to implement ERM program. However, empirical research towards ERM is still lacking. In response to that, this research attempts to resolve this problem. Furthermore, the findings could help companies in handling their potential wide array of risks in an integrated, holistic fashion towards the achievement of their companies' objectives. Khazanah Nasional Berhad is the investment holding arm of the Government of Malaysia entrusted to hold and manage the commercial assets of the government and to undertake strategic investments. Khazanah Nasional was incorporated under the Companies Act 1965 on the 3rd September, 1993 as a public limited company. The primary objectives of Khazanah Nasional are to hold and manage the investments assigned by the Government of Malaysia and also to undertake new investments where there are strategic opportunities in new sectors and in new markets. Khazanah Nasional becomes major shareholders in some of the public listed companies. These companies are considered as the Government-Linked Companies (GLCs).

Risks are inherent in all GLCs business transactions. Thus, it is important for them to manage their risks systematically and comprehensively. ERM has appeared as a new inspiration for managing the collection of risks that face an organization. Many researchers (e.g. Gates, 2006; Beasley et al, 2005, 2006; O'Donnell, 2005; Banham, 2004) have widely recognized the critical role of ERM as a new paradigm for managing the portfolio of risks that face organizations. While ERM is on the rise, not all organizations are adopting it. Little is known about why some organizations acknowledge ERM while others do not. To date, most of the literature on ERM has focused on developed countries. Very little attention has been directed to this subject in developing countries, including Malaysia. Studies of the management of risk by companies from developing countries, meanwhile, have also been scarce.

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This paper aims to come up with a conceptual framework that contributes to the understanding of ERM practices in the developing countries through the exploration of ERM practices in Malaysian companies. Based on this overarching goal, the objectives of this paper can be described as follows:

- a) To determine the level of ERM adoption among the Malaysian GLCs;
- b) To examine whether Quality of Chief Risk Officer (QCRO) and Quality of Board of Directors (QBODs) affect the level of adoption of ERM in Malaysian GLCs; and
- c) To investigate whether Quality of Internal Audit Support (QIAS) moderates the relationship between presence of Quality of Chief Risk Officer (QCRO) and quality of Board of Directors on the level of adoption of ERM.

In addition the specific research questions are as follows:

- a) What is the level of adoption of ERM by GLCs?
- b) Do the Quality of CRO and the Quality of BODs influence the level of adoption of ERM?
- c) Does the quality of QIAS influence the level of adoption of ERM?

2.0 Literature Review

Committee of Sponsoring Organizations of the Treadway Commission (COSO) defined ERM as:

“... a process affected by an entity’s board of directors, management and other personnel, applied in a strategy setting and across the enterprises, 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 goal.”

Based on definition above, ERM is considered as a discipline and it is a process, ongoing and flowing through an entity. Thus, ERM is an orderly prescribe conduct or pattern of behavior for an organisation. A full support and commitment of the top management and at every level of an organisation are required to ensure the effectiveness of ERM implementation. This is further supported by Shenkir & Walker (2006) that executives should be eager to make a commitment to ERM because they are ultimately responsible for protecting, creating and enhancing shareholders’ value. Ultimately, it is hoped that ERM becomes part of the culture of the organisation.

Despite all of the talk about ERM in the trade press, evidence indicates that it is still not widely practiced and empirical evidence regarding the determinants of ERM programs is lacking. For example, Yazid *et al.* (2008) found that ERM practices amongst main board listed companies in Malaysian Bourse are still at early stage. In the study, only about 30 percent of the companies involved in ERM. Why is ERM not common in practice? Some reasons may include organizational structure that are not conducive to ERM, individuals, who do not want to give up their specific responsibilities, a lack of understanding regarding

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how to effectively implement ERM and difficulties in measuring risks in an organisation (Kleefner et al., 2003). Since ERM is a relatively recent activity and has yet to be fully implemented in most companies, there has been little academic research about its accomplishments and about the obstacles to further progress. In particular, very little has been published about corporate attempts to identify and manage corporate strategic risks while integrating them into a corporate-wide ERM framework (Gates, 2006).

3.0 Proposed Framework

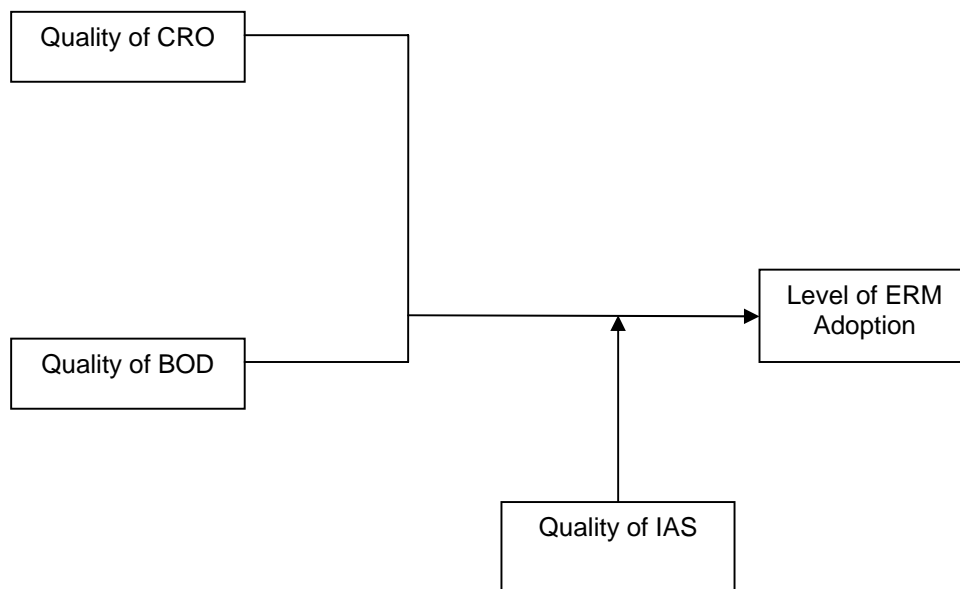
This paper will examine the level of ERM adoption by GLCs. In addition, the current status of ERM will be examined. According to the literature, the level of ERM adoption is influenced by several factors, namely, the Quality of CRO and the Quality of BODs (Beasley et al., 2005; Sobel, 2005). At the same time, the Quality of IAS also affects the practice of ERM. Hence, the proposed framework is as follows:

$$LO = f(QCRO, QBODs, IAS)$$

where

LO	= level of ERM adoption
QCRO	= quality of CRO
QBODs	= quality of BODs
IAS	= quality of IAS

Figure 1: Conceptual Framework



3.1 Quality Of Chief Risk Officer (QCRO)

Proponent of ERM agree that firms choosing to adopt ERM strategy need a person or group of person responsible for the coordination of the ERM program and the communication of goals and results to the board. The COSO Report (2004) on ERM defines the role of the Chief Risk Officer (CRO) as one working with other managers in establishing effective risk management and who has responsibility for monitoring progress and for assisting other managers in reporting relevant risk information up, down and across the entity. Unlike traditional risk manager, Thiessen et al. (2001) articulated that CROs are typically board level appointees who report directly to the CEO or CFO. These individuals often hold advanced degrees and possess a high level of technical expertise such as the CRO will be responsible for identifying, assessing, reporting and supporting the management of risk issues. Lee and Shimpi (2005) affirmed that current practice suggests senior managers do not automatically come from the ranks of existing risk managers. In fact, management looks for a CRO from a wide variety of disciplines; internal audit, strategic planning, finance, actuarial and risk management.

The position of CRO also requires a person instilled with certain requisite qualities. COSO (2004) proposed that to be a quality CRO, a person need to have an ability to serve as an advisor to CEO, in depth industry experience, integrity and credibility to communicate with business leader, regulators and other stakeholders, comprehensive risk management experience, excellence in managerial skills and able to motivate and lead a diverse group of professional with varying background, quick thinker, strong negotiation skills, strategic thinker and ability to effectively formulate policy to meet strategic objective. COSO (2004) also outlines the CRO job description whereby the CRO are responsible to ensure that the Risk Committee of the board fulfills its responsibilities as stated in its charter. The CRO must communicate and manage the establishment and ongoing maintenance of ERM pursuant to the corporation's risk management vision. The CRO also need to ensure proper risk management ownership by business unit CEOs and effective oversights by regional/business boards. Subsequently, the CRO require communicating with the risk committee regarding the status of ERM. Furthermore, the CRO need to promote the ERM model to the CEO and business unit heads and assist in integrating into their business plans and ongoing reporting. In addition, the CRO must ensure a risk management capability is developed and maintained in all business unit and enterprises, including new acquisitions and joint venture investment.

Adjacent to the CRO duties, COSO (2007) articulated that CRO also has specific duties as follows:

1. develops integrated procedures to report major risks to the board member
2. regularly meets senior executives to promote imbedding risk management into daily activities
3. develops a standardized risk information model to the firm

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4. maintains a cost benefit focus on ERM
5. ensures employees are educated about risk management
6. works with unit leaders to ensure risk identification included in business plans
7. works with unit leaders to ensure the most significant risk compliance with the organization's standards.

As been pointed out before, the announcement of a new CRO appointment is a signal that the firm is establishing an ERM program. According to Liebenberg and Hoyt (2003), many researchers are relying on survey data for a signal of the existence of ERM program. One such signal may come from the creation of a specialized managerial position, the CRO, which is responsible for ERM implementation and coordination. Many researchers concluded that the presence of a CRO is associated with a greater stage of ERM adoption (Beasley et al., 2005). Unfortunately, it cannot be said directly whether CEOs, CFOs, risk managers or risk committee are in fact charged with the ERM responsibility. However, by observing firms that have appointed CROs one can reasonably infer that these firms are engaging in ERM. Based on the above literature, the study hypothesizes that,

H1: There is a positive relationship between Quality of CRO and Level of ERM Adoption

3.2 Quality Of Board Of Directors (QBODs)

It is important to organization to elect a leadership team that fits the current business like. Then, in deciding on the variety of board members to be elected, stakeholders should consult the business' ERM initiative, which highlights the most significant risks that require dynamic leadership (Rosa, 2006). Furthermore, COSO (2004) suggests that in the first component in ERM, which is the internal environment, it provides discipline and structure and it is the basis for the other seven components of the framework, encompasses the responsibilities of the board of directors and the role sound organizational culture plays. Much guidance has been prepared in recent years on what constitutes an effective board. Berghe and Levrau (2004) stated that the board size, board composition and board leadership structure are three main criteria for good boards of directors.

Boards size is one of the well studied board characteristics from two different perspectives. First, the number of directors may influence the board functioning and hence corporate performance. Second, researchers have started to study board of directors as decision making groups by integrating literature on group dynamics and workgroup effectiveness. Hence, board size can have both positive and negative effects on board performance. Larger boards are more difficult to coordinate and may experience problem with communication and organization. Besides, large boards may face decreased levels of motivation and

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participation and are prone to develop factions and coalitions. Boards also need to consider how they can structure themselves to support good governance and risk management. Farrell (2004) makes the case that rather than responsibility for internal control being delegated to an organization's financial group, responsibility for evaluation of risk and control should be done by those most directly involved in each process of daily operation.

ERM involves in setting risk appetite policy, determining organizational structure and establishing corporate culture and values. These three tasks are closely allied to the work of the board. With ERM, in place it can be more easily communicated to the employees and further increase the transparency of management. According to Brancato et al. (2006) found that many directors believe they have a good handle on the risks their companies face but since many directors tend to approach risk more on a case by case basis, they may have adequately robust and systematic ERM processes in place. Therefore, based on the above literature, the study hypothesizes that:

H2: There is a positive relationship between Quality of BOD and level of ERM adoption

3.3 Quality Of Internal Audit Support (QIAS)

According to the Institute of Internal Auditors Malaysia (2002), internal audit can be defined as "an independent, objective assurance and assurance consulting activity designed to add value and improved an organization's operations. It helps an organization accomplish its objectives by bringing a systematic, disciplined approach to evaluate and improve the effectiveness of risk management, control and governance processes". Most internal auditors will acknowledge that their function is the right choice for the risk management job. Internal auditors, almost by definition, already possess good risk assessment skill sets and most have a reasonably broad understanding of risk principles (Hespenheide & Funston, 2006).

In recent years, internal audit has been called upon to help implement COSO, lead to quality initiatives, advice on IT improvement and root out fraud. Today, another undertaking has landed on the function's doorstep: ERM (Hespenheide & Funston, 2006). As a result, internal auditing has moved from a control based approach to one that focuses on risk management, corporate governance and adding value (Walker et al., 2003). Under this broadened orientation, internal auditors help organizations identify and evaluate risks, moving the profession to the front line of risk management. Therefore, internal auditors are in a position to make significant contribution to the ERM process and add value to ERM implementations.

The extent of internal audit involvement in ERM is receiving attention and is the focus of recent controversy. The COSO ERM framework lays out key elements of

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a process for managing all types of risk and released the final version of its ERM framework which outlines internal auditing role in supporting ERM. It calls for internal audit functions to 'assist management and the board of directors or audit committee by examining, evaluating, reporting on and recommending improvements to the adequacy and effectiveness of the entity's ERM process' (Beasley et al., 2006). This is consistent with the IIA's definition of internal auditing which specially mentions 'risk management, control and governance processes' as elements of internal auditor responsibilities. Thus, the following hypothesis is advanced:

H3a: Quality of Internal Audit Support will positively influence the relationship between Quality of CRO and the Level of ERM Adoption.

H3b: Quality of Internal Audit Support will positively influence the relationship between Quality of BOD and the Level of ERM Adoption.

4.0 Conclusion

In summary, this paper explains the relationship between the level of ERM adoption with factors that influence ERM practices by Malaysian GLCs. As suggested, several factors that might influence ERM practices are the quality of CRO and BODs as well as the quality of IAS as the moderating factor. Four hypotheses are developed under the proposed framework and need to be tested empirically. Hence, this study intends to add to the existing pool of research being done in the area of ERM adoption from the perspective of a developing country. Reflecting on the lack of empirical research in this area of study coming from this region, this study will also be able to contribute to the literature of ERM adoption in Malaysia.

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