Financial Risk Management: A Tool in Corporate Governance

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Abstract

Financial risk management is a vital tool in ensuring corporate governance is successful. Corporations have incurred losses due to inefficient financial risk management strategies. It is important for corporate governance to use risk assessment and management models or systems with proper balances and checks, and in an independent manner without external, internal, or personal interests influencing the process. An array of financial risk models can be utilized in the identification, assessment and the prioritization of risks within a corporation. The aim of this paper is to research on different financial risk models, analyse, and establish their role as an indispensable tool in managing financial risks in corporate governance. The study researched empirical data to find out financial risk models and their role in financial risk management as applicable in corporate governance. The findings show that financial risk management helps in identifying, assessing and putting priority of the financial risks that the organization is likely to come across and putting strategies on how to stop, manage or counter them. However, the process works bilaterally in case of corporations because both financial risk management and corporate governance have a reciprocal relationship where they depend on each other for the success of a corporation regardless of the financial risk model utilised. Financial risk management is a tool in good corporate governance and this is essential through proper controls over financial risk management. There is limited research in comparing effectiveness of different strategies and financial risk models; therefore, it is an area worth being ventured into for future research.

Key Words: *Corporation, Governance, Financial risk, Models, Management*

1. Introduction

This section introduces us to the research study. It consists of sections that discuss the background of the research, significance of the research, research rationale, scope, questions, hypotheses, aim, and objectives.

1.1 Background of the Research

Most corporations often fail in the management of the risks within the organization especially those related with finances (Choi and Powers, 2002). The failures in corporate governance, in an organization, point to the weakness of the financial risk management tool, as a system that can be used to guarantee accountability in the management (Davies and Schlitzer 2008; IMF, 2008). Present firms and enterprises have in most cases appreciated the essence of having a prudent financial risk management tool as a guarantee to corporate governance. This is based on the realization that the management of risks comes from the fact that they operate in an uncertain environment that would require the economical use of resources in the reduction, monitoring and controlling the likelihood of occurrence, and/or impact of unplanned but undesirable events. This research paper attempts to analyze different financial risk models and establish their role as an indispensable tool in managing financial risks in corporate governance.

1.2 Significance of the Research

Corporations and other entities modeled under a corporate culture are important in any economic order and usually endeavor to streamline their activities to ensure that they do not suffer from either anticipated or non-anticipated risks that may reduce their competitive advantage. This research paper seeks to analyze how the corporate organizations can use different financial risk models as a means of ensuring that they are properly governed. The implication of this research is that it would help corporate managers of corporations with the requisite tools and knowledge on financial risk management and its implementation to guarantee corporate governance. This study therefore lays a significant basis for corporate governance using different financial risk models that have had limited application in previous studies but remain effective in a competitive business world.

1.3 Research Rationale

A working financial risk management tool is important in ensuring success of corporate governance in any institution. Notwithstanding this, there has been no consensus in relation to the right financial risk management model that should be applied by corporate organizations. This research paper is therefore justified as it offers the corporate organizations to analyze and make a choice of the best financial risk management model that they can apply in order to enhance corporate governance within their entities. To a greater extent, the discussed and analyzed financial risk management models are effective tools in corporate governance in modern-era firms.

1.4 Scope of the Research

This research study covered different financial risk management models and how they enhance corporate governance. The concentration of this study will be on the International Organization for Standardization (ISO/DIS 31000, 2008) financial risk management model that comprises on the five activities to establish the context of risk, risk assessment which is composed of identifying risks, analyzing risks and evaluating risks, risk treatment, communication and consultation, and monitoring and controlling risk events. In addition, this research paper will discuss the Enterprise-wide Risk Management model that manages risk in a sequential manner involving eight steps that include: Establishing the context, identifying, analyzing, evaluating, developing the risk mitigation strategy, monitoring and Reviewing the risk mitigation strategy, quantifying the risks, and consulting and communicating the risk (Anderson and Terp, 2006; Carey, 2001; Choi and Powers, 2002; DeLoach, 2004; IMF, 2008; Davies and Schlitzer, 2008; ISO/DIS 31000, 2008; and Kendrick, 2009). Therefore, the study will involve the analysis of financial risk management using the two models and identify their efficacy in corporate governance. Further, the findings of the study will be compared with the available scholarly articles obtained in the literature review in order to make reliable and viable conclusions.

1.5 Research Questions

The research will address the following questions:

1. Does having a financial risk management tool enhance corporate governance?
2. What are the implications of not having a financial risk management on the corporate governance of the organization?
3. How can financial risk management tools help in the identification, assessment and prioritization of risks?
4. How can the identification, assessment and prioritization of risks help in stopping, countering and management of the risks within the organization?

1.6 Research Hypothesis

H1 A financial risk management tool fosters corporate governance in organizations.

H2 Financial risk management tools help in identifying, assessing and putting priority of the financial risks that the organization is likely to come across.

H3 Financial risk management tools help in the stopping, management and the countering of risks.

1.7 Research Aim and Objectives

The aim of the research is to analyse the importance of financial risk management tools in corporate governance and give a recommendation on the most desirable model that can be adopted by these entities in their day to day activities.

Objectives of the research will be:

1. To find out if financial risk management tools enhance corporate governance.
2. To find out if the financial risk management tool can help in the identification, assessment and the prioritization of the financial risks that can be incurred by the organization.
3. To find out how the financial risk management tools can be used in stopping, managing and countering of risks.

2. Research Methodology

This section provides insights on the research methodology and the most appropriate methods used in the carrying out of this study. It consists of sections covering the research purpose, study design, empirical evidence, theoretical modelling, ethical considerations, and challenges encountered in the course of the study.

2.1 Research Purpose

This research aims at showing the importance of risk management tools in corporate governance. It being a descriptive research, it attempts to provide a description of different aspects that have a correlation with the situations or events within an organization, in this case financial risks. Therefore, the purpose of having such a study would be to generalize the outcomes so as to develop theories. Further, it takes the form of a descriptive research as the researcher only possess adequate knowledge about the problem in question and there is limited intention to find out the relations between the causes and effects of the problem. I will adopt this approach as secondary data will be involved in the investigation of the problems to be solved by this research study. For this study, secondary data will be derived from the literature review section and theories from these used to support the empirical evidence.

2.2 Study Design

This study incorporates the theoretical study design and the empirical research design. The theoretical study design involves the creation of different mathematical models while the empirical research design will involve the use of the scholarly articles and books as a means of lending credence to the assertions therein. The pros of adopting such a design is that it takes less time in adoption and implementation, is cheap and makes it easier to compare data in order to come up with reliable and valid findings.

3. Empirical Evidence

The empirical evidence section takes a careful observation of the wide body of knowledge that discusses financial risk management and corporate governance. This will be derived from a review of relevant literature from scholarly articles, peer-reviewed articles and books and a comparison made with the evidence from the methodology section in order to make reliable and valid assertions.

In corporate circles, corporate governance refers to the performance of the right activities in the right manner for the organization in an independent manner without the influence of the personal interests of the individual charged with such activities (Zimmerli, Richter, and Holzinger, 2007). However, risk management that often involves the management of risks that have financial implications on the organization refers to the assessment, identification, and prioritization of the risks that the organization might encounter in its operations (Kendrick, 2009).

Over time, risk management has become a focal point in corporate governance especially in the financial sector where there is a high level of uncertainty and volatility. This is because the financial sector is the most exposed to risks. Due to this reason the financial sector remains the sector that widely adopts a financial risk management tool in corporate governance (Carey, 2001). In corporate governance parlance, risks are defined by the probability that they bring an adverse effect on the profitability of several but different sources of uncertainty. These risks may be systematic that refers to those risks that are entrenched within the system or the entire market or they may be unsystematic that involves risks that are associated with the individual assets of the organization and are a bit easier to avoid through diversification.

Risk management seeks to eliminate, reduce or control the risks while at the same time enhancing the benefits and avoiding detrimental effects that may come about due to the speculative exposures (Anderson and Terp, 2006). This implies that the major aim of financial risk management is to maximize on the potential for the corporation succeeding, offer security, and reduce the potential of incurring losses. In addition, risk management may be defined as the process that is adopted by the management of an organization that entails the application of strategy that identifies the events that may affect it and manage the risks. The purpose of this is usually to minimize the likelihood of the occurrence of the risk and the negative impacts that may result according to the impacts (Partnerships, 2005).

The management of risks also involves the identification, measurement, monitoring and the controlling of risks in order to ensure that an individual charged with the management of a corporation understands it and fulfills the business strategy and objectives (Partnerships, 2005). Therefore, the management of the financial risk involves the elimination, reduction and the controlling of risks that requires that there is the identification, analysis, measuring, monitoring and the controlling of risks within the entity. In order to understand to formulate financial risk management models, it would therefore be important to have a better understanding of the concept of risk management and the role it plays in corporate governance.

There have been different models that have been used in effecting financial risk management within corporations. The first is the Enterprise-wide Risk Management Guideline model that manages risk according to eight steps that include establishing the context, identifying, analyzing, evaluating, developing the risk mitigation strategy, monitoring and Reviewing the risk mitigation strategy, quantifying the risks, and consulting and communicating the risk (Anderson and Terp, 2006; Choi and Powers, 2002; Carey, 2001; Davies and Schlitzer, 2008; DeLoach, 2004; IMF, 2008; ISO/DIS 31000, 2008; Kendrick, 2009; Partnerships, 2005). The other model that has become quite popular is the ISO/DIS 31000, 2008 that has a process comprising five activities aimed at establishing the context of risk, risk assessment that identifies the risks, analyzes and evaluates them, risk treatment, communication and consultation, and monitoring and controlling risk events.

Figure 1: ISO/DIS 31000 (2008) Risk Management Model

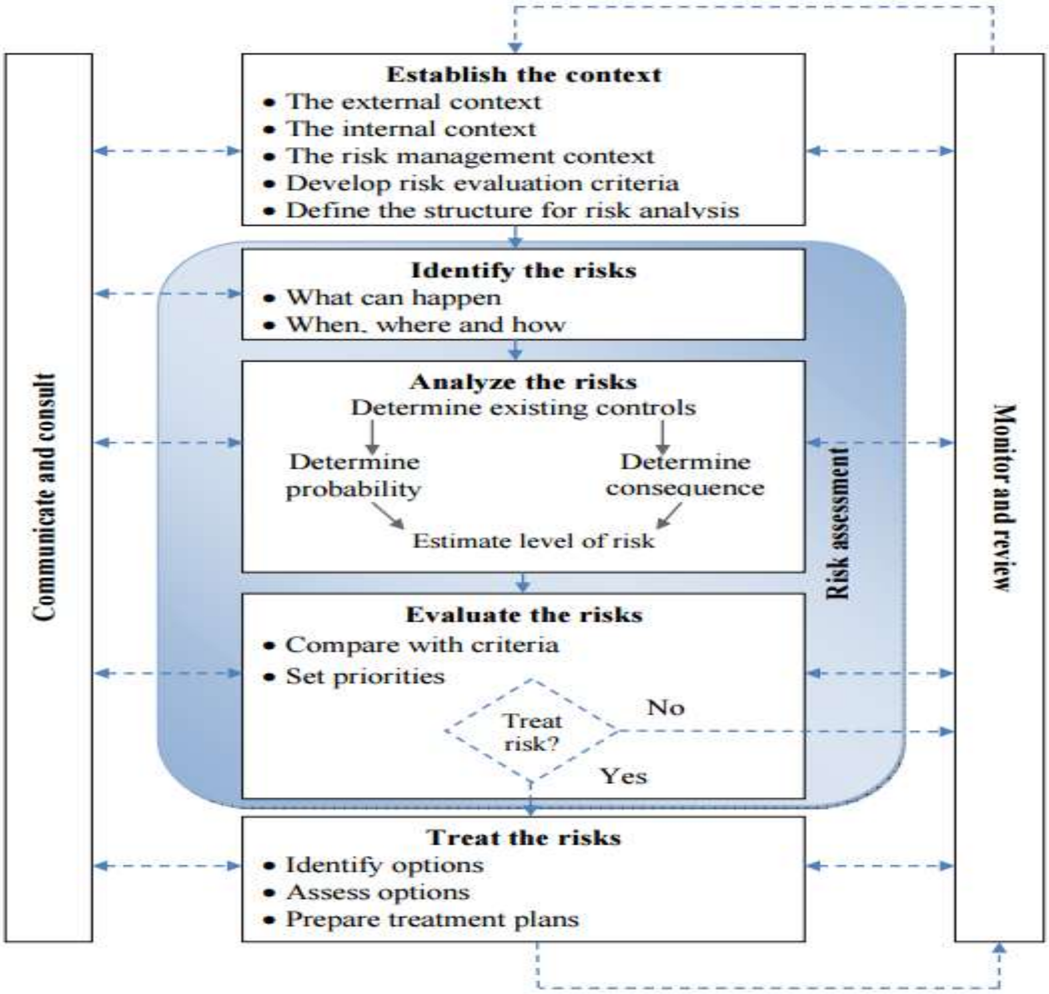
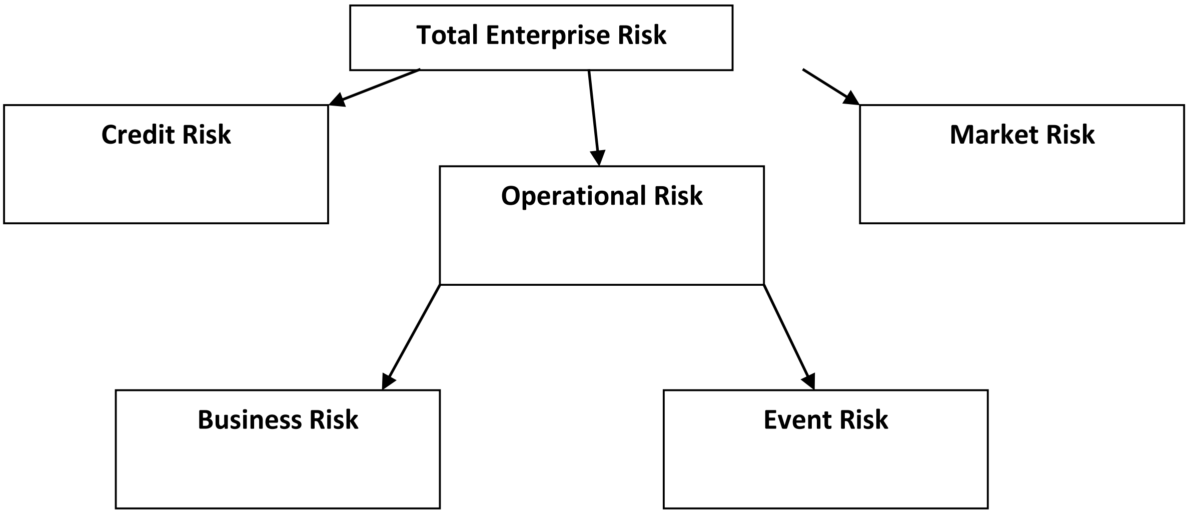


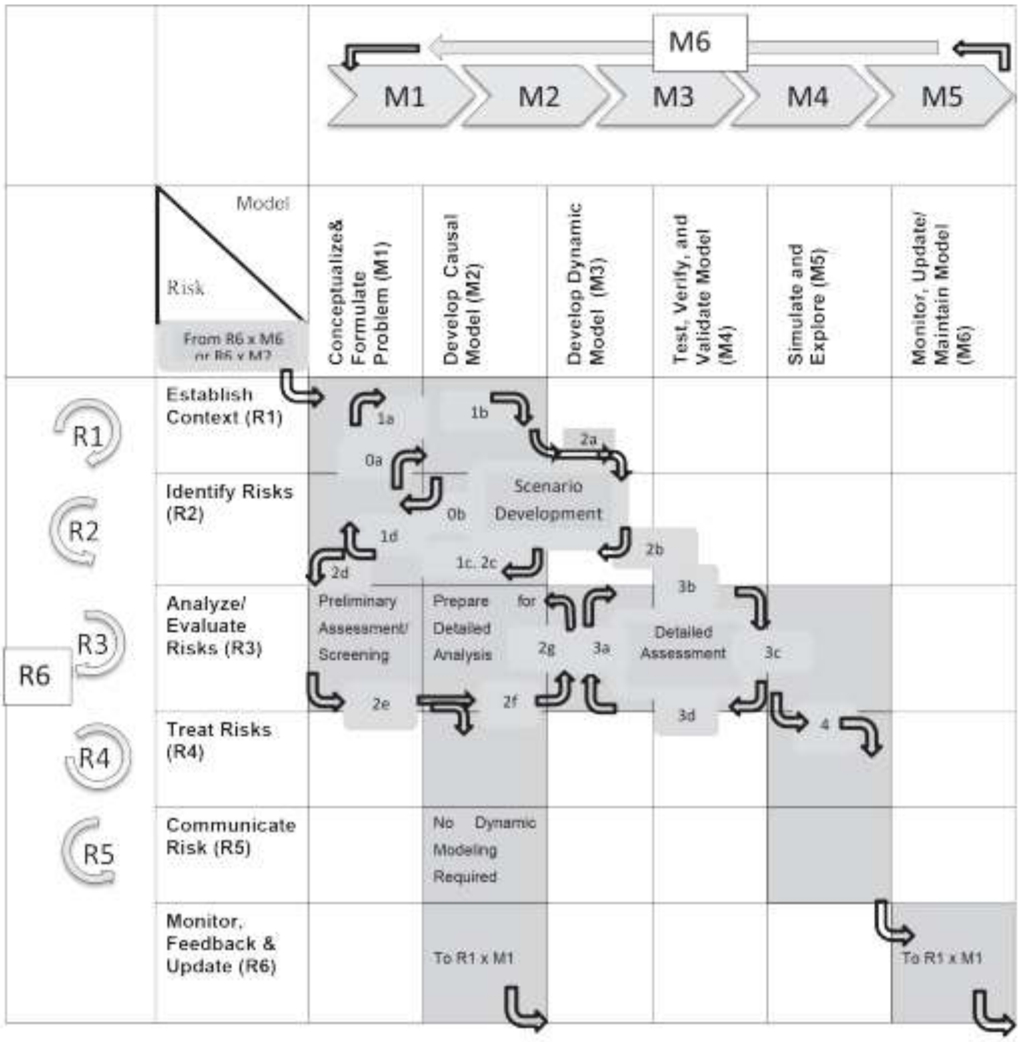
Figure 2: The Enterprise Risk Model



In this study, the researcher adopts the ISO/DIS 31000 (2008) Risk Management Model that consists of seven iterative sub-processes as shown in figure 1 above. According to this model, the first step of risk management is to communicate and consult in order to identify the entities that should be involved in the assessment, identification, analysis and evaluation of the risk as well as its subsequent monitoring. Establishing the context is the second stage and it helps the organization to define the parameters that must be considered in the management of the risks as well as setting the risk criteria for the remaining phases of risk management.

Further, there is the risk identification that reveals and determines the likelihood of the risks occurring and their frequency. This step is important as it helps in the effective management of the risks. Further, there is the analysis of the risk that evaluates the potential impact of exposure and the likelihood of the said outcome occurring. From this point, there is the evaluation of the risk to find out how tolerant the organization will be as well as the risk appetite in order to make sense in specific situations that require prompt decision making. The sixth step will involve the risk treatment that involves the selection and the implementation of the options that can be used to treat the risk. Finally, it would be important to monitor and review the risks so that the risk priorities are adhered to and ensure the successful implementation of the risk in order to promote corporate governance. The financial risk management can also be approached as in figure 2, where all the constituents and processes are analyzed for any risk. These can be modeled into different models as illustrated in the figure below (Figure 3).

Figure 3: Matrix of Interaction between Risk Management and Modeling Processes (ISO/DIS 31000, 2008)



3.1 Mathematical Modeling Analysis

Measuring the efficacy of financial risk management in corporate governance in corporations is important as has been explained in the empirical analysis. In corporations, having an effective risk management model depends on the probability of risks occurring that affects the profitability. In order to test the efficacy of the financial modeling, the study adopts the empirical studies that can be found in the reviewed literature.

A confirmatory factor analysis (CFA) can be used to show the correlation between risk management and corporate governance. Let x_1 denote the observed indicator that shows the variable for risk management that are viewed as a construct latent variables represented by ξ_1. The CFA model can therefore be written in a matrix form in the equation (1) below.

$$\mathbf{X} = \mathbf{\Lambda}\xi + \boldsymbol{\delta} \tag{1}$$

Where

X denotes the vectors of the observable variables of risk x_1;

Λ is a 12×3 matrix of the λ coefficients that depict the relations between variables **X** and ξ ,

ξ is the vector of latent variables (ξ_1, ξ_2, ξ_3), and

δ is the vector of residuals ($\delta_1, \delta_2, \delta_3, \ldots \delta_{12}$).

The correlation obtained under the CFA shows the frequency of the occurrence of risks in an organization. Further, let y_1, denote the manifest variables for the risk management. With this in mind, the structural financial risk management model can be represented in the two equations:

$$\boldsymbol{\eta} = \mathbf{B}\boldsymbol{\eta} + \boldsymbol{\Gamma}\boldsymbol{\xi} + \boldsymbol{\zeta} \qquad (2);$$

and the measurement model for y is

$$\mathbf{Y} = \boldsymbol{\Lambda}\boldsymbol{\eta} + \boldsymbol{\varepsilon} \qquad (3);$$

Where

Y is a vector of the observable variables ($y_1, y_2, \ldots y_{12}$),

η is a vector of the three latent variables,

Λ is a 12×3 matrix of λ coefficients that depict the relations between observable variables **Y** and latent variables **η**,

ε is a vector of the measurement errors ($\varepsilon_1, \varepsilon_2, \varepsilon_3, \ldots \varepsilon_{12}$),

B is a 3×3 matrix of coefficients of **η** variables,

Γ is a 3×1 vector that describes the relationship between the regulation latent variable ξ, and

ζ is a 3×1 vector of equation errors.

3.2 Ethical Considerations

This study was conducted under the ethical considerations of a research study, firstly by seeking the permission of relevant authorities. The literature review contains peer reviewed articles and books that have been consistently used for scholarly purposes. These texts have been referenced in the bibliography in order to conform to policy against plagiarism.

3.3 Challenges Encountered

This research study encountered challenges such as the possibility of the literature review not correlating with the findings of the modeling and empirical evidence. It was also time consuming to obtain the peer reviewed articles on the topic as researchers continue to explore the field of risk management and corporate governance. The sum total of these made the study take a considerably more time in its accomplishment.

4. Results and Analysis

Based on the model above, this study confirms the hypothesized structure for risk management through the confirmatory factor analysis (CFA). The results indicate that the net effects of financial risk management in the governance of corporations. However, with sufficient information to carry out an estimate, this study has used the model above to show the effects between the two variables on risk management. The results show that risk management has a positive effect on the corporate governance of a corporation. It is noteworthy that the net effect of risk management on a corporation leads to consistently positive direct effects on the running of an entity.

It was therefore found that the financial risk management model adopted in this study is important in the corporate governance of an organization, hence confirming the three hypotheses. Firstly, the study confirmed **H1** that hypothesized that a financial risk management tool fosters corporate governance in organizations. Similarly, the results confirmed **H2** that hypothesized that a financial risk management tools help in identifying, assessing and putting priority of the financial risks that the organization is likely to come across. Further, the results confirmed **H3** that states that a financial risk management tools help in the stopping, management and the countering of risks.

5. Discussion

The aim of the research was to analyse the importance of financial risk management as a tool in corporate governance and give recommendations on the most desirable model that can be adopted by these entities in their day to day activities. The aim was achieved by answering the research questions. It was found that having a financial risk management tool enhances corporate governance, and negative implications that can result in corporate governance failure are common in the absence of financial risk management in an organization. Financial risk management help in the identification, assessment and prioritization of risks, which is indispensable in stopping, countering and managing of the financial risks within the organization. A financial risk management tool fosters corporate governance in organizations. The hypothesis; financial risk management as a tool helps in identifying, assessing and putting priority of the financial risks that the organization is likely to come across; and financial risk management helps in the stopping, management and the countering of risks were confirmed to be true.

The results under the financial risk management model above shows that risk management is important in the corporate governance of an organization. This is because it helps in the identification, assessment and the prioritization of the risks that the organization is likely to encounter and putting strategies on how to stop, manage or counter them. From the results it can be showed that risk management can help the organization to structure its processes so that they are consistent with the corporate strategy of the organization and possess the quality of integrity. This confirms the notion that risk management and corporate governance are interrelated in that they help organizations to implementation consistent internal control structures to manage the risks. In addition, having a functional risk management model has been shown to help in the coordination of the risks, ensuring of the consistency and the collation of the risk management processes. From this, the research confirms that a robust corporate governance structure is dependent on the management of risks as the information about risks within the organization can be acted upon promptly to maintain the efficacy of the systems and processes within the organization. The findings were compared and confirmed with available body of evidence.

6. Conclusion

This research study has shown that in practice, the identification and collation of risks in corporations can help in the realization of the corporate. This is because the coherent assessment of the risks that an organization is likely to meet or encounter helps it to steer clear of threats as they occur, before they occur and their management when they occur. Therefore, financial risk management is an integral part of an entity in that it ensures that there are appropriate corporate governance practices that are meant to propel the organization to better performance in terms of revenue, profitability and the reputation or the image.

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