Empirical Examination of Enterprise Risk Management's Value Creation Mechanism

FONG-WOON LAI
Department of Management and Humanities
Universiti Teknologi PETRONAS
32610 Bandar Seri Iskandar, Perak Darul Ridzuan,
Malaysia
laifongwoon@petronas.com.my http://www.utp.edu.my/

Abstract: - This paper espouses an enterprise risk management (ERM) implementation framework which encompasses 3 dimensions that comprised of 7 areas, which in turn, made up of 14 elements. This paper also empirically examines the value creation transmission mechanism of ERM implementation. Unlike the neo-classical finance theory, the espoused ERM framework underscores the idea of managing firms' unsystematic (specific) risk that leads to the enhancement of shareholders' value. The mechanism through which the firms' value enhancement takes place is theorized by a strategic conceptualization of risk premium model. The model cites managing the firm's four classes of risks, namely macroeconomic, tactical, strategic, and normative risks. Hence, this paper investigates the validity of the theorized value creation transmission mechanism of the proposed ERM framework via the strategic conceptualization of risk premium model.

Key-Words: - CAPM, enterprise risk management, value creation mechanism, strategic risk premium

1 Introduction

This paper posits that implementation of enterprise risk management (ERM) program by firms can create value for shareholders with the notion of managing firms' systematic and unsystematic (specific) risk via an ERM implementation framework that leads to the enhancement of shareholders' value. The mechanism through which the firms' value enhancement takes place is theorized by a strategic conceptualization of risk premium model. The model cites managing the firm's macroeconomic (systematic) risk as well as three classes of unsystematic risk, namely tactical risk, strategic risk, and normative risk. Hence, this paper investigates the validity of the theorized value creation transmission mechanism of an ERM implementation framework underpinned by the strategic risk premium model.

The ERM conceptual framework is such that its implementation will lead to some tangible and intangible benefits to the firm in ways of optimizing the risk/return profile of the company, reducing earning volatility, strengthening management's confidence in business operations and risk monitoring, creating smooth governance procedures, enriching corporate reputation, improving clarity of Organization-wide decision making and chain of command, encouraging corporate entrepreneurship, and boosting enterprise's profitability [1] [2] [3]. These benefits derived from ERM implementation, in turn, will define the distinctive competitiveness of the firm.

The above benefits will lead to lower cost of capital and contribute to improved business performance, i.e. improved price-to-earnings ratio of share price. The lowering of cost of capital is due to risk premium reduction as a result of the firm lowering its systematic and idiosyncratic or unsystematic risk profile. The improved price-to-earning ratio of the firm's share prices on the other hand, happens because investors are willing to pay a higher price for the company's share at a given level of earning-per-share (EPS) due to the firm's perceived lower risk profile. These two causal relationships represent the value creation from ERM program.

2 The Proposed ERM Implementation Framework

We propose an ERM implementation framework to encompass 3 dimensions (i.e. structure, governance