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# The Impact of Risk Management on Organization Efficiency

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## ABSTRACT

Risk management is receiving much attention, as it is seen as a method to improve cost, schedule, and technical performance of new products. However, there is a lack of empirical research that investigates the effective integration of specific risk management practices proposed by various standards with new products and their association with various dimensions of risk management success. Due to globalization and intense competition, risks are increasing and risk management is becoming an integral part for the success of almost every organization. The complexity of the industrial activities and the important mass of flows crossing the supply chain promotes the emergence of risks that must be considered in the decision process. This review attempts to contribute in the literature by evaluating the concept and impact of risk management on an organization efficiency.
Keywords: Risk management, Globalization, Program management, Capital expenditures.

## INTRODUCTION

The current globalization and complex business environment leads many business to think beyond just profitability only. The domino effect of world incidences lead the future to be more dynamics and unpredictable than it was before. Factors such as perpetual perplexity and dynamics in social, political and economic environment [1], strong competition [2], rapid technological advancements [3], and methodological changes in the value chain are among other issues urging for companies to establish strong risk management system.

The collapse of big and trust worthy public companies such as Enron and Lehman brother bank due to accounting fraud and the expansions of systematic corporate scandals were not only a shock for investors, professionals and even academics but also creates doubt on the traditional Risk management and Internal control mechanisms. Risk management is a process by which firms identify measure, prioritize and mitigate the adverse effect of uncertainties [4]. Accordingly, risk management is a systematic approach to alleviate negative consequence of any specific phenomenon. The approach that defines risk from only down perspective could leads to risk aversion.

Risk aversion can be an individualistic behavior but in business it is impossible to avoid all kinds of risk. Most risk taking activities are associated with opportunities. Hence, companies need to be intelligent enough in managing their risks not only to grasp the benefit out of it but also to survive in business. Risk management has strong inspirational effect on the major shareholders to invest more on the organization. This investment is a weapon for the company to provide better business opportunities which ultimately leads to long lasting competitive advantage.

Ineffective risk management results in extra costs and costly lower tail outcomes on both the company and stockholders [5]. Traditionally risk management had two broad concepts. Risk management is the management of adverse effect of risk rather than the opportunities associated with it. The other view is independent management of risks by classifying risk in to different silos [6] [7]. For example the occurrence of one event can have a negative impact on one unit of the entity, but also be an opportunity for another unit of the organization. Traditional risk management however, manages the treat without considering the offsetting effect of the opportunity.

To the contrary to traditional risk management total risk management deals with both potential down turns and exploitation of opportunities due to dynamic phenomena [8]. Hence, in this sense it is possible to define risk management as a systematic and practical method that attempts to holistically understand, measure, evaluate and manage entire risks faced by the company. Though the topic of risk management is an important issue among higher level corporate executives; due to conceptual complexity of risk management, the area has not been explored enough. There are very few empirical studies that have studied the relationship of company performance and total risk management risk management, mostly depending on companies listed on very advanced and highly developed stock markets [9].

On the other hand most articles on the area of risk management focus on measuring the effectiveness of different risk management systems by only examining risk management effectiveness in protecting down turn [10]. This might lead to see risk management as an end by itself, rather than taking it as a means for higher corporate performance.

## Risk management concept

In recent decades the dynamicity and complexity of business environment put up the risk management issue to be the major concern of stakeholders. Risk management is the fastest growing discipline. However, the concept and concern of risk management, the practical and functional behavior of risk management and the major purpose of it, differ based on different perspectives. The concept of risk management in business and considering it as a strategic issue emerged in 19th century [11]. Firm's ability to manage risk, identifying risks which are to be assumed or to be mitigated and making calculated and concrete decisions in this regard, lift up not only the strength of the firm but also the entire economic system of the country. Risk management is an effective method, applied in order to alleviate unwanted effects of exposures and earn optimum benefit from risky situations [12].

Effective Risk management aimed at providing reasonable assurance as to the achievement of company's objectives and helps the company in achieving its financial targets. Effective risk management continuously assesses and identifies risks and reduces surprises that affect the organization. So that, effective and integrated risk management is part and parcel of good organizational governance [13]. On the other hand risk management activity includes providing executives and personnel at different levels of the organization with continuous, relevant and reliable information, and designing practical frameworks and systems to establish the risk management decisions on solid ground.

However, the aim of risk management is not limited only to minimizing risks and risky situations. Rather, having the fact in mind that business is always associated with exposures, the aim of effective risk management is also to maintain balance between risk and return. This enables the risk management process to be both defensive and offensive. Thus, risk management needs to be among the top corporate strategic objectives and it must be managers' permanent concern to balance between risk and opportunities associated with risks [14].

## Risk management and performance

When the company is able to prevent the undesirable effects of external risks and react to the environmental changes, it will be less sensitive to economic consequences of market variation. In other words, when the company effectively manages the risk, it successfully adapts to changes in environmental conditions and profit variation will be decreased [15]. According to previous discussion, the following three reasons clarify that better economic performances result from effective risk management. The three reasons are: Less average rate of capital expenditures [16], Higher cost of contracts, and Increase in company's specific investment.

## Less average capital expenditures

Profit stability reduces company's business risk, increases repayment of debts and stabilizes going concern. Furthermore, when company benefit from low risk, it will access higher borrowing resources and pays less interest expenses. From owners' point of view, when company decreases the risk of bankruptcy, the likeliness of reduction of paid in capital decreases and company would have higher expected future dividends.

On the other hand, less variation of projects' profitability may cause higher inducement of potential investors and consequently better availability of capital with less required rate of return [17]. All these factors will lead to less average cost of capital from lenders and stockholders' equity. Also less financing costs will result in less interest expense and better economic performance. In other words, higher availability of capital can lead to improvement of economic performance. The reason is that higher capital availability increases the available investment opportunities to the company.

**Higher contract costs**

Although, investors have reasonable chance of adjusting and updating their portfolios, but such possibility does not exist for other company's stakeholders like customers and employees. In addition, in small companies that hold small portion of capital market, there is little possibility for investors to change and update their investment portfolios. Because in such companies volume of stock supply will influence the stock price and may lead to excessive decrease of price and cause stockholders a heavy loss. Therefore, only stockholders of big companies are able to easily change their portfolios [18].

If company does not pay enough attention to risk management, this will affect its relationship with stockholders and consequently harm business transactions. Company's counter parties like suppliers and customers demand higher premium for dealing with the company and this increases company's cost of commercial transactions. For example, suppliers may require company to pay the cost of goods and services immediately or even in some situations the suppliers expect advance payment for goods and services that they offer. Furthermore, since employees think that the company is facing going concern problem, they are not fully committed to their jobs and spend some time in search of new job. Based on the discussion so far there are higher costs in companies that do not manage their risks properly [19].

**Increase in company's specific assets**

When companies' bankruptcy risk Increases, major stockholders are not inclined to provide long-term commitment to company and will cut relations and resources that cause company's appreciation. This is why the company's specific assets are direct resources of activities that enhance company's profitability and appreciation. Hence, if capital is used for other goals, then company will lose potential opportunities [20]. For instance, when company is unable to establish its past commitments in relation to other companies, resources should be spent to other activities.

Effective risk management decreases the probability of occurrence of such conditions and lessens the imposition of losses on stockholders. Therefore, risk management persuades stockholders to invest in companies specific assets. These resources include processes of producing specific products or using certain technologies in industries that use knowledge for productions and services. In addition, such investments that are caused by employees, suppliers, customers and partners are a kind of financial resource that are often rare and valuable and are basis for higher economic value and gaining competitive advantage. Therefore, total risk management reduces bankruptcy risk and decreases risk of company's commitment to customers, suppliers, partners, managers, employees, etc. this lower risk will motivate institutional investors to invest in companies specific assets that provide long-term value for company.

**Benefits of Risk Management**

**Availability of capital at a lesser required rate of return**

Regardless of the difference in the argument, effective risk management minimizes the probability of bankruptcy and reduces the cost of acquiring capital. Effective risk management expected to stabilize earnings. A stabile earning keeps the organization to be prompt enough to repay claims timely which is an indication of a lower company and market risk. This makes easy for the company to access borrowing at a lesser interest rate. A lower volatility of earning may create higher external demand on the company's shares [21] [22].

Potential investors may be encouraged to invest in the company's projects due to the promising facts of less volatility in earning [23] [24] [25]. These all facts potentially lead to lower average cost of capital. Thus, the company can get both debt and equity capital at a lesser expense. The lower average cost of capital on the other turn also results in good company performance. Therefore, it is expected that effective risk management leads to stability in earning and lowering average cost of capital, which ultimately associated with greater company performance.

**Transaction cost**

Poor risk management could jeopardize the company's relationship with its stakeholders. Company's day to day operations are related with its customers, suppliers and other partners. They all are external and the company has little control on them. The frailer in risk management could severely affect the perception of these important elements. This results in higher contractual costs with its stakeholders [26] [27]. Suppliers and customers may engage in negative bargaining process in every transaction that could ultimately increase transaction costs with them. Companies needs to give appropriate concern for improving risk management system in order to satisfy their counter parts such as customers and suppliers there by, a fair and win-win commercial engagement could be reached with all company's counter parts.

**Company's Specific Asset**

Stability in earning also motivates major shareholders to invest more on the company, believing stability in earning would mean a lesser likelihood of bankruptcy and would results in higher expected future dividend and capital gain [28] [29]. Major shareholders could lose their confidence and not willing to provide long-term commitment with the company if the company does not manage its risk properly and shows bankruptcy risk indicators. Company's specific assets are the immediate sources to finance company's profitable projects. Hence, inappropriate management of risk could divert this asset and could result in loss of future potential opportunities.

Effective risk Management expected to persuades company's own shareholders to invest more on company's specific assets [30]. The resource could be utilized in improving production line and technological advancement that could directly and/or indirectly boosts company's performance. On the other hand the proper management of risk also persuades company's customers, employees, suppliers and other stakeholders to invest more on company's specific assets [31]. This investment is valuable and a foundation for company's growth and enhancing competitive advantage. In general, integrated and effective risk management enhances company's performance in three dimensions. First, the positive signal of stability in earning facilitates external sources of finance at a lower required rate of return. Second, it facilitates the lower and non-bargaining counter party transaction, thereby reduce costs of transactions. Finally, it boosts company's own shareholders confidence to invest more on the company and motivate company's employees, customers and suppliers for more commitment with the company [32].

## CONCLUSION

There is a positive and significant relationship between total risk management and company performance. Traditional approach to risk management is highly concentrated on defensive side. The defensive approach manifested by limiting the concept and practice of risk management only in protecting the company from down turn or hazards. Companies need to see risk management not only from defensive approach, but also as a key successes factor for sustainability of earnings and improvement in overall performance of the business. Effective risk management has direct implication on the earning performance of the company.

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