

THE ROLE OF RISK MANAGEMENT AND TREATMENT METHODS APPLIED IN TODAY'S ECONOMY

Alexandra Dănciulescu *

Abstract

Risk is one of the biggest and most fascinating challenges of all times for humanity, because of its presence in all fields. Risk management as a component of modern management, has become a main concern for the modern world and one of the “key mechanisms” of economic development, a complex process that includes a series of activities meant to alleviate the impact of risk over business and planned or foreseen results. Risk management in an organization means to determine what risks that should be avoided and what risks should be accepted as they are.

The organization plan for risk management, no matter how good and effective cannot be translated in another organisation. Every plan should be adapted to the company and its field of activity. The article at hand focuses on the role of risk management in the organisation, as well as on the treatment methods used by an organisation.

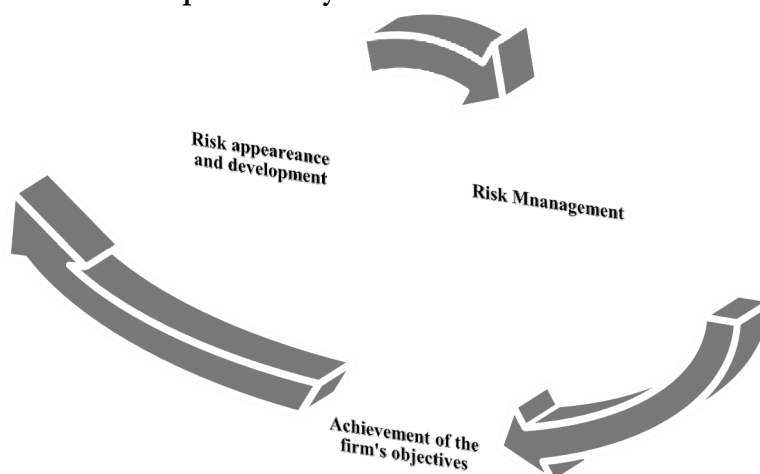
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The purpose of each company is reflected by the way that it achieves its mission. Whether it is a public sector company (with whole or state majority capital), or a private sector company that we analyze, its purpose is fulfilled to the extent that it succeeds to achieve its goal.

Since the event risk in the firm may result in extreme bankruptcy, it is necessary to define a risk protection instrument by which any firm can operate and achieve their goals. This instrument is called risk management and consists both in preventing and minimizing the occurrence of events that may affect the company's activity and may depart from achieving its mission as well as in the process of identifying, evaluating and quantifying them as shown in Figure 1.

* Alexandra Dănciulescu is at the Romanian American University in Bucharest.

Figure 1: The steps taken by the firm in order to achieve its mission

Risk management is how the negative effects of event risk is managed and how the potential opportunities are exploited. For example¹, the company must take into account the effect of the mortgage crisis, oil prices, and the impact of Chinese and Indian economies in the short term and long term.

Risk management is a central part of the strategic management of any company, represents the process by which companies deal methodically with risks for each activity in order to obtain benefits from all company activities. Risk management focuses on identifying and treating these risks, the main objective being to add value to all company activities.

Risk management increases the probability of success and reduces the probability of failure, and also of the uncertainty of failing to meet the company's objectives.

Risk management should be a continuous and developing process in the company strategy and in its strategy implementing; it should address all past, present and future risks associated with the company's activities.

Popular opinion about risk management was that it would protect the company from loss, avoiding the disadvantages. A more complex approach of risk management would be" that it searches advantages while managing disadvantages".

The International Organization for Standardization (ISO/IEC-International Electro technical Commission, Guide 73), defines risk, in the Risk Management Standard (Risk Management Institute, 2002), like the combination of probabilities of a certain event and its consequences, that is risk management focused on the negative and the positive side of risk.

¹ Paul M.Collier, Fundamentals of Risk Management for Accountants and Managers-Tools and Techniques,Elsevier Ltd, Great Britain, 2009;

Literature defines risk as the threat that an action or event will affect in a negative way the ability of a company to achieve its goals and to successfully execute all its strategies².

In 1921, Frank Knight published the book: *Risk, Uncertainty and Profit*. According to him, risk means the fact that you don't know what will happen in the future, but that you have the possibility to estimate the probabilities while uncertainty means the fact that you don't know the probabilities.

Risk started to be studied in a series of publications like: *The society of risk* (Beck, 1986, translated in 1992), *Risk* (Adams, 1995), *In spite of probabilities* (Bernstein, 1998), and the more recent publication *Organized uncertainty* (Power, 2007).

The International Accounting Federation (IFAC) has published in 1999, a study on *Increasing the wealth of a stakeholder through a better organization of business risk*. The study defined risk as future uncertain events that can influence the strategic, operational and financial objectives of the company. This study translated the negative concept of risk into a positive interpretation that presented risk management as a component generating sustained value of stock.

The report argues that risk management establishes, calibrates and aligns the relationship between risk and profit growth. In a similar way, the Turnbull report (issued by England and Wales Accounting Institute in 1999), now a part of *Combined Code on Corporate Governance* (Financial Council, 2003), defines risk as any event that could affect the performance of a listed company, including social, ethical and circumstantial risk.

The purpose of risk management is to increase the company value. If it is correctly implemented, risk management may represent an effective decision framework for managers. The existence of an efficient risk management leads to:

- increase capital efficiency by setting objective basis of resource allocation;
- reduce spending on intangible risks and exploiting the natural advantages;
- support decision making by identifying areas with potential adverse impact;
- identifying and exploiting those decisions that present economic benefits;
- Building investor confidence by establishing a process to normalize accounting results by protecting them from external influences and also showing proactive assistance system for risk.

Risk management follows these objectives in a company:

- ✓ determines the necessary level of risk capital for the firm;
- ✓ shows effective methods of capital investment and company profit growth;
- ✓ allows favourable capital allocation to business sectors, increasing the performance of these segments;
- ✓ helps the company's management to evaluate alternative structures generating profit;

² Phil Griffiths, *Risk-Based Auditing*, Gower Publishing Limited, Aldershot, England, 1998, a definition by Economist Intelligence Unit, British Government department, pg. 17;

- ✓ provides a method that insures profit for stakeholders depending on the degree of associated risk ;
- ✓ helps to stabilize income by identifying and managing volatile risks;
- ✓ guides the development of a better management strategy for the risks identified;
- ✓ Provides detailed information that increases transparency between interested parties of the company.

The objectives of risk management may suffer alterations, because they have to adapt to the needs of the company, either circumstantial or time lined.

Nowadays economic conditions generated the necessity of an international standard regarding risk management. This was completed by a definitions and terms guide that insured a unique terminology on risk. Later, they were linked by a standard on evaluating risk techniques; together they provide a set of instruments for approaching situations that could prevent achieving their objectives.

ISO 31000-Risk Management-Principles and Guidelines contain the principles, framework and requirements needed to run a management process of any form of risk in a transparent, systematic and credible way within the scope. By implementing ISO 31000, organizations can compare their risk management practices with an internationally recognized benchmark, providing sound principles for an effective management. The standard recommends that organizations implement and continuously improve risk management process as a primary component of the management system. For this standard companies cannot claim certification.

ISO / IEC 31010:2009, Risk management - Risk assessment techniques, was developed by ISO and IEC (International Electro technical Commission) and is a support for the ISO 31000 standard. It provides guidance on selecting and applying of systematic techniques for risk assessment.

Romanian legislation established a structure for organising an enterprise through the following regulations:

- ✓ *Order no. 946/2005* for the approval of the Internal Control Code, including management standards / internal control for public entities and for developing management control systems, as amended and supplemented;
- ✓ *Methodology for the implementation of the standard 11 – “Risk Management” of Order no. 946/2005*, prepared by the Central Harmonization Unit for Financial Management and Control Systems - Ministry of Finance, 2007;
- ✓ *Government Emergency Ordinance no. 90/2008* on statutory audits of annual accounts and consolidated annual financial statements, as amended and supplemented;

- ✓ *Order no. 3055/2009* for the approval of Accounting Regulations according to the European directives.

The development of risk³ management generates a series of advantages for companies:

- Support for business strategies planning;
- Helps achieving companies' goals;
- Improves communication between different levels in the company;
- Promotes progress;
- Offers the certainty of control over the activity performed;
- Leads to operational efficiency;
- Allows understanding of threats for an activity or project.

Companies can avoid this risk but it requires conducting operations in markets that are not exposed to risk. In an open economy this alternative of risk-hedging is unlikely, because even if companies can avoid⁴ direct exposure to risk through business relationships they have, they are inevitably exposed to indirect risk.

To implement the strategy defined by the company on risk is necessary internal organization and establishment of actions that lie on the strategy adopted and the involvement of all employees (the activities and organizational entities, hierarchical levels) in achieving its objectives. Within this activity:

- All causes and possible sources of risk will be identified ;
- All types of risk that could manifest will be identified;
- acceptable levels will be set based on the impact in sizing risk and the likelihood of their event for shaping a common image of the most significant risks;
- target values of key risk indicators will be established ,in order to identify potential risks;
- Treatment measures will be taken for each type of risk manifested measures based on economic and technical arguments, following the impact of the activities throughout the company, and the impact on the external environment. If risks can not be controlled from the inside, then you have to consider different methods of transfer by calling upon insurance or financial market instruments.

Depending on the specific situations that can be applied, there are five distinct categories of risk mitigation strategies⁵:

1. Accepting risks – refers to how the manager understands the risk and its probability of happening, as well as the consequences arising and makes the decision to not remove the risk . This kind of strategy is usually used when the probability of risk appearance is small or/and the consequences arising are insignificant.

³ Cristian Paun, coordinator, Risk Management in International Business, Universitară, 2009,pag.54-55

⁴ Economic Tribune, Romanian economists' publication, editions 42-46, 2007

⁵ Paul Marinescu, Project management, course, Bucharest,2007

2. Avoiding risks –the second strategy used in certain conditions in order to minimize risks. Minimizing risks does not represent avoiding making decisions or eliminating risk from the project. This strategy is used when it is necessary to change the goal or to eliminate a part of the project, a situation that causes interference in the expected activities and the final results; thus considering an act of wisdom from the manager avoiding the risk of accepting certain alterations that could lead to special problems.

3. Risk monitoring and training plan for the unexpected- this process is based on choosing a set of indicators and following them evolve. Planning for an unpredictable situation appeared as an alternative for risk, by preparing a response strategy before the situation happened. Usually these plans are based on response strategies in case of financial risk (budget overrun, unexpected expenses) or technological risk (unforeseen failure of installations and equipment, inaccuracies relating to technology). The ultimate goal of these plans for the unexpected is that in case of major risk situations, the management team should already have a viable response able to avoid blocking the whole business or even bankruptcy. To this regard, these plans can be similar to certain insurance methods of a company when involved in certain projects.

4. Transfer and risk distribution- in activities that involve special risks or use expensive technologies is preferable to ensure them to specialized insurance companies. This process is practically, a risk transfer to another institution that will insure monitoring and controlling risks. When dealing with important projects, with consistent amounts of money every insurance company must reassure itself in order to avoid risk. Thus, a risk transfer exists even when insurance companies are considered.

An important chapter for risk transfer, specific to financial projects is reimbursable expenses⁶. They refer to the payment of work subcontracted to other companies or businesses regarding labour, equipment or materials used. The contract management of reimbursable expenses is similar to team management within a company, requiring a clear direction for its activities, setting tangible results and especially monitoring them.

5. Systematic mitigation of risks – is mainly a complex of methods and strategies meant to decrease risks until they become acceptable. Usually, although they were addressed separately, these mitigation strategies are rarely used individually, the most frequently used form, being that of combining them in order to use a complex strategy, capable of providing an appropriate response in an appropriate amount of time.

Based on this it is hard to identify and indicate a unique method of treatment of a certain risk because each risk is treated in a different way by each company. Especially when the environment is in a continuous change, risks evolve and treatment methods have to change as well.

⁶ John Holliwel, *the Manual of Financial Risk. A Systematic Guide to Identify and Managing Financial Risk*, London; Pitman, 1997, pg.120

Any system of risk treatment should provide as a minimum⁷:

- *effective and efficient operation of the organisation;*
- *effective internal controls;*
- *Compliance with laws and regulations.*

Conclusions

The essence of risk management is not to eliminate risk but to decide what risk can be exploited what risk can be overlooked or avoided.

Risk management of an enterprise is constantly changing as a result of process development by entities like: the Sponsorship Committee of Organizations (COSO), the Risk Management Institute and the Institute of Internal Auditors, as well as academic perspectives that help understanding risk management and its role in today's society.

Specialized firms continue that process by improving the products offered, by trying to beat competitors. The process is also improving through risk managers that develop new instruments and techniques, proving their value through publications and conferences.

The increase of risks and their complexity forced companies to recognize the importance of risk management; they understood that it is better to prevent than to suffer losses.

Risk management's infrastructure is viewed as a process constantly moving, constantly evolving, and allowing making decisions based on probability evaluation and interpretation.

Integrating risk management into the business planning process is an important component of enterprise risk management and ensures that the organization is able to take advantage of emerging opportunities while also being able to deal when something goes wrong. The focus on risk and strategy is that enterprise risk management is primarily concerned with the failure to achieve business objectives. Thus, integrating risk management with strategy leads to a focus on the "performance" rather than "conformance" aspect of risk.

Strategic planning and risk management should not be distinct activities. Strategies to manage risks and enhance opportunities should be incorporated into strategic plans and should be kept up-to-date. Both strategic and risk management plans will support specific projects and actions that provide the basis to take advantage of opportunities.

⁷ A Risk Management Standard, 2002, published by AIRM, the National Forum for Risk Management in the Public Sector, The Institute of Risk Management

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