# MEDIATING EFFECT OF ENTERPRISE RISK MANAGEMENT PRACTICES ON RISK CULTURE AND ORGANIZATIONAL PERFORMANCE

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**ABSTRACT**

*Major organizations around the world agree that managing risk is crucial to survive in this globalized and competitive world. Enterprise Risk Management (ERM) has emerged as a new popular concept of managing organizational risk holistically. Past researches found that adopting and practicing ERM makes an organization more prepared in addressing possible threats. Furthermore, there is also general argument by scholars and researchers that organizations adopting ERM will improve their business performances. Hence, ERM has received a positive response from business leaders and organizations around the world. However, evidence from various studies shows that there are lacking in the practice of ERM among Malaysia organizations. Why is this so? There are various factors that influence ERM adoption and implementation. But several studies indicate that risk culture is one of the important attributes of risk management aspect that board members should comprehend. This is because the implementation of ERM will be unsuccessful without a risk culture awareness being embedded at all level of the organization. As such, this paper aims to propose a conceptual framework to investigate the mediating effect of ERM on organizational culture and firms' business performance among public listed companies in Malaysia. This study will broaden the scope of literature in this area by providing evidence on Malaysian environment and enhancing the frontier of knowledge in this area.*

**Field of Research:** *Enterprise Risk Management, Risk Culture, Organizational Performance*

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## 1. Introduction

Every businesses face a number of risks in their business operations and activities that could present threat in achieving their business objectives .Moreover, the business environment also has become more riskier for businesses to operate; with the advent of technology and internet, globalization, mergers and acquisitions. Furthermore, the news of the collapsed of many large and strong multinational companies over the past few years reveal that ineffective risk management and internal controls as one of the reasons that contribute to this incident (Yazid, Razali and Hussin, 2012). However, the emergence of a popular concept known as Enterprise Risk Management (ERM) is believed to be an effective technique to manage risk and is fast becoming best practice standard (Lam, 2000).

Currently, there is in depth examination on whether the approach to corporate governance through risk management has improved the performance of organizations, both operationally and financially (Fraser and Henry, 2007). Research conducted by Hoyt and Liebenberg (2008) found that Enterprise

Risk Management improve the capital efficiency and return on equity of the organization. This is because the organization are better able to recognize all risks inherent in their business activities and process. However, evidence from various studies shows that there are lacking in the practice of Enterprise Risk Management among Malaysia organizations.

Empirical findings in the study undertaken by Yazid, Razali and Hussin (2008) found that only 18% of manufacturers practice risk management and have implemented Enterprise Risk Management framework in their strategic business operations. Recently, Wan Norhayate (2011) stated that there are about 43% of public listed companies that practiced Enterprise Risk Management. So there is a question arises as to why there are some organizations practice Enterprise Risk Management and the other organizations do not do so. Furthermore, the implementation of Enterprise Risk management in Malaysia is still slow. The Star (7 Dec, 2011) also reported that Malaysia has about 6400 standards but only 5% of these standards were mandatory and this caused many Malaysian organizations that produce products and services to lag behind.

Based on the Agency Theory, Enterprise Risk Management is a mechanism that may overcome agency problem. This is because the idea of risk management has become fundamental to corporate governance and is connected to the organization internal control (Puan Yatim, 2009). Therefore, from an agency theory perspective, the clear implication for corporate governance is that sufficient monitoring or control mechanisms must be created in protecting shareholder values from management's conflict of interest as corporate governance's goal is to maximize the firm's value for stakeholders (Jensen, 1993).

The paper aims to come up with a conceptual framework that contributes in enhancing the frontier of knowledge and understanding of Enterprise Risk Management practices. This is done by investigating the practices of Enterprise Risk Management among public listed companies in Malaysia. Based on this, the objectives of this paper are as follows:

a) To examine the extent of Enterprise Risk Management practices among public listed companies in Malaysia.
b) To examine the relationship between risk culture and organizational performance.
c) To investigate the mediating effect of Enterprise Risk Management practices on risk culture and organizational performance.

## 3. Risk Culture

Levy, Lamarre and Twining (2010) had defined risk culture as "*the norms of behaviour for individuals and groups within an organization that determine the collective ability and understand, openly discuss and act on the organization's current and future risks*". Every organization has a different organizational culture that led the organization towards excellent organizational performance. This has been supported by Shahzad, Luqman, Khan and Shabbir (2012) which they stated that organizational culture has a significant impact towards employee's job performance and this will lead to better productivity thus enhance organizational performance.

Kefela (2010) concur and said that in order for the organization to accomplish their business goals and objectives as well as executing the business strategy; the organizational culture has a considerable impact on it. However, when it comes to implementing Enterprise Risk Management previous studies had identified organizational culture as a barrier and limitation (Kleffner, Lee & Mc Gannon, 2003).

Therefore without a risk conscious culture being embedded at all levels of organization, the large amounts of resources that had been consumed by the organization to implement the enterprise risk management program will be unsuccessful (Rosa, 2006). This has been supported by Kimbrough (2009) where his research result indicates that the organization's culture impacted the enterprise risk management deployments effectiveness and speed. Furthermore, in order to achieve a sound system of Enterprise Risk Management, the board as well as the management must make sure that the risk management framework is embedded into the culture, processes and structures of the company (The Institute of Risk Management, 2012). Moreover, the board has a responsibility to set, communicate and enforce a risk culture that consistently influences, directs and aligns with the strategy and objectives of the business. This led to the following hypothesis,

H1: There is a positive relationship between risk culture and organizational performance

**4. Enterprise Risk Management**

Risk Management is crucial as risk is an essential component of corporate governance (Fong and Samad, 2011). They also reported that businesses today are prone to risk as a result of corporate governance scandals and improper financial management. However, the scope and functions of risk management have increased over time due to rapid environmental changes. In response to these changes, Enterprise Risk Management has received much attention globally (COSO, 2004). Enterprise Risk Management has been defined by The Committee of Sponsoring Organizations of the Treadway Commission (COSO) as *"….a process effected by an entity's board of directors, management and other personnel, applied in a strategy setting and across the enterprise, 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 objectives."*

Beasley, Branson and Hancock (2009) clarify that Enterprise Risk Management is an effective approach as this approach involve a process of identifying, assessing and monitoring risks throughout the organizations. Furthermore, this approach also involve communication procedure to spread this risk information across the organization.

Moreover, organizations which have adopted a more integrated approach namely Enterprise Risk Management in managing enterprise wide risks have experienced significant benefit relating to business performance (Gordon, Loeb and Chih Yang, 2009). Even the International Organization for Standardization (ISO) has seen the importance of risk management towards businesses and had endorsed an international standard for Enterprise Risk Management (ISO 31000:2009). Malaysia also has come out with its own risk management standard known as MS ISO 31000:2010.

Besides, Enterprise Risk Management has been highlighted in the National Integrity Plan (PIN) in order to foster good corporate governance. Based on the above literature, the study hypothesized that,

H2: There is a mediating effect of Enterprise Risk Management practices on risk culture and organizational performance.

## 5. Proposed Framework

This paper intend to examine the extent of Enterprise Risk Management practices among public listed companies in Malaysia. Based on literatures, there are various attributes that become the forces in the risk management adoption and implementation. As such the encouragement from the board of directors and top management (Puan Yatim, 2009) and dedicated chief risk officer (Rochette, 2009). Therefore, this paper proposes a conceptual framework of the relationship between risk culture and organizational performance as well as the mediating effect of Enterprise Risk Management on this relationship.

## 6. Methodology

### 6.1 Sample and data collection method

The target population of the study is the eight industries listed on the main board of Bursa Malaysia. The sample size is 767 organizations consist of consumer products, construction, industrial products, infrastructure, plantations, properties, trading/services and technologies. Financial industry is excluded because they have different rules and approach of ERM. The unit of analysis is the multinational organizations listed on the main board of Bursa Malaysia. Questionnaires with measurement of a seven point likert scale ranging from "strongly disagree (1)" to "strongly agree (7)" will be addressed to the senior management who has direct dealing with Enterprise Risk Management practices in the organization.

### 6.2 Instrumentation

The following Table 1 indicates the measures of the study variables used in the study. The instrument items will be adopted from previous studies by Kimbrough (2006), COSO (2004) and Hoyt and Liebenberg (2008).

Table 1: Instrumentation of the study variables

| Variables | Source of scale | Type of scale |
|---|---|---|
| Risk Culture | Kimbrough (2006) | 7-points Likert scale |
| ERM Practices | COSO (2004) | 7-points Likert scale |
| Organizational Performance | Hoyt & Liebenberg (2008) | 7-points Likert scale |

## 7. Conclusion and Future Recommendation

As a conclusion, this paper conceptual framework explains the significant relationship between risk culture and Enterprise Risk Management and its affect on the organizational performance. There are two hypotheses that need to be tested empirically under the proposed framework. The adoption and implementation of Enterprise Risk Management among Malaysian organizations are still in an early stage. Therefore, this paper is intended to broaden the scope of literature in this area in terms of fostering good corporate governance in line with the National Integrity Plan (PIN). Furthermore, this paper also will provide an insight and understanding in formulating policy for mandatory implementation of Enterprise Risk Management standards as well as a clear benchmark for quality related accreditation in the future. Further researches are recommended to test other factors that may influence the adoption and implementation of Enterprise Risk Management practices. This conceptual paper is subjected to some limitations surrounding similar conceptual academic works.

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