ANALELE UNIVERSITĂȚII
"EFTIMIE MURGU" REȘIȚA
ANUL XV, NR. 1, 2008, ISSN 1453 - 7397

Adina Popa, Nicoleta Farcane, François Fulconis, Ovidiu Megan

Enterprise Risk Management and Disclosure

Our paper deals with aspects regarding risk and uncertainty. Many risk management methods are today implemented in organizations. This perspective reveals that managers are linked in different forms to the activities they are managing, depending on the conditions and levels of uncertainty they are in. Actually, these multiple levels of uncertainty lead to the conclusion that any situation in an organizational system can be classified in two different models of organizational phenomena: the organizational phenomena that are putting managers and stake-holders in conditions of risk and the organizational phenomena that are putting them in condition of uncertainty. Using content analyze in this paper we survey the disclosure level of risk management information in the annual report of top Romanian listed companies.

Keywords: *decision, disclosure, risk, risk management, uncertainty.*

1. Introduction

Mass media is full of examples of organizations recently face "uncertainty". The term "risk" is recurrent. Uncertainty and risk are now the usual vocabulary of the managers; stakeholders are also interested about the risk of the business they are connected to. In terms of risks, stakeholder is any individual, group or organization that may affect, be affected by, or perceive itself to be affected by, a risk. If the first term "uncertainty" is still seen today in a largely negative sense, around the second one "risk" a mythology has been formed, which often leads us away from its first meaning given in management or in political science. Sometimes, these two terms appear to be used interchangeably, especially when we talk about a situation "risky" or "uncertainty". Sometimes, on the contrary, it seems that they can not be confused. In interviews with corporate executives, staff members of the same organizations, we have seen the same ambiguity in their words.

Managers are often confronted with uncertain and risky situations and they have to improve theirs ability to manage and make decisions that take into account

the potential negative impacts that can occur on profits, performance, enterprise value and business goals.

2. Uncertainty and risk: distinction or similarity?

When one hears the words risk or uncertainty, it usually thinks about negative events that could occur. In some cases, there is advanced knowledge and information of the likely occurrence of some negative event. Economists use the terms "risk" and "uncertainty" to define the level of knowledge and information about an event or occurrence. The importance of this knowledge is that it affects how the manager plan what decisions to make, and what tools are at his disposal to use (Alcaras *et al.*, 2004).

"Risk" and "uncertainty" are two basic terms to any decision making framework.

Specifically, *uncertainty* is defined as a situation when the all possible outcomes are not known, all the probability of the outcomes is unknown, or both the outcomes and the probabilities are unknown. Uncertainty refers to those situations and events that there is not enough information for the identification of the probability. Though, the situation is considered uncertainty when there is no information or it is insufficient for identify and anticipate the occurred evolutions.

Any definition of risk is likely to carry an element of subjectivity, depending upon the nature of the risk and to what it is applied. As such there is no all encompassing definition of risk.

Smith (1999) defines *risk* as a decision expressed by a range or possible outcomes with attached probabilities. Risk can be defined as imperfect knowledge where the probabilities of the possible outcomes are known, and uncertainty exists when these probabilities are not known (Hardaker *et al.*, 1997).

Thus, managers have more information and knowledge on what may likely result from a risky event that from an uncertain event. To this point, one might conclude that events are either uncertain or risky.

Referred to the chance of something happening that will have an impact on objectives. A risk is often specified in terms of an event or circumstance and the consequences that may flow from it. Risk is measured in terms of a combination of the consequences of an event and their likelihood.

Probability is defined as the proportion of times that some outcome will occur over the long run if the action is repeated many times under uniform conditions (Mansfield, 1987).

Even though uncertainty and risk are polar extremes, but in the real world many situations have characteristics of both. The probability of an event and the outcomes are the factors that interact for defining the two terms (figure 1).

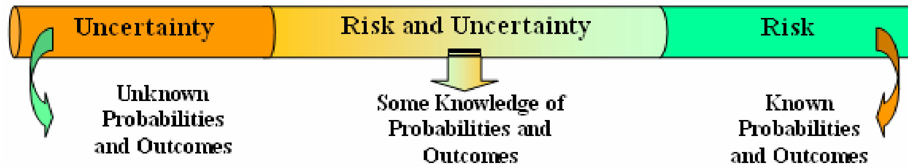

Figure 1. Risk and Uncertainty

The risk refers to situations in which it can identify targets probability for possible outcomes. In other words it can be quantified. Uncertainty refers instead to situations or events about which there is sufficient information to identify probability. Depending on the probability it can be highlighted three categories of cases:

- certainty,
- uncertainty,
- risk.

Risk is situated between the other two categories.

From another point of view and a more common usage of these terms we would state uncertainty as an imperfect knowledge and risk as uncertain consequences. Also terms risk and uncertainty have become interchangeable, and one can often be found in the description of the other.

Beyond planning and proactive approaches, the economy has developed probability models that management has adopted as a technical "decision support". The reduction of uncertainty implies while we opt for a body of specific assumptions. Then the selected decision is the one that maximizes the expected gains. This set of assumptions is not without cause problems in practice. This is the reason why additional methodological issues have been developed on:

- identification of probabilities;
- choice criteria,
- taking into account the decisions of third party (Game Theory);

Economic theories considering the uncertainty as irreducible, even if they give rise to complex models, prohibit assimilation between the two concepts. Knight (1935) highlights the difference between uncertainty and risk. A situation is uncertain in his view if it is characterized by the inability to construct a probability distribution on all possible future events.

The risk (chaos theory) comes from imperfect information of the observer because of its own limitations. On the contrary, the uncertainty comes from an incomplete knowledge purely due to the potential of its object.

3. Management in risk or uncertain conditions

Risk management is becoming an increasingly important activity within firms and organizations.

As a part of the management activities, risk management helps an organization to meet its objectives through the allocation of resources to undertake planning, decision making, and carry out productive activities. *Risk management* is unique in that it focuses on uncertainties that an organization faces: uncertainties in the probability of occurrence of events, uncertainties in the value to the organization of consequences of events, and other uncertainties that fall outside the "normally expected" range of variation. Generally risks are low probability, but high consequence events that can cause major disruption to the organization.

Risk management is a discipline which lies midway between art and science. The interest in aspects "defensive" of risk management ignored the importance of the guiding role of risk management, which promote efficient use of the company risk management capacity and will in many cases have to choose how to allocate this capacity.

The criterion for judging par excellence of a risk management policy is whether it increases shareholder value. A systematic and dynamic use of risk management tools significantly increases the value. This is true not only for tools to identify and assess risks, but also for those who provide information to management to decide what it can cover or reduce risk, what risk transfer or sell, and which risks keep.

It should be a clear call for caution for the leaders and regulators are often inclined to prescribe, codify and standardize risk management techniques.

A rigorously analytical approach to risk measurement is only the imperative one of a good internal political risk management. The other elements were necessary in our view, the degree of risk transparency, timeliness and quality of information, the effectiveness of policies and internal controls, the extent of supervision made by management and independent bodies, the importance of diversification and spreading risk and, finally, judgment and experience of staff who knows the limits of models.

There is a discrepancy between the techniques used to measure and aggregate risks in circumstances "normal" and the methods used to assess the risks induced by extreme events.

The days when organizations were content to measure their market risk by the VAR (Value at Risk) are gone. While now, it is admitted to supplement VAR by various forms of "stress tests", professionals are aware and in agreement on how to conduct these tests rather than on how to use them. It is irrational to evaluate the compromise between risk and performance when extreme events and highly improbable (such as those assumed in "stress tests") receive a probability almost equal to that of ordinary events.

This leads to the thought: we are now significantly more sensitive to the value of liquidity and its fragility, but there are no simple way to integrate this value methods of risk management. In many ways, when they conduct stress tests, risk managers are trying to estimate the potential cost of liquidity in case they should change or transfer their risks in markets disrupted. Experience shows that deal with shocks in the markets (or the sudden bankruptcy of a significant contribution), market prices start to develop in an unusual way, liquidity is reduced, and will even up 'to disappear.

4. Risk management framework and disclosure: the case of Romanian listed companies

Starting from the presumption that risk management, like other management activities, must be practical, cost effective, and help the organization survive and prosper we survey in this section of our paper risk management disclosure of the Top 15 Bucharest Stock Exchange (BSE) Romanian listed companies. A good corporate governance practice faced company with a better disclosure and become more transparent also in the field of risk management.

The growth in risk management is directly linked to the increasing number of risks an organization faces due to more complexity and interactions in the world, greater scrutiny by stakeholders and the media, and so forth.

Risk management is an integral part of the corporate governance arrangements and has been built into the management processes as part of the corporate overall framework to deliver continuous improvement.

Risks are usually described by a list of risks, arranged in priority order with the largest risks first.

A risk management framework is a description of an organizational specific set of functional activities and associated definitions that define the risk management system in an organization and the relationship of the risk management organizational system. A risk management framework defines the processes and the order and timing of processes that will be used to manage risks. A good risk management framework should enhance and improve risk management by:

1. making it more transparent and understandable to stakeholders,
2. making its processes more efficient,
3. allowing for cross fertilization of risk controls, risk estimation, risk assessment from others because of standardization of terms, processes, tools etc.

Finally, risk management must produce a net value for the organization. This value is estimated and reviewed and consists of three basic elements: costs, financial benefits, and trust and respect of stakeholders and the public.

Risk is inherent in any decision, at any level in the organization. As such the risk management framework closely follows the typical management decision-making structure of:

1. identify and assess the situation,

2. consider treatment options,
3. decide,
4. implement management control
5. monitor business decision based risk management framework.

Stakeholder's needs to be better informed regarding the risk and opportunities company is faced with, that's make managers to voluntary or mandatory disclose information regarding risk management, usually as a part of the Annual Report. In this part of our paper we present the results of a survey we conducted on the top 15 BSE listed companies. Using content analyze we investigate the Annual Reports of this companies.

Our findings are:

- Only one Romanian company from Top 15 BVB are not disclosing information regarding risk management,
- 8 companies presents a synthesis of the risk categories that affects their activity during the reported year,
- 6 companies' presents more detailed information regarding their risk management activity.

5. Conclusion

Looking back a moment to the presentation of the problem which this article is intended to provide some answers, it seems that the analysis of literature developed here goes beyond the issue of the distinction between uncertainty and risk. Indeed, the preparation of a research on a specific field sometimes raises questions outnumber those originally asked. If the uncertainty in generic terms, is ignorance or total or partial failure of events, one can, according to the body of assumptions that we adopt, seen as irreducible or reduced as a given intangible, or as the result of a more or less off time.

In trying to give advice the enterprise policy makers we can show that the statistical uncertainty is "the stochastic nature or error from various sources, as described by statistical methodology". The technical consultation defines risk as "the probability of the occurrence of something unfortunate". It is noteworthy that in terms of decision-making theory, the risk is defined as the average loss or forecasted loss when something unfortunate happens.

The process of communication the risk to policy makers is in its infancy and represents major challenges for both technicians and managers. In return, managers and participants must find a way to objectively evaluate the potential costs of adverse events, define acceptable levels of risk and quantify the short-term production to waive that to reduce these risks.

There are no standard methods to reflect the uncertainty and risk to policy makers. The statistics provide a basic set of means to account for variability, which can be used to indicate the uncertainty associated with a specific estimate, or the likelihood that an adverse event occurs. The method choused by managers for

measure the probability of uncertainty and risks will depend on their level of technical knowledge. In most developing countries, it will be important to link the uncertainty of environmental characteristics that are well known. For many economically important stocks, it is justified to try to quantify the uncertainty and risk.

Living without uncertainties resembles a film which systematically knows the end.

It includes stakeholders and managers, who have many cases to confront the type of uncertainty whose management they deserve, in general prefer not to think about the possibility of a crisis as they did not have Instead leaves, if necessary, to delegate the management to specialists. But it is necessary now to prepare for such an eventuality.

Regarding our sample companies we may conclude that the risk management in the majority of Top 15 BSE Romanian listed companies 60% are in an incipient faze of implementation, only 40% of this Top 15 companies have already defined their objectives regarding risk management or already have an integrated system of risk management.

Because our empirical study is limited to a descriptive examination of the level of risk management disclosure in annual reports of the Top 15 BSE companies, some aspects can be mentioned as reason for future research:

- to extent the study to all companies listed on BSE;
- to investigate the level of implementation of risk management by the Romanian listed companies;
- to investigate the association between the risk management disclosure, the investors' behavior and the companies' performance indicators.

References

[1] Alcaras J.R., Gianfaldoni P., Paché G., *Décider dans les organisations – Dialogues critiques entre économie et gestion*, L'Harmattan, Paris – Budapest – Torino, 2004.

[2] Cooper J.C., Selto F.H., " *Is risk preference induction a reliable method of controlling risk preferences ?* ", Journal of Management Accounting Research, vol. 5, 1993, 109-123.

[3] Dymski, G.A., "*Keynesian Uncertainty and Asymmetric Information : Complementary or Contradictory"*, Journal of Post-Keynesian Economics, vol. 16., 1993,

[4] Godlewski Ch . "*Modélisation de la prévision des défaillances bancares : une application aux banques des pays émergents* » document de travail LARGE, Université Robert Schuman Strasbourg, 2003.

[5] Hardaker B. J., Huirne R.B.M., Anderson J.R., *Coping With Risk in Agriculture*, New York: CAB International, 1997.

[6] Horngren C.T., Sundem G.L., Stratton, W.O., *Introduction to Management accounting*, Prentice Hall International Inc., New Jersey, 1999.

[7] Lavoie, M., "*La distinction entre l'incertitude keynésienne et le risque néoclassique*", Economie appliquée, Tome XXXVII, 2, 1985, 493-518
[8] Llewellyn D. "*An Analysis of the Causes of Recent Banking Crises*", The European Journal of Finance 8, 2002, 152-175.
[9] Mansfield E. *Statistics for Business and Economics - Methods and Applications*, W.W. Norton & Company, New York, 1987
[10] Rojas-Suarez, "*Rating banks in emerging markets: what credit rating agencies should learn from financial indicators*", Working paper of Institute of international economics. The Modern Theory of Corporate Finance, McGraw-Hill Inc, New York, 2001.
[11] Smith N. J., *Managing Risk in Construction Projects,* Oxford, Blackwell Science, 1999.

Addresses:

- Lect. Dr. Ec. Adina Popa, "Eftimie Murgu" University of Reşiţa, Faculty of Engineering, Traian Vuia Square 1-4, 320085, Reşiţa, popaasa@yahoo.com
- Prof. Dr. Ec. Nicoleta Farcane, The West University of Timişoara, Str. Pestalozzi, *Faculty of Economics and Business Administration, Romania*, J.H.Pestalozzi 16, 300115, Timişoara, nicoletafarcane@fse.uvt.ro
- Dr., Assistant Professor, François Fulconis, University of Avignon (UAPV), Laboratoire CRET-LOG (Université d'Aix-Marseille 2), IUT d'Avignon, Site Agroparc - BP 1207, 84911 Avignon Cedex 9 (France), francois.fulconis@univ-avignon.fr
- Lect. Dr. Ec. Ovidiu Megan, The West University of Timişoara, Str. Pestalozzi, *Faculty of Economics and Business Administration, Romania*, J.H.Pestalozzi 16, 300115, Timişoara, ovidiu.megan@fse.uvt.ro