

7 Risk Management and Corporate Governance

7.1 Introduction

It is being recognised everywhere that good governance is important for corporate performance. Indeed firms are being expected to make statements about their governance as part of their annual reporting and every corporate website makes a statement about the company's governance procedures. It is easy to claim that this is because of a reaction to all the corporate scandals which we have witnessed in the last decade, starting with the collapse of Enron.

The relationship is direct and the evidence is overwhelming. The evidence is so great that it is clear that investors are increasingly willing to pay a premium to invest in a company with good procedures for its governance. This is because they recognise that this will lead to expected improvements in sustainable performance which will, over time, be reflected in future dividend streams. In other words it is more profitable for an investor to invest in a well governed company and the benefits accrue both in the short term and in the long term.



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There has been much written about globalisation – either positive or negative – and the effects which it is having. One consequence of globalisation though is manifesting itself in the structure and organization of corporations. This is concerned with the harmonisation procedures and structures which will manifest themselves through the emergence of global norms for corporate governance. One factor which is significantly affected by such governance is that of risk assessment and management. Good governance reduces and facilitates the management of risk.

7.2 Attitudes to risk

Risk management has become an important aspect of business management and governance has a role to play in this because a full understanding of corporate governance and its implications can reduce risk. In terms of their attitude to risk, people can be classified into three types:

7.2.1 Risk seeking

A risk seeker is a person who will value the opportunity of a positive outcome more highly than the risk of a negative outcome. When faced with two equal possibilities of a profit or a loss arising from a particular decision, a risk seeking person will choose to proceed because of the possibility of profit.

7.2.2 Risk averse

A risk averter would value the possibility of a negative outcome more highly than the opportunity of a positive and in the same situation would choose not to proceed because of the possibility of a loss.

7.2.3 Risk neutral

A risk neutral person would value both outcomes equally and would be indifferent about whether to proceed or not in this situation.

Different people have different attitudes to risk and this influences their decision making and how they value possible outcomes. Research has shown however that for important business decisions, such as capital expenditure appraisal, managers tend to be risk averse in their decision making. They therefore tend to choose decisions which might have lower expected values than other decisions but which have less risk associated with them.

Managers of a business have responsibilities to the owners of that business (ie the shareholders) and one of these responsibilities is to act as stewards of that business and to maintain the value of the business and its future viability. It might be thought that this duty will tend to lead managers towards less risky decisions, because they are making them on behalf of the owners of the business, than they would perhaps make on their own behalf. In actual fact the evidence tends to show the opposite – that they are more inclined to take risks because it is not their own money which is being risked.

7.3 Managing risk

In dealing with risk there are three steps to be considered:

- Risk assessment
- Risk analysis
- Risk management

These can be considered as separate steps in the treatment of risk. The meaning of each steps is as follows:

7.3.1 Risk assessment

This is concerned with the identification of risks which might occur and an identification of which particular risks might occur in the situation with which we are concerned. Once these risks have been identified then it is possible to plan strategies to manage those risks and also to undertake analysis of the possible effects of the risk.

7.3.2 Risk analysis

This is the statistical quantification of the effects of the risks identified through risk assessment. The technique is based upon the probabilistic treatment of risk through the quantification of the effect of any particular risk and its consideration in terms of a probability distribution.

7.3.3 Risk management

This is concerned with the development of strategies for dealing with risk. The development of these strategies is dependant upon the assessment of the types of risk to which the situation is susceptible and the quantification of the possible effects through analysis.

The steps in the treatment of risk can be modelled as follows:

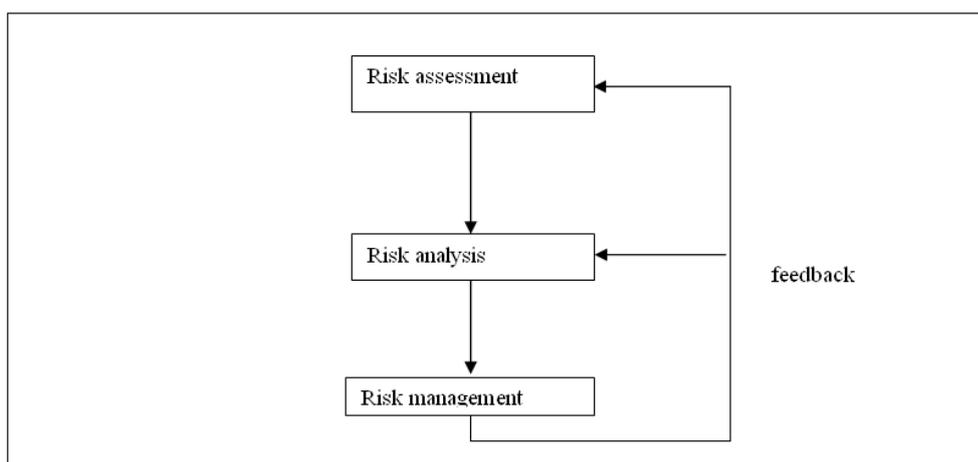


Fig 7.1 Steps in the treatment of Risk

7.4 Risk Management Strategies

From this diagram it can clearly be seen that feedback and reiteration is a constant part of the risk management process. This is necessary in order to continually reassess the effectiveness of the risk management strategies adopted. Possible strategies are:

7.4.1 Risk avoidance

Avoidance would involve not becoming involved in the situation in the first place. For example a building project in an unstable country might be considered so risky that the company would not tender for the project in the first place.

7.4.2 Risk reduction

This would involve taking steps to reduce the probabilities of certain unfavourable events happening in the assessment. For example for a building contract in an unstable country it might involve going into partnership with a firm from that country.

7.4.3 Risk protection

Protection would involve taking steps to limit the risk so in this example it might involve setting up security procedures to prevent sabotage to the building works.

7.4.4 Risk managing

This would involve contingency planning to cope with both foreseen and unforeseen situations arising during the course of the contract.

7.4.5 Risk transfer

One strategy for containing risk is to transfer that risk onto another party. Possible ways of doing this include taking out insurance or sub-contracting and passing on the risk in this manner.

In all cases of strategy development the selection of an appropriate strategy depends upon a realistic assessment of the risk and a quantification of possible effects through analysis. It is to risk analysis therefore that we now turn.

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7.5 Risk probability profiles

When a range of possible outcomes for an event exist then obviously the sum of the probabilities for all of the possible outcomes must equal 1 – as one of the outcomes must occur. The assignment of probabilities to each of the outcomes however enables us to construct a probability distribution showing the range of possible outcomes and their respective probabilities. Such a distribution may well be important to the analysis because merely selecting the most likely outcome might not reflect the level of risk involved.

For example, in two projects the best estimate of profitability for each of the projects is

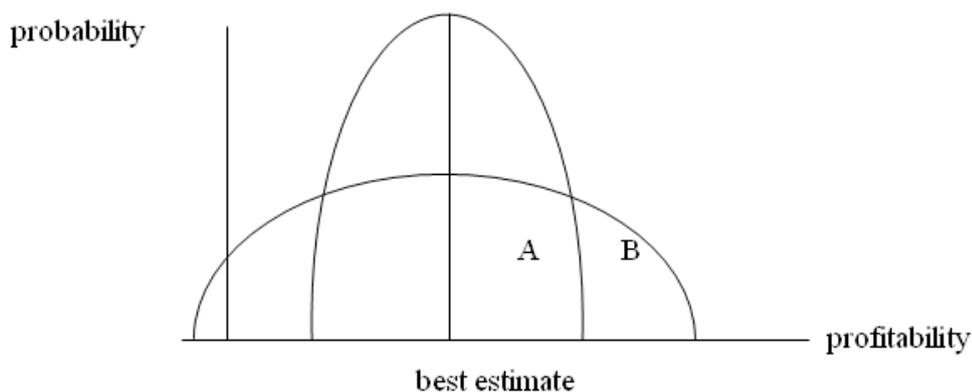


Fig 7.2 Profitability distribution profiles

The likely profit from each of them is identical but it can be seen from the probability distributions that the risk associated with them is quite different, with one of the projects having a risk of incurring a loss (project B). Without the probability distributions therefore a firm would be indifferent as to which project was chosen but with an understanding of the distribution of risk then it can be seen that project A is the preferable project, providing always that the expected returns for the two projects are similar.

Risk analysis can be used to quantify the expected values of the return from each project but assessing the relative relationship between risk and rewards inevitably relies upon managerial judgement and a person's attitude to risk.

7.6 A Typology of risk

There are a variety of pressures acting upon organisations in terms of risk to which they are subject, and these can be viewed as representing different dimensions of risk. In order to consider the way in which the various aspects of risk affect an organisation and its behaviour in relation to sustainability it is possible to construct a typology of these different types of risk:

7.6.1 Global risk

As the world has become more integrated – a facet of the globalisation which we considered in the last chapter – the risk from global competition has naturally increased. Consequently both the nature of the risks and the scale of the risk have increased.

7.6.2 Environmental risk

An organisation affects its environment and this includes not just the physical environment, in geophysical terms, but also the local environment through such things as pollution, noise or traffic congestion.

7.6.3 Social risk

A firm is of course part of society and reacts with that society, both positively and negatively. Risk naturally arises from this interaction.

7.6.4 Cultural risk

Much has been written¹⁷ about the relationship between a firm and its employees, which is often negative in nature. This relationship is a source of risk which is particularly significant when the relationship breaks down and litigation or industrial action ensues.

7.6.5 Financial risk

All corporate activity has financial implications. Indeed the nature of a corporation requires the undertaking of financial risk and the acceptance of the consequences. Ideally these will result in financial rewards which are commensurate with the level of risk¹⁸ undertaken but sometimes small rewards lead to a high level of exposure to risk¹⁹. Here we will mention that good governance is one way to prevent, or at least minimise the possible consequences of this kind of risk.

7.6.6 Long term/short term risk

Often consequences of corporate activity become manifest in the long term and all decisions are subject to both long as well as short term risks. This is of particular significance as some of the long term risks might not be apparent²⁰ when decisions are taken and action is commenced. Some risk therefore might exist which cannot even be recognised.

7.6.7 Stakeholder/shareholder interests

The power and influence of various stakeholder groups is increasing – something to which we will return – and this might increase the level of risk brought about by conflicts of interest between shareholders and other stakeholders, or between different groups of stakeholders.

7.6.8 Technical risk

Developments take place for all corporations and these include product or service development and mechanisms for delivery. We will return to this later as this is very significant for our consideration of sustainability, at this point however we must recognise that developments have associated risks.

Once risk has been identified then it is possible to develop appropriate strategies to manage it. Risk management is an important topic for a business in its own right. In fact it is a topic which is of increasing importance in the current economic climate. But it is a topic which is too specialist for this book. Here we will focus upon the relationship between risk and governance. Consequently we are considering primarily financial risk.

7.7 Risk analysis: the cost of capital

7.7.1 Components of the cost of capital

The level of risk for a company – or rather the level of risk that it is perceived to be exposed to – determines the cost of capital. And the lower the level of risk then the lower the cost of capital, and so the cost of borrowing is lowered. This is obviously beneficial for the company.

Understanding how to calculate the cost of capital is important for understanding its impact upon risk. It is also important for the measurement of performance of the company as many techniques measure performance against the cost of capital. There are primarily two sources – share capital and debt. The cost of capital for a firm is therefore made up of these two elements:

- the cost of share capital
- the cost of debt

The weighted average of these gives the cost of capital for a company, known as the weighted average cost of capital – the WACC.



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For example:

A company has debt of £1,000,000 and share capital of £500,000. The cost of debt is 8% while the cost of share capital is 5%.

The WACC of the company therefore is

$$\begin{aligned} \text{WACC} &= \frac{1,000,000 \times 8 + 500,000 \times 5}{1,500,000} \% \\ &= 7\% \end{aligned}$$

Of course the actual calculation of the cost of capital is considerably more complex than this and the managers of many companies spend considerable periods of time in trying to arrive at an accurate calculation of the cost of capital of the company. This is because so many strategic decisions for the company depend upon the NPV²¹ calculations, and these in turn depend upon a cost of capital being applied. Different costs of capital will result in different NPV calculations, and therefore different decisions being made. Thus the calculation of the cost of capital is a crucial part of decision making.

This calculation is of particular difficulty for shares, which have no fixed rate of return but rather a fluctuating return based upon results. Nevertheless this fluctuating return is based upon share price, which is determined by market expectations. In general terms the financial return on the use of capital can be expected to increase as risk increases. We have however to define the precise relationship between risk and return.

The Capital Asset Pricing Model (CAPM) is used to describe an explicit relationship between the degree of uncertainty in income flow for a financial investment and the level of return, and therefore helps to explain how discount rates are established and how shares can be valued.

7.7.2 Systematic risk

The CAPM divides a shares' risk into two parts: systematic and unsystematic. Systematic risk refers to the extent to which share returns vary when the returns on the market as a whole change; it is measured by beta. A share with a beta of 1 tends to rise by 10% for a 10% rise in the market index; a share with a beta of 2 tends to rise by 20% when the returns to the market rise by 10%. In other words shares of companies with higher betas are more volatile.

The systematic risk element for a firm is determined by risk factors common to all firms to a greater or less extent – for example such things as changes in GDP or in exchange rates. No firm is entirely unaffected by changes in these variables and as a result the prices of nearly all shares tend to move together – they are generally positively correlated.

7.7.3 Unsystematic risk

Unsystematic risk is that portion of total risk which is unique to a firm (or possibly an industry); examples include the quality of management, equipment failure, or new inventions. Because this type of risk is specific to the firm it is possible to reduce the variability of an investors' returns by choosing not to place all funds in one company. That is, the investor diversifies with the expectation that if one or two shares in the portfolio are doing badly this is compensated for by the good performance of others. In a fully diversified²² portfolio unsystematic risks cancel each other out.

This can be illustrated in figure 7.3 where the amount of unsystematic risk reduces as the number of individual types of share in the portfolio increases:

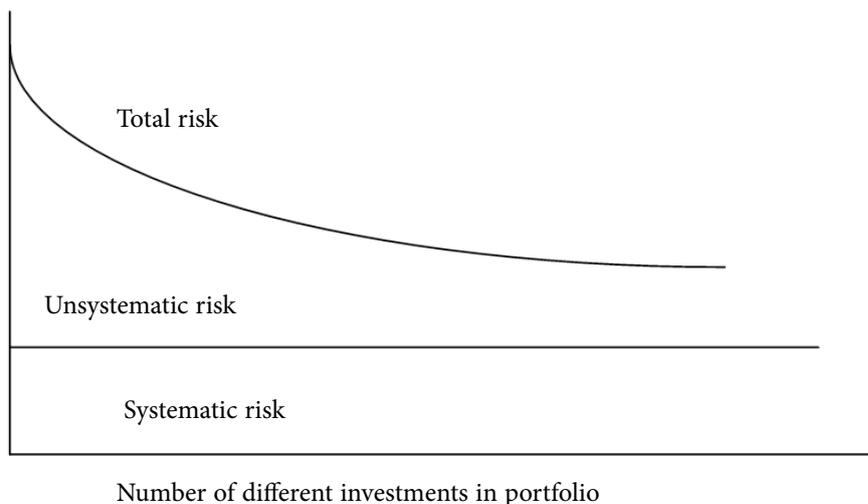


Figure 7.3 Risk and Diversification

A major implication of the CAPM is that investors will not be rewarded for bearing unsystematic risk, since they are able to diversify this risk away. Imagine that you are an investor who is undiversified and you require a return of between 30% and 40% p.a. on shares before you invest to compensate for the variability of returns caused by unsystematic and systematic risk.

You will not find such a share because there are plenty of fully diversified investors willing to buy shares which yield significantly less than 30-40% and so the share prices would never be low enough for you to invest and obtain your target rate of return. Investors continue to bid up the price of shares until only systematic risk is rewarded.

Once unsystematic risk is eliminated the risk of an individual share is measured not as the standard deviation of return of that share but as the volatility of the share relative to the market as a whole i.e. its beta. Using this definition of risk all securities plot along a security market line relating return and systematic risk.

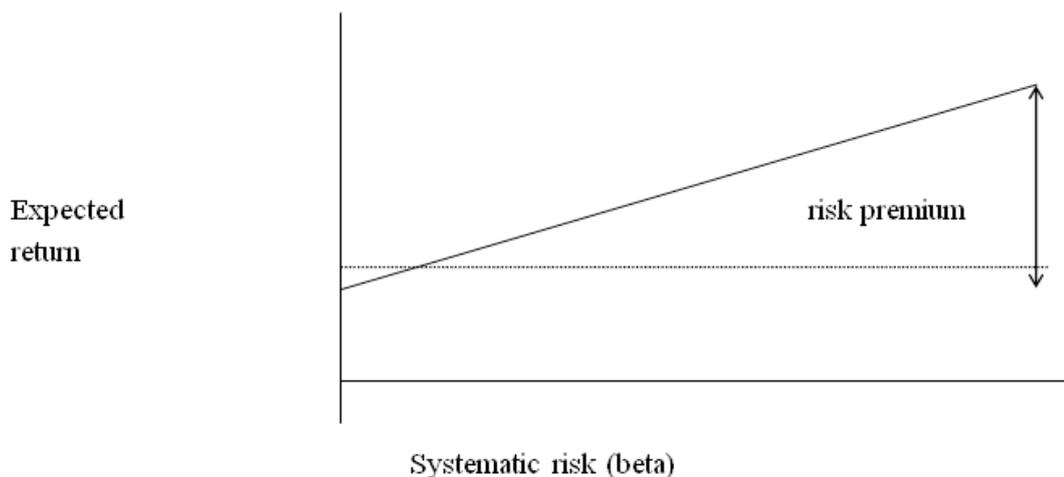


Figure 7.4 The risk premium calculation

7.8 The Capital Asset Pricing model

The Beta of a share measures the expected return for a share in relation to the expected return for the market as a whole. Thus the higher the Beta the greater is the expected return from a particular share when compared to other shares. Consequently the higher the Beta the higher is the cost of share capital for a company because of the greater expected returns and the lower level of risk.

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Betas are calculated by a number of organisations. Datastream is one such organisation which derives a beta factor by performing a "least squares" regression between weekly adjusted prices of the stock and the corresponding Datastream market index for a five year period. Typical values are around 1.00 and might range from 0.7 to 1.3 although higher or lower figures are not unknown.

7.9 The cost of capital for a business

Although this would appear to be a relatively simple calculation, the reality for a business is more complex than this. We have seen that Beta measures the level of risk for a share but that this is based upon an average of past performance, and Beta will tend to change over time. Moreover past performance is no predictor of future performance, whereas investment appraisal is based upon a prediction of future performance.

Thus knowing the Beta for your company at the present will provide an indication of past performance but will not enable an accurate calculation of the cost of capital to be used in the future. This is particularly the case when a proposed investment is based upon factors which are quite different to the past.

Thus, for example, an exercise leading to increased diversification could well be much more risky than current operations (because of such things as lack of experience or uncertainty about future demand) and this may well need to be evaluated using a very different cost of capital in the appraisal. The CAPM provides no basis for calculating such a cost of capital, and managerial judgment is required in this instance to derive an appropriate discount factor.

Most large companies are not composite businesses but consist of a number of different business units. These different units may well be engaged in very different activities for which different rates of return (in terms of either net profit percentage and / or ROCE (return on capital employed)) could be expected. If these business units were separate entities then they would be expected to have different Beta values and different costs of capital.

In such a circumstance a company wide cost of capital is not appropriate, and therefore different costs of capital for each of the business units should be used. However as they are not different entities no such Beta values exist and in this case also the CAPM provides no basis for calculating such a cost of capital and managerial judgment is required in this instance to derive an appropriate discount factor. This argument can also be extended to a consideration of different investment alternatives in a single business unit. If different levels of risk are associated with the different alternatives then the reality is that different discount rates should be used for the different alternatives.

7.10 Summary

It is clear that the definition of corporate governance has extended considerably beyond investor relations and encompasses relations with all stakeholders – including the environment. This is essential for the longer term survival of a firm and is therefore a key component of sustainability. There is evidence that some firms understand this but they are in a minority. So it is possible to say that good corporate governance will address this but that not all firms recognise this.

Similarly the amount of disclosure regarding all activities has been increasing rapidly over the last decade, as firms have recognised the commercial benefits of increased transparency. Therefore it is reasonable to argue – as we are doing – that the amount of information regarding the relationship between governance and social responsibility will also increase, not just as firms gain a clearer understanding of that relationship but also as they understand the benefits of greater disclosure in this respect. Thus we consider that this will become more apparent over time.

The most important point to note however is the relationship between corporate governance and the level of risk to which a firm is exposed. Good governance reduces the exposure of a firm to a whole variety of risks. This is clearly recognised by investors and potential investors and so the cost of capital is lower if a firm has good procedures for its governance.

7.11 References

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7.12 Further reading

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7.13 Self-test questions

1. What is the relationship between a beta value and the level of risk?
2. How many risk management strategies are there? Name them.
3. Describe the different attitudes to risk.
4. How does corporate governance affect the cost of capital?
5. List the different types of risk to which a corporation is exposed.