



Research Report

Do risk management activities impact earnings volatility?



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ABSTRACT

This study investigates whether changes in the quality of risk management are associated with changes in earnings volatility. Our findings are consistent with firms achieving lower earnings volatility by implementing higher quality risk management systems. These results are robust across profit and loss firms, although the economic impact of risk management quality is more pronounced for loss firms. Our results provide evidence as to how companies accomplish market performance through a quality risk management framework, and offer a reason why companies should allocate resources toward risk oversight. In addition, our results also suggest that recent public policy initiatives to improve risk management practices have tangible rather than superficial benefits to external stakeholders.

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Introduction

In the wake of the 2008 financial crisis, many observers have asked why companies were not better informed about the risk exposures facing their organizations. As a result, a renewed emphasis on risk oversight has led to several public policy initiatives to address this concern. In a 2008 speech, Ben Bernanke, Chairman of the Federal Reserve, emphasized the importance of strong risk oversight; stating that “effective oversight of an organization as a whole is one of the most fundamental requirements of prudent risk management” (Bernanke, 2008). The 2010 Dodd–Frank Act established the Financial Stability Oversight Council, which monitors financial markets and makes recommendations on heightened standards of risk management. Motivated by these recent policy initiatives, we investigate the association between risk management and earnings volatility. An understanding of this relation is important in determining the true benefits of risk management.

To conduct our investigation, we utilize SEC risk disclosures related to the board’s involvement in risk oversight to capture risk management quality. The board’s involvement in

risk oversight has been identified as the foundation of effective risk management (e.g., Beasley, Pagach, & Warr, 2008; Deloitte, 2011; Gordon, Loeb, & Tseng, 2009). To capture quality, we evaluate each disclosure based on criteria set by the Committee of Sponsoring Organizations of the Treadway Commission (COSO). Our findings are consistent with firms achieving lower earnings volatility through higher quality risk management systems. To address causality concerns, we employ a first differenced model and find a negative relationship between changes in the quality of the risk management systems and changes in earnings volatility. Our results are robust across profit and loss firms, although the economic impact of increases in risk management quality is more pronounced for loss firms. In sensitivity tests, we measure risk management quality as changes in the length of risk disclosures and only find statistically significant results for loss firms. These findings suggest that non-loss firms may only implement corporate governance mechanisms for compliance purposes rather than true economic gain.

Our research should be of interest to practitioners, regulators, and policy makers because it tests a very important prediction (i.e., the link between earnings volatility and risk management) and offers a reason why companies should allocate resources toward risk oversight. By showing a change in earnings volatility, a key input into valuation models, we provide evidence as to how companies accomplish market

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performance through risk management implementation. In addition, we also show that recent public policy initiatives to improve risk management practices have tangible rather than superficial benefits to external stakeholders.

The remainder of this paper is organized as follows. The second section describes the research design and sample selection process, and the third section presents the descriptive statistics. Results and supplemental analyses are presented in the fourth section, followed by a summary in the fifth section.

Research design and sample selection process

Background

In general, corporate risk management seeks to identify risk exposures and determine a response strategy to either manage or bear the risk. The risk management literature (e.g., [Beasley et al., 2008](#); [Gordon et al., 2009](#); [Hoyt & Liebenberg, 2011](#)) frequently identifies lower earnings volatility as a primary benefit from risk management because of its ability to reduce costs associated with financial distress. Reducing financial distress costs is a potential value enhancing characteristic of risk management implementation, given that these costs hamper a firm's ability to achieve strategic objectives and, ultimately, may impact firm value. Stakeholders that lose confidence in a company's ability to continue as a going concern can lead to lower customer sales, tightened credit requirements by suppliers, and employee turnover.

From a public policy perspective, the importance of risk management is illustrated by recent regulatory initiatives aimed at the board's role in risk management. Effective February 28, 2010, the SEC issued final rule 33–9089, an amendment to public companies' proxy statement disclosures, to provide stakeholders with better and more relevant information in the area of risk oversight ([SEC, 2009](#)).

SEC final rule 33–9089 increases the information available regarding risk related management control systems which not only benefits financial information users but also the firm. Through the amendment, the SEC seeks to increase the transparency of the board's risk oversight responsibilities. Specifically, the SEC encourages companies to share information about how the board and management work together in monitoring and addressing the material risks facing the company. Disclosures communicating a firm's ability to manage risk may lead to increased confidence among investors regarding the company's future prospects and allow stakeholders to differentiate operating performance due to luck rather than management's ability to direct the firm. Academic research finds higher quality disclosures lead to lower costs of capital, an obvious benefit to an organization (e.g., [Heflin, Shaw, & Wild, 2011](#)).

Operational measure of risk management quality

To conduct our study, we evaluate the board risk oversight disclosures to capture risk management quality, and empirically examine whether changes in risk management practices influence earnings volatility. [COSO \(2004\)](#) develops a framework for enterprise risk management (ERM) built on the board's role in risk oversight and provides guidance regarding a board's

risk oversight responsibilities. The COSO framework offers an independent template for measuring the board's risk responsibilities and oversight areas that contribute to risk management quality ([COSO, 2009a](#); [COSO, 2009b](#)):

1. Understand the entity's risk philosophy and concur with the entity's risk appetite.
2. Know the extent to which management has established effective enterprise risk management of the organization.
3. Review the entity's portfolio of risk and consider it against the entity's risk appetite.
4. Be apprised of the most significant risks and whether management is responding appropriately.

Following the COSO objectives, we develop an eight point scale to evaluate the quality of firms' risk management. Each of the four COSO objectives is scored as 0, 1, or 2. If the disclosure does not fulfill any part of the COSO objective, we assign a score of 0. If the disclosure partially fulfills the COSO objective, we assign a score of 1. If the disclosure fulfills all parts of the COSO objective, we assign a score of 2. Therefore, a firm that does not comply with any part of the COSO objectives would receive the minimum score of 0 and a firm successfully complying with all four COSO objectives would receive the maximum score of 8. Two researchers independently coded each disclosure in our sample and reviewed any differences. The coding process resulted in a success rate between researchers of 90.3% ($Kappa = .812$).

$$RiskMgmtQual_{it} = \sum_{Obj=1}^{Obj=4} Obj \cdot Score_{it} \quad (1)$$

Our measure of risk management quality offers three distinct advantages relative to prior studies that operationalize risk management through S&P ERM ratings.¹ First, S&P ERM ratings are only available for regulated industries, thus limiting the sample to insurance and finance companies. By coding firms' risk disclosures based on the COSO objectives, we extend our sample to firms in unregulated industries, making our results more generalizable to the overall population. Second, S&P ERM ratings are initiated by rating agencies and do not provide insight into the level of commitment toward risk management that is initiated by the firm. Changes in the actual risk management disclosures are more likely to correlate in time with real changes in risk oversight. Third, research relying on S&P ERM ratings must control for self-selection bias since firms compensate S&P to rate their ERM systems. Since the SEC requires the risk disclosures for all SEC registrants, self-selection is not a concern in our study.

Sample selection

We automate the process of sample collection by employing software to connect to the SEC's Edgar website and downloading proxy statements. Software embedded with textual parsing routines is used to extract the board risk oversight disclosure contained within each proxy

¹ S&P explicitly rates insurance and financial firms' ERM and incorporates this rating into firms' overall bond ratings ([S&P, 2008](#)).

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