Abstract

Enterprise Risk Management (ERM) encompasses activities and strategies which enable the company to identify, measure, reduce, or exploit, as well as to control and monitor the exposure to various types of corporate risks – strategic, financial, operational, and reporting, as well as compliance risks for the purpose of increasing the organization’s value to its stakeholders. The primary goal of ERM is to increase the likelihood that an organization will achieve its objectives, meaning that ERM should be created and implemented with the aim to protect and create shareholder value. For ERM to bring benefits, as it is well-explained in the existing ERM literature (e.g. see Beasley et al., 2005; Cumming and Hirtle, 2001; Lam, 2001, 2003; Liebenberg et et and Hoyt, 2003; Meulbroek, 2002; Nocco and Stulz 2006), it should be integrated in the most important business processes, such as strategic management, strategic planning, as well as in the finance and investment decisions in order to ensure the consistent evaluation and management of risks that arise from business initiatives and plans. This paper is both conceptual and empirical. It is aiming to (1) develop ERM Index that measures quality of ERM process within the company, (2) to explore level of ERM development in listed Croatian companies by employing ERM Index (3) to explore determinants of risk management system development in listed Croatian companies (4) to explore whether risk management decisions have different rationales in Croatian companies than among their western counterparts. Different theories of risk management derived from capital market imperfections are used to argue for the relevance of corporate risk management function. Empirical research was conducted on the listed Croatian non-financial companies. Data were collected from two sources; annual reports and notes to the financial statements and survey. Research results have revealed low levels of ERM development in listed Croatian companies. Managers are focused on financial and operative risk management, while strategic and other risks have been neglected. Regression analysis has indicated somewhat unexpected but important conclusion - the explored risk management rationales have weak predictive power in explaining corporate risk management decisions in Croatian companies. The level or risk management system development is dependent only on the size of the company and value of the growth options.

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1. Introduction

Enterprise Risk Management (ERM) is an important element of an effective corporate governance system. It is defined as a combination of activities and strategies that result in reduction of a negative impact of various types of risks - financial, operational and strategic - to the planned business results and value created to shareholders and other company’s stakeholders. According to Casualty Actuarial Society (2003) Enterprise Risk Management (ERM) is the discipline, by which an organization in an industry assesses, controls, exploits, finances, and monitors risks from all sources for the purpose of increasing the organization’s short and long-term value to its stakeholders. This novel and holistic approach to corporate risk management, entitled Integrated Risk Management, Strategic Risk Management, Enterprise Risk Management or just ERM, includes an assessment of the total exposure to all identified risks that directly or indirectly affect the value of the company as well as the implementation of a risk management strategy that is complementary to the business strategy of a corporation. ERM has been applied in financial institutions and corporations since the beginning of 21st century, and the number of users has increased significantly in recent years.

Effective risk management is considered to be a leading competitive advantage that determines the survival and success of the company in an uncertain global environment (Bartram, 2000). The global financial crisis has focused attention to the proper identification, analysis and management of key business risks because inadequate risk assessment has been identified as one of the main factors of a failure or financial difficulties of a large number of organizations worldwide. Hence, inadequate risk management has become a problem of broader social interests, resulting in recommendations of the OECD and the European Commission1 on the necessary changes in the existing risk management systems. As a result, an increasing number of companies are moving on from traditional silo-based risk management (TRM), where different corporate risks were managed on the individual basis without taking into account their correlations, toward ERM, where a holistic view of corporate risks is conducted and overall risk exposure is assessed (Hoyt and Liebenberg, 2011). There is a belief among increasing number of scholars (e.g., see Cumming and Hirtle, 2001; Lam, 2001; Meulbroek, 2002; Lam, 2003; Liebenberg and Hoyt, 2003; Nocco and Stulz, 2006; Beasley et al., 2005) that ERM offers companies a more comprehensive approach toward risk management in comparison to TRM. By adopting a systematic and consistent approach to managing all of the risks confronting an organization, ERM is presumed to lower a firm’s overall risk of a failure and thus increase the performance and, in turn, the value of the organization (Gordon et al., 2009). For ERM to bring benefits, as it is well-explained in the cited ERM literature, it should be integrated in the most important business processes, such as strategic management, strategic planning, as well as in the finance and investment decisions in order to ensure the consistent evaluation and management of risks that arise from business initiatives and plans.

This paper is both conceptual and empirical. It contributes to the existing literature in few ways. Firstly, we develop ERM Index that measures quality of ERM process within the company. Second, we explore level of ERM development in listed Croatian companies by employing ERM Index. Third, we explore determinants of risk management system development in listed Croatian companies, what has enabled us to study whether risk management decisions have different rationales in Croatian companies than among their western counterparts. Different theories of risk management derived from capital market imperfections are used to argue for the relevance of corporate risk management function. Empirical research was conducted on the listed Croatian non-financial companies. Data were collected from two sources; annual financial reports and survey. Research results have revealed low levels of ERM development in listed Croatian companies. Managers are focused on financial and operative risk management, while strategic and other risks have been neglected. Regression analysis has indicated somewhat

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