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A Study on Enterprise Risk Management in the Chinese Context

Qingrun Xia[1,a,*]

[1]*Commercial college, Jiangsu Normal University, Xu Zhou, 221000, China*
a. 1328758864@qq.com
**corresponding author*

Abstract: The establishment of the market economy, accompanied by the emergence of risks, requires enterprises to consider not only the economy and profitability but also the risk. Therefore, enterprise risk management problems arise. Many developed countries see risk management, strategic management, and operation management as the three main management functions of modern economic organizations, which will become a critical factor in the competitiveness of businesses in the future. Therefore, the paper reviews the development of traditional risk management theory, financial risk management theory, and internal control theory, with a focus on Enterprise Risk Management (ERM). After analyzing the current situation of ERM in Chinese enterprises, the paper proposes suggestions for improving risk management methods, strengthening the internal control system, and enhancing staff quality. Finally, the paper emphasizes the importance of Enterprise Risk Management (ERM) development in China and suggests the need for a risk management system tailored to the country's specific circumstances.

Keywords: Risk Management, Internal Control, Chinese Enterprise, Economic Policy Uncertainty

1. Introduction

In the backdrop of China's economic resurgence, enterprises are navigating a landscape characterized by both opportunities and threats, necessitating a strategic approach to risk management. The concept of Enterprise Risk Management (ERM) has gained prominence as firms seek to identify, assess, and mitigate risks effectively. This paper delves into the realm of ERM within the Chinese context, examining its evolution and current status. The evolution of risk management theories, including traditional, financial, and internal control theories, underscores the importance of a comprehensive approach to risk management. While traditional risk management focused on mitigating pure risks, financial risk management introduced strategies to manage speculative risks. Internal control theory, as integrated into ERM frameworks, emphasizes the alignment of risk management with broader organizational objectives. This paper aims to analyze the current state of ERM in Chinese enterprises and propose strategies for improvement. By addressing these challenges and optimizing risk management practices, enterprises can navigate uncertainties, enhance resilience, and achieve sustainable growth in the dynamic Chinese market.

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2. Risk Management Theories

2.1. Traditional Risk Management Theory

In the mid-1960s, risk management emerged as a subject; in 1963, American scholars MEL and Hesch published "Risk Management of Enterprises" in the "Insurance Manual," which attracted widespread attention from some developed countries. The Risk Management and Insurance publication by Williams and Hans in 1964 marked that the risk management theory officially entered the historical stage. They believe that risk management is not only a technology, a method, or a process but also a new management science.

The critical achievement of risk management theory in this stage is to realize the integration with mainstream economics and management disciplines. The proposal of risk management methodology is undoubtedly the most important. In 1965, Hedges put forward the methodology of constructing enterprise risk management for the first time. It makes risk management more comprehensive and perfect from the perspective of methodology. Close (1974) combined risk management with the complex organizational system model of modern management, providing a more mainstream theoretical source for developing risk management discipline. Cummins (1976) integrated risk management with traditional enterprise theory and used the analysis method of modern economics to determine the optimal risk management strategy [1]. The financial market theory was integrated into risk management, making it a significant area of finance.

2.2. Financial Risk Management Theory

Suppose the traditional risk management theory is to solve pure risk. In that case, financial risk management is to cope with a speculative risk problem. It is to achieve “the biggest risk under the condition of minimum income, " which is the most critical difference between traditional and risk management. Markowitz’s asset portfolio theory strongly endorsed financial risk management [2]. The variance in statistics is used to measure the risk, and the expected value is used to measure the return. On this basis, Hart and Jaffee put forward the theoretical framework of managing all assets and liabilities of banks as a specific type of security portfolio. The Capital Asset Pricing Model (CAPM) proposed by Sharpe is the pioneer of modern risk asset pricing theory [3]. It suggests the fundamental law that investment return is proportional to risk, and it proves that the non-systematic risk can be effectively dispersed and avoided by the security portfolio. Still, the systemic risk with overall characteristics cannot be disseminated. Scholes and Black presented the renowned Black-Scholes option pricing model, which solved the option pricing dilemma and gave enterprise risk management more precise tools.

The proposal of these theories makes risk management break through the thought of transferring risks by insurance under the traditional mode and begin to use risks to obtain benefits, which marks the beginning of the in-depth development of risk management theory.

2.3. Internal Control Theory

The 2004 COSO "Enterprise Risk Management-Integrated Framework" has made internal control theory a key component of risk management theory, making the relationship between risk management and internal control more evident. Consequently, internal control is now incorporated into the enterprise risk management framework.

2.4. Enterprise Risk Management Theory

Enterprise Risk Management - Integrated Framework released by COSO is a Risk Management report with epoch-making significance. Offering a comprehensive definition of Enterprise Risk Management (ERM) in its new form. It provides more specific ideas for enterprise risk management. An examination of the effect of derivatives on enterprise value, with Tobin's Q as a substitute variable, was conducted by Allayannis in 2001 [4]. It is found that after applying foreign exchange derivatives, the value of enterprises presents a positive growth trend. An examination of 2000 to 2004 operating conditions of 166 U.S. listed insurance companies conducted by Hoyt and Liebenberg (2008) revealed that the rise in corporate value of companies that adopted ERM was generally widespread [5].

2.4.1. Definition of Enterprise Risk Management

The Treadway Commission's Committee of Sponsoring Organizations (COSO) characterizes enterprise risk management as a procedure executed by an organization's board of directors, management, and other personnel in the formation of strategies across the entire enterprise. The Treadway Commission's Committee of Sponsoring Organizations (COSO) defines a process implemented by an entity's board of directors, management, and others to be used in strategy formation and throughout the enterprise. This process is meant to recognize potential events that could impact the entity and manage risks within its risk tolerance, thus providing reasonable assurance that its goals are being achieved.

ERM is not just used to reduce the risk. It is the process of managing a project or enterprise in a decidedly risky environment to minimize the possible adverse effects of risk.

2.4.2. Value of Enterprise Risk Management

ERM's effects on companies, both macro, and micro, are of great value. At the macro level, ERM allows senior management to accurately assess and handle the risk-return balance that the whole firm faces. By taking this viewpoint, ERM helps the company keep access to capital markets and other resources needed to execute its strategy and business plan.

Although the academic literature has mainly focused on its macro-level benefits, ERM is of utmost importance in practice. At the micro level, it becomes an integral part of the lives of managers and employees at all levels of the organization. As we will demonstrate, a well-crafted ERM system guarantees that all material risks are "owned" and risk-return tradeoffs are carefully evaluated by all managers and employees throughout the firm. Moreover, ERM has numerous other advantages. It can help enterprises to make diction.

3. Current Situation of Chinese Enterprise Risk Management

3.1. Chinese Financial Situation

The macroeconomic situation at home and abroad is complex, and domestic problems caused by imbalanced and inadequate development and threats caused by international economic and trade conflicts have increased downward pressure on the economy. To adjust to varying economic stages and to reach different macroeconomic objectives, the country constantly introduces and adjusts various economic policies, which leads to the problem. It is the uncertainty of economic policies (Economic Policy Uncertainty, EPU), as shown in Figure 1.

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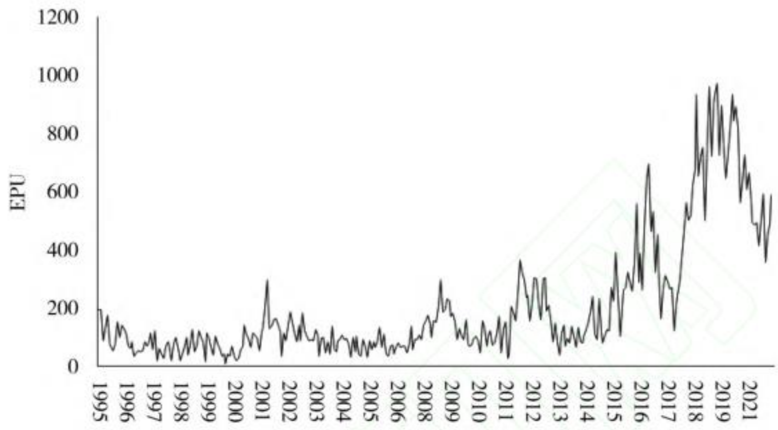

Figure 1: Changes in Economic Policy Uncertainty in China: 1995-2021 [6]

It can be seen from the picture that EPU Index in China presents a rising trend. The rise of economic policy uncertainty will impact the macroeconomy and financial markets and cause the micro-enterprise living environment turbulence.

3.2. Current Situation of Chinese Enterprises

With the advance of global integration and the sustainable development of the commodity economy, enterprises face market risk, operational risk, investment risk, and so on. [7] Moreover, enterprises are no longer isolated individuals but establish supply chain relations with multiple enterprises and become supply chain members. [8] The main body of market competition gradually evolves from enterprise to supply chain. Previous studies have shown that supply chain relationships will impact enterprise financing capacity, investment efficiency, and performance.[9] As an essential factor affecting enterprise development, supply chain relationship plays a vital role in resisting external shocks and promoting high-quality and sustainable development of enterprises.

3.2.1. Weak Risk Awareness

Currently, many enterprises in China lack awareness of risk management and do not carry out risk management positively. They are manifested in two aspects: first, enterprise risk management activities are usually temporary or intermittent, and they are aware of management but are later put aside and ignored. Second, the enterprise cannot regularly review and reassess risks, reducing its ability to adapt to environmental changes, manage and avoid risks. The fundamental goal of obtaining maximum profits leads some enterprises only to follow the immediate interests, while ignoring the adverse impact of certain behavioral decisions on the future development of enterprises, which often fails to analyze the project risks systematically and comprehensively, resulting in enormous losses for enterprises.

3.2.2. Inadequate Organizational Structure for Enterprise Risk Management

There are serious structural problems in most enterprises in our country, which lead to unclear responsibilities and operation procedures of various departments and posts and unclear risk assumption, so it is difficult to form a separate risk management division, and there is no specialized personnel to manage enterprise risk. Even if the corresponding risk management department has been set up, there is no professional risk management personnel, and the subject of risk undertaking is unclear. The work of various departments shirks responsibility for each other, which makes them lack constraints in risk management so that they can not bear the responsibility of effective enterprise risk

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management. In China, enterprise risk management remains at the decision-making level for vital interests.

3.2.3. Enterprise risk management and internal control detachment

First, enterprise management failed to organically unify enterprise risk management with internal control to form a more effective internal control system with superior risk management. There is a lack of knowledge about enterprise risk management and usually no storage of the necessary data and information for risk evaluation and management. Second, there are not many behaviors of enterprises to arrange risk transfer for loss reduction and prevention. Third, in the strategic aspect, enterprises often have excessive risk gambling because they do not understand the importance and skills of scientific risk assessment, resulting in Chinese enterprises often assuming the risk that should not be undertaken. At the same time, they should seize the opportunity as a risk and be rejected outside. Fourth, in business, the feeling is subjective. The decision-making is subjective and arbitrary, lacks scientific investigation, and has short-term behavior in the management concept.These risk properties make it necessary to control the consequences of losses caused by risk accidents through practical methods.

4. Implementation of Enterprise Risk Management in China

To effectively implement ERM, it is essential to recognize the risks that the enterprise is exposed to. A typical strategy is to determine the types of risks that will be assessed [10]. Initially, corporate risk management was mainly concentrated on market and credit risks, but eventually, operational risk was incorporated. Consequently, banks often categorize all risks into market, credit, and operation. To encompass all the risks the company is exposed to, operational risk must be a broad term that includes all risks unrelated to market and credit.

Managers must identify the enterprise's significant risks and devise a consistent method to measure their exposure, a common approach that can be used to recognize and quantify all significant exposures. Without such a method, the same risk could have varying impacts on the decision-making of different business units, resulting in different amounts of capital allocated to the same risky activities. Tension in the company would certainly be generated.

The concept of ERM is simple, yet its execution is arduous. If a business desires to succeed in executing ERM, personnel in the company must comprehend how it can generate value. Managers must understand that ERM is fundamental to achieving the firm's plan [11].

4.1. Optimization of Risk Management Methods

In the process of economic activities, an enterprise's internal and external environment will change. When dealing with these changes, the enterprise should optimize the existing management methods according to different risks. The external environment of enterprises has changed to different degrees, mainly because the development speed of the industry is relatively fast, and the competition has gradually become fierce. In this case, the enterprise also began to optimize the management method actively and also spent a lot of energy not only to improve the economic efficiency, but also improve the quality of risk management so that all departments could actively complete their tasks under the appropriate management of the supervision department, to avoid sacrificing the collective because of personal interests, so that all kinds of risks can be effectively avoided. [12]

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4.2. Enhancement of Internal Control System

Many Chinese companies fail to acknowledge the correlation between ERM and the internal control system. Risk management encompasses internal control, an essential component of risk management. COSO states that risk management comprises eight elements: internal environment, goal setting, event identification, risk assessment, risk countermeasures, control activities, information and communication, and supervision. Risk management necessitates including internal control, as the British Turnbull Committee (2005) has declared. This system comprises five components: control environment, risk assessment, control activities, information and communication, and supervision. Consequently, managers should view internal control as a fundamental element of broader risk management. Here are some methods we can use to improve the internal control system.

First, to improve the internal control system, enterprises should strengthen the internal control mechanism. In this process, it is necessary to sort out the external environment of enterprise operation, evaluate its development level from the actual point of view, and on this basis, strengthen supervision, and establish an internal control mechanism in line with the law of the enterprise's development. Second, for enterprises in the rising stage of development, establishing and continuously strengthening the internal control mechanism can play a role in restricting enterprises. Enterprises can only obtain more significant economic benefits by analyzing the problems encountered in the development. In a word, the internal control system should better play its guiding role in the operation to ensure the rationality of internal control work. [13] Only by strengthening the internal control system can the part of internal control management be better played, and various management risks can be avoided. [14] For example, in operation, enterprises should not only supervise the operation process but also regularly integrate the management ability and the performance of managers to give better play to the independence of internal control work and strengthen the supervision effect of the internal control system.

4.3. Improvement of Staff Quality

Many employees are not aware of the importance of ERM. So it is essential to leave efforts to improve the quality of management personnel and establish a complete talent promotion management strategy. The development and growth of an enterprise cannot be separated from the hard work of employees. Employees' personal quality and working ability can directly affect an enterprise's development speed. [15] Therefore, high-quality talents have become scarce resources, and the demand for high-quality employees is also increasing.

5. Conclusion

In conclusion, the paper emphasizes the importance of strong Enterprise Risk Management (ERM) procedures in Chinese businesses. The research identifies critical difficulties such as a lack of risk awareness, structural weaknesses in the business, a gap between ERM and internal control, and low staff proficiency. To effectively apply ERM, businesses must first thoroughly identify and assess their risks, ensuring alignment with strategic goals. It is critical to enhance management techniques, strengthen internal control systems, and improve workforce competencies. These metrics are critical for Chinese businesses to navigate the changing business landscape, build resilience, and achieve long-term success.

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