Chapter 8
Importance of Risk Management and Risk Management Process

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ABSTRACT

Importance of risk exposure and risk management practices have attracted the attention of companies, investors, and all other parties who benefit from performances of companies. Competitive environment and global effects force the companies to pay attention to manage their risks. Therefore, governmental bodies and international associations embarked on researches in risk management and as a result of these efforts regulations have been put in place. Germany, USA, and UK are the leading countries that made significant progress in risk management field by enacting laws, regulations, and issuing guidelines. But the subject is still new for some countries and difficult for companies, especially small and medium sized, to apply. The chapter starts with the benefits and importance of risk management. Then steps of risk management are explained with the examples.

INTRODUCTION

Risk is one of the fundamental elements that influences economic behavior of people and businesses and has been studied in different areas such as accounting, finance, economics, safety, and health. Since researchers have approached risk from different dimensions, several definitions of risk are used in literature. Usta (2012) defined risk as a positive or negative difference between a realized value and an expected value depending on the future alternatives. In financial markets, “risk” and “uncertainty” are used interchangeably but they are basically different concepts. In a simple way, the measurable part of uncertainty is called risk and it shows the probability of occurrence of an event and whether the result will be good or otherwise (Usta, 2012).

Graham (2008) stated that risks can arise due to various reasons. They can be related to internal factors such as management (accounting system, management style, and the like), technology (production methods), people (staff, customers and suppliers), or adequacy of controls as well as external reasons such as business environment, political issues, regulations and policies, country and industry they operate.
in. In addition to the risks these factors can cause individually, interactions among them can also raise some other risks. For example, risks related to employees can have an impact on the risks associated with management or adequacy of controls; meanwhile managerial risks are also affected by technological risks. Likewise, economical risks (government regulations, exchange risks, political stability) also have an impact on the financial risks (foreign currency risks, interest risks, liquidity risks, credit risks) of the entities. Global factors have effect on businesses or business environment directly and this link continues with operations, reputation and infrastructure of the company, respectively.

With the emergence of new risks, changes in their effects can be more brutal now because of the exposure, volume and volatility in the markets. On the other hand, companies are more aware of the negative effects of risks. Therefore, they are trying to manage risks they are exposed to. But not all kinds of risks can be managed effectively; accordingly, risks are classified as controllable risks and non-controllable risks. The business structure and the business-specific risks arising from the industry in which they operate are the risks under the control of the entities and can be avoided or their effects can be reduced or increased with actions taken. The risks that are not under the control of the companies are generally country related or worldwide affected risks.

In this chapter, the importance and benefits of risk management practices is emphasized and the steps of risk management processes are explained. This chapter starts with literature review and the bases of the related regulations have been explained and supported by relevant reports. Benefits and objectives of risk management are discussed to reason the importance of the risk management practices. Then a general overview of risk management is given and steps of the process is detailed with the examples. Finally, future research opportunities are discussed.

BACKGROUND

Risks caused by the exposure to emerging markets, the toughening competition in markets, and the fluctuations in the national and international markets have significant effects on the companies’ financial performances and future expectations. On the other hand, companies cannot avoid all the risks they are exposed to. Therefore, adaptations to changes and fluctuations, elimination of potential negative effects and evaluation of opportunities for possible future benefits have significant impact on the future success of companies.

Additionally, changes in the financial sector and developments in the banking system in recent years have also changed the market dynamics. Instability in the markets have affected companies’ financial results and has made them less predictable. Since they cannot be easily predictable and controllable, more precarious financial results are experienced and they have become a threat to countries and economies. Because of these, the financial crises are experienced, and they are one of the factors that draw attention to the importance of risk management and risk disclosures. Linsley (2011, p. 5) has reached the following results in a study on risk disclosures of banks relating to pre-financial crisis he has made:

*In all cases prior to the crisis the narratives portray the banks as having a sound awareness of the risk environment and a propensity to adapt their risk management approaches as the risk environment changes. They display a confidence in their ability to manage the risks they are confronted with and there is no forewarning that a crisis may be imminent within these narratives.*
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