The Relationship Between Enterprise Risk Management (ERM) And Firm Value Mediated Through The Financial Performance

Review of Integrative Business & Economics Research

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ABSTRACT

The purpose of this research is to analyze the influence of Enterprise Risk Management upon the firm value mediated through its financial performance as an intervening variable. A purposive sampling is the technique used in obtaining the qualified 53 samples included in the criteria. The sample includes banking companies listed in Indonesia Stock Exchange from 2011 until 2013. The data are analyzed using path analysis method. The results indicate that ERM has no significant influence upon the firm value and profitability while profitability has significant and positive influence to the firm value. Financial performance is unable to mediate the influence of ERM upon the firm value. Further researches may develop ERM implementation variable through the primary data, direct analysis or interviews upon the interested parties to obtain data which surely may describe the overall implementations of ERM.

Keywords: Enterprise Risk Management, Firm Value, Profitability

1. INTRODUCTION

One of the goals upon the establishment of company is to create a value by providing advantages for the owners, known as the shareholders. Retno (2012) reveals that sustainable increase of the company value is the company's long-term goal to maximize the shareholders' value. The company's value is the available value that investors can pay to have the ownership of a company. Investors need assurance upon funds that they have already invested and returns upon their investment. The company will try to maximize the value of shareholders' investment, by increasing the company performance.

Wang (2011) states that the increase of company value is the reflection of shareholders' funds optimization, which is frequently valued by Price to Book Value (PBV). This ratio shows the willingness of investors to buy shares with the price at above or below the nominal value. The higher the value of a company the more prosperous the owners are. Thus, the value of company in investors' and creditors' view is very important that they become more selective in investing and providing credit for the company.

Since monetary crisis stroke Indonesia in 1997, many companies experienced decrease in value resulted from foreign exchange risk management failures. In banking sector, 45 banks were in troubles and 16 private national banks were liquidated and at the same time licenses had been revoked by the government. 38 banks were closed in

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1999, Bali Trading Bank and Aspac Bank are liquidated in 2004, Global Bank was then closed in 2005, Century Bank case following arose and Indover Bank was also closed in 2008, and finally IFI Bank business license was revoked by the government in 2009 (Silaban, 2013). These phenomena indicate that risks in banking have not been fully managed by the management.

The existence of Bank Indonesia Regulation No. 5/8/PBI/2003 on Risk Management for Commercial Banks make banking focus more in the existing risk management through the Risk Management Committee. Risk Management Committee is a part of Good Corporate Governance implementation. The objects of this study are banking companies listed in Indonesia Stock Exchange. In accordance with Bank Indonesia regulation, all commercial banks are required to implement risk management in their businesses.

The firm value is influenced many factors, including financial performance and Enterprise Risk Management (ERM) implementation. Financial performance measures the management success level in managing the financial resources owned by the company. The higher the financial performance is proxied with financial ratios, the higher the value of a company (Andri and Hanung, 2007). Mahendra (2011) reveals the profitability may significantly influence the company value since the higher the profitability the higher the profit sharing is guaranteed.

Enterprise Risk Management (ERM) is a recent popular topic. This is related to the increasing number of uncertainties, either caused by economic conditions or the global ones. Investors not only require a high level of return, but also the provided fund security assurance. Muthohirin et al. (2012) reports that the ERM strikes are generally influenced by company's internal. According to the *agency theory*, ERM mechanisms are taken to provide security upon the existing risks that possibly appear in the future upon funds deposited by the *principal* party. The existence of ERM means that agent has the guidance to implementation the upcoming company's operations that the optimization of ERM may influence the improvement of company financial performance (Hanafi: 2010).

The improvement of company performance which is supported by good corporate risk management may produce more optimal income. This will make the value of company better. This study outlines the influence of ERM implementation upon the value of company moderated by financial performance variable. The company's value is proxied by the price to book value (PBV) while the financial performance is measured by the profitability.

2. LITERATURE REVIEWS AND HYPOTHESIS DEVELOPMENT

The theories underlying this study are the signaling and agency theory. Jogiyanto (2000) mentions that the information published as an announcement may signal investors upon their investment decision-making. Signalling theory emphasizes on the importance of information released by the company upon investment decisions outside of the company. The financial performance in financial statements may provide investors signals. Financial performance in many proxies may also transfer the information from management (internal) to prospective investors (external) as a basis in decision making. The development of good financial performance over time may become positive information for potential investors, and vice versa.

Information about Enterprise Risk Management in company's annual report may signal investors upon their investment decision making. This is part of efforts of full

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disclosure in the provided reports. ERM is a part of company risk management which also provides investors signals. Financial performance and ERM give signals and transfers of information from well informed manager to poor informed stockholders in reducing the asssimetric information between them. Financial performance and ERM positive signals in turn may increase the value of company.

Jensen and Meckling (1976) explain that agency relationship as a contract under which one or more persons (the principals) engage another person (the agent) to perform some service on their behalf which involves delegating some decision making authority to the agent. This theory generally assume that the principals are risk-neutral while the agents are risk and effort averse. The agents and the principals are assumed to be motivated by their own interests but those are frequently in clash (Leslie and Kren 1997). In this case, there is a difference between the stockholders' (the principals') interests who expect optimal returns on capital they have invested and the management (the agents) who want a reasonable compensation for the performance resulted. ERM as a part of the existing corporate governance mechanism comes to provide certainty upon the undertaken management risk by the management that there is company's operational certainty in the future, and the agents deserve to obtain rewards for their performance in providing certainty in the future.

2.1 The Influence of Enterprise Risk Management Implementation upon the Firm Value

One form of enterprise risk management is by managing the market risk. According to Bank Indonesia (2003), market risk is the risks arising from market movement variable (adverse movement) of portfolio held by banks which make the bank experience loss. Market risk is caused by interest rates and exchange rates changes. Market risk associated with exchange rate is closely related to the company's value, determined by market conditions in determining the shares value of company.

A company which is able to reveal good ERM in its annual reports indicates that the company is able to manage the arising risks in the various programs implemented. This is similar to Hoyt and Liebenberg (2006) who find that ERM positively and significantly influences the value of company. ERM contributes 3.6% of the total value of company. ERM as a non-financial information is able to become a signal for investors related to the invested capital security. The better and more obvious ERM presented by the company in its reports will make investors fell more confident upon the capital security invested. Thus, investors will compete to obtain property certificate and willing to compete upon the shares purchase price. The first hypothesis of this study is:

H1: The implementation of Enterprise Risk Management (ERM) positively influences the value of company.

2.2 The Influence of Enterprise Risk Management Implementation upon the Financial Performance

Asymmetric information conflicts in accordance with agency theory may be minimized by reporting the company to the owners as a form of management activities transparency to the owners. Corporate reporting is one of management responsibilities in accordance with the development of *Corporate Governance* issue. The reporting forms and disclosures of Enterprise Risk Management (ERM) is one form of

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management responsibilities due to the transparency principle of Good Corporate Governance.

Hanafi (2009) mentions that Bank Indonesia requires banks to manage four keys of banking risks, including market risk, credit risk, operational risk and liquidity risk, in addition to three other risks, including compliance risk, legal risk, reputation risk. One of those risks is the operational risk which according to Bank Indonesia (2003) is a risk partly due to the insufficient or the failure of internal processes, human errors, system failures, or external problems influencing the operations of Bank. Bank operations is of course related to their ability to generate profits. In this case, the operational risks are associated with the company's profitability. Operational risk management by risk management committees provides assurance to stakeholders that the company has to maximize company's profitability by optimizing the existing operational risks. The operational risk management at ERM section is an overview of risk management made by the company to maximize the company's profitability. The second hypothesis of this study is:

H2: The Implementation of *Enterprise Risk Management* (ERM) positively influences profitability

2.3 The Influence of Financial Performance upon the Firm Value

Investors not only want to have lower risks, but also higher returns. Tandelilin (2010) mentions investment returns have two major components, including *yields* (dividends) and *gains* (capital gain or loss). The company's ability to provide dividends to the owners is also based on company financial conditions and performance during a period. Capital gains (losses) are also influenced by the power of supplies and demands upon the ownership certificate in the existing capital markets. Tandelilin (2010) also mentions that in determining investment decisions, company analysis is one of fundamental analysis steps. In analyzing this company, investors will see the company conditions and performance as one decision reference.

Financial performance provides the true company profile information and the management efficiency and effectiveness evidence in managing the available capital as a the third party's responsibility form. In accordance with the concept of Signaling Theory, financial performance is a part of company's financial information as a basis of investors' decision making. Financial performance becomes significant signals in determining investment decisions. Profitability is a reflection of the company's operational activities. Its ability to generate profits based on the owned capital assets becomes a part of company's performance assessment in a period. Stefano (2013) mentions that Return on Assets (ROA) has positive influences upon the value of company. Higher profitability reflects company's effectiveness in managing the existing properties to generate profits. Higher profits means higher dividend gains are guaranteed. Dividends, part of hareholders' returns, have positive signals for investors in their investment decisions making. The higher the profitability of a company, meaning the higher the guarantee of returns that investors are more confident to invest. Many investors want, of course, the increase of shares value in markets that the company may also increase. The third hypothesis of this study is:

H3: Profitability positively influences the firm value

2.4 The Influence of Enterprise Risk Management Implementation on Firm Value Mediated by the Financial Performance

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Signaling theory claims that risk and financial performance which are parts ofcompanybecome signals for investors in their decision making processes. The risks ofcompany which are managed and reported regularly as parts of company's annual reports, sometimes are not considered to be the important ones. Skerci (2013) reveals that many investors do not pay more attentions upon ERM. These are due to the nature of ERM qualitative data that need to be examined one by one and can not be compared directly from one company to the others. Many investors do not base their decisions on ERM information but on the quantitative information ofcompany's financial statements which are then proxied in various proxies performance of company which that are comparable to one another.

Nugroho (2013) supports that ERM positivelyinfluences the company’s value and financial performance. The financial performance is considered capable in mediating the influence ofERM upon the company’s value as proven empirically by Sunarsih and Mendra (2012) that is financial performance is capable to bridge the influence of *Intellectual Capital* upon the company’s value.

Operational risks are risks related to not only company direct operations, also to shape the company's performance, especially its profitability. Profitability which is a measure of company profitabilityto generate profits is closely related to the efforts in minimizing the risks incurred inthe company's operational processes. Profitability is also an important information for investors in determining investment choices. Higher profitability reflects higher guarantee of return. Based onthis assumption, profitability is considered capable in bridging the influenceof ERM upon the value of company. The fourth hypothesis of this study is:

H4: Profitability is able to mediate the influence of Enterprise Risk Management Implementation upon the firm value

3. Research Method

The population of this study is banking companies listed on Indonesia Stock Exchange. The samples are collected using purposive sampling technique. There are 30 companies as samples with 53 annual reports used as units of analysis. Annual reports of 2011 and 2012 are used as ERM implementation and financial performance data, while ICMD (Indonesia Capital Market Directory) data of 2012 and 2013 are used as the company value data. The criteria used in purposive sampling are as follows:

1. Banking companies listed on Indonesia Stock Exchange publishing annual reports for the period ended on December 31 of 2011-2013 in accordance with the circular letter no. 13/23/DPNP on October 25th of 2011 related to the amendments of Circular letter No. 5/21/DPNP on the Application of Risk Management for Commercial Banks, which comes into effects for annual reports of 2011.
2. The company has risk management committee included in the board of directors and the disclosure of Enterprise Risk Management in its annual reports of 2011-2012, to ensure that the independent variable (ERM) is truly implemented by the company in a related period.

This research consists of three variables: ERM, profitability, and firm value. *Enterprise Risk Management* (ERM) is measured using the guidelines of risk management for commercial banks as stipulated in Bank Indonesia Regulation no. 5/8/PBI/2003 on the Application of Risk Management for Commercial Banks. The ERM consists of 106 items including the supervisions of the board of commissioners and directors, human resources, organization, procedural policies and limits

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establishment, inherent risk, and tolerance risk, policies and procedures, limits, risk identification processes, risk measures, risk monitoring, risk controls, management information systems and management control systems. Information on the application of ERM is shown in the company's annual reports published through the company website and idx.go.id.

The firm value is reflected in stock market prices. The firm value was measured by Price to Book Value (PBV). According to Hanafi (2005) PBV value is measured by comparing price per share with book value per share. Financial performance is the manifestation of company's performance which, in this study, is measured with the profitability ratio. This ratio is measured in Return on Equity (ROE) focusing on the company ability to obtain earnings during the operations of company. ROE ratio according to Bank Indonesia Circular Letter No. 6/23/DPNP on May 31 of 2004 at Appendix 1d, is measured by comparing the ratio between net income before taxes with total equity. Data collection method is obtained through documentation. The data analyzed using descriptive analysis, linear regression, and path analysis.

4. RESULTS AND DISCUSSIONS

4.1 Statistical Descriptive Analysis results

Table 1

Statistical Descriptive Analysis

	N	Minimum	Maximum	Mean	Std Deviation
PBV	53	0.39	4.57	1.570530	0.9316976
ROE	53	-0.0338	.4249	0.190143	0.0897778
ERM	53	28	118	79.81	20.168

Source: Processed Secondary data, 2014

Table 1 shows that the average value of all variables are quite good. Standar deviation of all variables is lower than the mean. It indicates that the distribution variation of the company value tends to be similar each other.

4.2 Hypothesis Testing

Results of the first hypothesis test:

Table 2

Statistical Test of the Influence of ERM Implementation upon the Company Value

Model	Unstandardized Coefficients		Standardized Coefficients	T	Sig.
	B	Std. Error	Beta		
(Constant)	206.249	52.747		3.910	.000
ERM	-.616	.641	-.133	-.961	.341
a. Dependent Variable: PBV					

Source: Processed secondary data, 2014

Table 2 shows that ERM has insignificant negative influence upon the company value. Implementation of Enterprise Risk Management (ERM) may not influence the companyvalue that H1, in this study, is rejected.

The results of statistical test H2 show that the influence of ERM implementation upon the financial performance by ROE proxies are as follows:

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Table 3
The Statistical Test Results of Influence of ERM Implementation upon Company Profitability

Model	Unstandardized Coefficients		Standardized Coefficients	T	Sig.
	B	Std. Error	Beta		
(Constant)	28,089	4,958		5,665	,000
ERM	-,114	,060	-,255	-1,887	,065
a. Dependent Variable: ROE					

Source: processed secondary data, 2014

Table 3 shows that the implementation of Enterprise Risk Management (ERM) has no significant influence upon the company profitability that is proxied by Return on Equity (ROE) shown in the significance table of 0.065 which is greater than $\alpha=0.05$.It can be concluded that H2 in this study is rejected. Furthermore, the statistical test results of profitability influence upon the company value:

Table 4
Statistical Test of The Influence of Profitability upon the company Value

Model	Unstandardized Coefficients		Standardized Coefficients	T	Sig.
	B	Std. Error	Beta		
(Constant)	71.289	27.472		2.595	.012
ROE	4.510	1.309	.435	3.446	.001
a. Dependent Variable: PBV					

Source: processed secondary data, 2014

Table 4 shows that the significance level of profitability influence(ROE) upon the company value (Price to Book Value) of 0.001 which is below $\alpha=0.05$. It shows the significant influence of ROE and PBV. The Value b = 4.510 means that there is a significant positive influence between these two variables. Thus, it can be concluded that H3 in this study is accepted. Furthermore, the statistical test results of ERM influence upon the company value mediated by profitabilityare as follows:

Table 5
The Statistical Test Results ofthe Influence of ERM upon Company Value through Financial Performance (ROE)

Indirect Influences of IV on DV through Proposed Mediators (ab paths)					
	Data	boot	Bias	SE	t hitung
ROE	-.5292	-.5369	-.0078	.3625	-1.45986207

Source: Processed secondary data, 2014

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Table 5 shows that the t value of ROE is -1.45986207 while the t table is 1.6741. Since the t value is less than the t table (1.45986207 <1.6741), it can be concluded that H4, in this study, is rejected.

4.2 Discussion

Enterprise Risk Management (ERM) is non financial information which is able to become a signal for investors related to the invested capital security. H1 in this research is rejected. It means that the implementation of Enterprise Risk Management is not able to increase the value of company. Based on signaling theory, the ERM implementation is evidence for bank's capacity to manage the related risks. Companies which are able to have good ERM annual reports indicate that they are able to manage the existing risks in various programs performed.

Results of this study are dissimilar with the research conducted by Hoyt (2006) and Bertinetti (2013), which previously found that there are influences of both. However, this study is similar to Pagach and Warr (2010), Tahir and Razali (2011), Skerci (2013) who found that there are no significant influences of both. The reasons may be explained as follows: First, the implementation of ERM for the banking company is an obligation as stipulated in Bank Indonesia Regulation No. 5/8/PBI/2003 on Risk Management for Commercial Banks. ERM implementation is considered as an obligation for Bank's activities rather than an effort to attract investors to own the company. The average value of ERM implementation is 79.81 of the overall 106 obligation items that must be implemented. The standard deviation of 20.168 is much lower than the average value indicating that each company tends to be equal in presenting information in its annual reports. This uniformity is based on the basis standard regulation that banks should perform as stipulated in Bank Indonesia circular letter no.13/23/DPNP. Second, as revealed by Skerci (2013) stating that the information upon ERM is qualitative which needs to be examined one by one that many investors do not need to pay more attention to this information. Investors are possibly happier to pay more attention to quantitative information that it is possible to be compared to one another. Third, the implementation of ERM is regulated by Bank Indonesia in Circular letter no.13/23/DPNP on October 25 of 2011 on the Revision of Risk Management for Banking. This circular letter provides signs for bankers to perform and inform ERM implementation within the company that the information obtained tend to be similar. Banking is a business with full of risks. Operational risk management by risk management committees provides assurance to stakeholders that the company has made its efforts to maximize the company's profitability by optimizing the existing operational risks.

Statistical test results for H2 in this study is rejected. The Enterprise Risk Management (ERM) implementation has no influence upon the company's profitability. This finding is in contrary with the study conducted by Nugroho (2013) finding that the influence of ERM implementation upon the company's financial performance. The absence of this influence is due to the implementation of ERM which is considered as investment upon long term business survival efforts, while the proxied profitability in the Return on Equity (ROE) is a temporaral or static financial performance proxy. The amount depends on its profit or loss in the related period.

Profitability is a reflection of company's operational activities. Its ability to generate profits based on the owned capital or assets becomes a part of assessment upon the company's performance in the related period. H3 test results show that the

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profitability influence upon the company's value is accepted. The higher the profitability is, the higher the company's value is as well. These results support the study conducted by Stefano (2013) and Bertinetti (2013) finding that there is a positive influence between profitability and company's value, but in contrary Tahir (2011) finds that there is a negative influence between them.

The fourth hypothesis in this study is rejected since the profitability has no capacity to mediate the influence of ERM upon the company value. According to the agency theory, profitability should have the capacity to mediate the influence between them. Operational risk management participates in determining the profitability of the company. The implementation of ERM upon the fulfillment of obligations by commercial banks due to the regulations stipulated in the circular letter of Bank Indonesia, is not an effort to mitigate the real risks. Thus, the profitability has no capacity to mediate the influence of ERM upon the company value.

5. Conclusion

The implementation of Enterprise Risk Management (ERM) has no significant influence upon the company value since the performed implementation tends to fulfill obligations upon the regulation of Bank Indonesia only. Moreover, Skerci (2013) reveals that the external party does not focus more on the qualitative reporting that it will be harder to compare one another. The Implementation of Enterprise Risk Management (ERM) does not significantly influence the company's financial performance (profitability) since the implementation of ERM in a company is merely due to bank compliance to the existing regulations. In addition, Bank Indonesia Circular Letter no.13/23/DPNP on October 25th of 2011 amended to the Circular latter No. 5/21/DPNP on Application of Risk Management for Commercial Banks which means that the implementation should be performed similarly one another. Thus, it is not quiet significant to influence the company's performance.

Profitability may significantly influence the company value. It shows that in profitability capital returns is considered significant by investors in investment decisions making. Overall financial performance is also considered as a positive signal for assessment decision of external parties upon the company. Financial performance has no capacity to mediate the relationship between the implementation of Enterprise risk management (ERM) and the value of company since the implementation of ERM in banking world is an attempt to only fulfill the obligation.

If further researches are interested in developing this study, it is better for them to use *lag-1* or *lag-2* period of time for financial performance, by considering the application of risk management as an investment for the future of the company due to the survival of company operations itself. ERM variable implementation can be developed more through the primary data, direct analysis or interviews to the interested parties to obtain the data that truly can describe the overall ERM implementation. Researchers may focus more on the types of non-financial (non-banking) companies regarding to banks' obligation to implement ERM based on the applicable guidelines. Since the implementation of annual reporting tends to be similar one another, it makes the risk mitigation efforts unable to be described to through this risk management.

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