Chapter 2
The Relationship Between Risk and Firm Performance:
A Review

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ABSTRACT

The relationship between risk and return is a crucial point in typical decision making, and empirical previous studies can help related stakeholders in this process. Henceforth, this chapter aims to present some fundamental theoretical concepts and interpretations of the relationship between risk and firm performance. Accordingly, this chapter offers a review of some highlighted studies in this field by presenting methodologies used and developed by several scholars. The chapter provides a timely reference source for a range of target audience from both academia and industry who have common interests to decompose and examine the relationship between risk and firm performance.

INTRODUCTION

Viewed from a historical retrospective and nowadays, the role of risk management to business decision-makers is indisputable and especially in times of crisis as it is the ongoing pandemic COVID-19. This role is increasingly reinforced because of the influence of several factors that affect the business directly and indirectly.

Risk management helps managers to measure and estimate risk and return of investments. This role remains crucial in finding a proper solution toward maximizing shareholders' value. However, estimating and composing an efficient risk-return relationship is not easy due to finding the probability or likelihood that an event is going to happen and have an influential impact on the expected outcome, e.g., firm performance.

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Hence, risk managers will be faced with forecasting accuracy because there is no such a certain business environment in which operate investors. Consequently, risk managers often are not able to precisely forecast the risk-return relationship due to several unknown factors influencing it.

Given a broad range of risks that a firm might face including interest rate, credit risk, bankruptcy, liquidity, default risk, corporate risk, political risk, and other risks. However, given the past and merging different shocks of global uncertainties such as the 2008 Global Financial Crisis (GFC) and the emerging 2019/20 Global Health Pandemic (GHP) that have put great challenges faced by firms across countries and regions putting big questions on "How different kinds of risk emerge and volatile during the Global Crises (GCs)?" and "How can firms overcome those challenges and deal with several kinds of emerging risks to avoid going bankrupt?". Those questions are especially important to small and medium enterprises (SMEs) with lower market capitalization, quicker human resources, corporate governance, financial and operational management compared with higher market capitalization firms[1].

Further, by deploying risk management, managers, shareholders, and other related decision-makers can turn opportunities into real returns. Obviously, there are no so ready-made and general recipes on how to minimize the risk and maximize the return. Investors would composite such a risk-return relationship according to their own preferences. For example, Kukeli, Deari and Rocşoreanu (2019) show the composition of an efficient portfolio using the Lagrange multiplier method (short sales are allowed) and Kuhn-Tucker system (short sales are not allowed) in the light of the investor's risk tolerance.

Given the established motives and in this light of importance, this chapter is prepared as a timely reference source to synthesis previous literature in the field ideally for a range of target audiences such as corporate stakeholders, directors, policymakers, analysts, researchers, and students bringing experts from both academia and industry who have common interests in risk management and firm performance optimization.

The chapter aims to investigate the relationship between risk management and firm performance by covering theoretical and empirical studies. These studies are selected by no preferences to any article/author/journal and are collected in the context of problem definition. The chapter is oriented toward the research question if risk management affects firm performance by presenting a plenty number of empirical studies. Further, Enterprise Risk Management (ERM, hereafter) is expected to influence firm performance, and a significant relationship between risk and firm performance exists.

Based on the arguments above, the study provides the following hypotheses for the relation between risk management and firm performance:

Hypothesis 1: There is a relationship between risk management and firm performance. In other words, the better the risk management the higher the firm performance.

Hypothesis 2: Implementing ERM leads to better firm performance.

Motivated by those critical hypotheses, this chapter contributes to the existing literature by revisiting the relationship between risk management and firm performance that is associated with several financial and economic disciplines from the theoretical perspective. It presents a systematic review of some empirical studies realized in the field of risk management.

This book chapter is structured as follows. Section 1 provides a gentle introduction of the context, background, different kinds of risks, emerging trends in risk management and firm performance. Section 2 provides a systematic literature review on risk management with a strong focus on liquidity, default, and bankruptcy risk. Section 3 synthesizes the methodology and approaches that can be used to hedge, manage, and mitigate different types of risks mentioned in Section 2. Sections 4 and 5 present insightful discussion, conclusions, and further research needed.

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