INFLUENCE OF RISK MANAGEMENT PROCESS IN ESTABLISHMENT OF PERFORMANCE BASED BUDGETING

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ABSTRACT

Effective organizations typically have a system of management that can assess risks and a budgetary system for the day-to-day operations of the business. Risk management is a method and process that can optimize the efficiency of the organizations. Risk management allows a business to minimize potential liabilities. The nature of risk management and the challenges generated by its theory and practice have been in a state of evolution over the past ۱۰ years. This process of evolution has created a number of difficulties for those involved in the management of risk, who now increasingly find themselves lacking the necessary capabilities to cope with the nature of this change – not least because of the increased volume of information around the various sources of threat and the trans-disciplinary nature of the problems.

The goal of risk management is to assess the effect of uncertainty on the goals of the organization, regardless of whether these goals are positive or negative. Risk management involves going over the operations of the organization and identifying any potential threats, assessing the probability that the threats will occur and taking actions to minimize the likelihood of the threats.

Performance-based budgeting is a type of budgeting mostly used by public organizations. This type of budgeting links funding to results. To encourage the effectiveness of public expenditures, municipalities adopt performance-based budgeting.

By design, this system provides results instead of getting bogged down by internal processes that exceed the budget and prolong public projects. When implementing performance-based budgeting, priority is placed on employees being committed to producing positive results. Budgeting is a formal process in which cost estimates are made for a future period.

For Performance-based budgeting to work, the organization must reprioritize fund allocations. The organization must also create a new system to rate and categorize performance to continue funding successful and completed projects. This budgeting method requires effective and efficient accounting of money spent on projects with reliable performance information, therefore truly understanding of risk and methods of risk management can help organization to do the budgeting process efficiency.

This paper based on investigation process in Bank sector in China and The aims of this paper are, identifying and explain the different types of risk and new approaches and methodologies of Risk Management that include Risk avoidance, Hazard prevention, Risk reduction, Risk sharing, Risk retention and then explain how we can use these methods in reducing risks and understanding the effect of risk management in establishment of performance based budgeting as a one of optimization method in organizations.

KEY WORDS:

RISK MANAGEMENT, PERFORMANCE BUDGETING, ASSESSMENT OF RISK, BUDGETING RELATED RISKS, RESILIENCE OF RISK, BUDGETING APPROACHES.

INTRODUCTION

Organizations commonly develop and rely on rules as a primary tool for managing risk, equating compliance with overall effective risk management. While complying with rules may be adequate to manage certain types of risks, history has demonstrated that not all types of risk can be effectively dealt with through compliance-focused risk management. This article presents a new framework for defining and addressing an organization's risks that expands beyond rules-based models. Central to this framework is the idea that an organization's risks can be broken down into the following three categories:

- Internal risks, relative to an organization, that can be controlled.
- Strategic risks taken on by an organization in the pursuit of value.
- External risks, relative to an organization, that are largely beyond control.

Risk management ensures that an organization identifies and understands the risks to which it is exposed. Risk management also guarantees that the organization creates and implements an effective plan to prevent losses or reduce the impact if a loss occurs. Risk management provides a clear and structured approach to identifying risks. Having a clear understanding of all risks allows an organization to measure and prioritize them and take the appropriate actions to reduce losses.

A risk management plan includes strategies and techniques for recognizing and confronting these threats. Good risk management doesn't have to be expensive or time consuming. The nature of risk management and the challenges generated by its theory and practice have been in a state of evolution over the past ١٠ years.

This process of evolution has created a number of difficulties for those involved in the management of risk, who now increasingly find themselves lacking the necessary capabilities to cope with the nature of this change – not least because of the increased volume of information around the various sources of threat and the trans-disciplinary nature of the problems.

Principles of risk management include the following steps and it should:

١-create value – resources expended to mitigate risk should be less than the consequence of inaction, or (as in value engineering), the gain should exceed the pain. ٢-be an integral part of organizational processes. ٣-be part of decision making. ٤-explicitly address uncertainty and assumptions. ٥-be systematic and structured. ٦-be based on the best available information. ٧-take human factors into account. ٨-be transparent and inclusive. ٩-be dynamic, iterative and responsive to change. ١٠-be capable of continual improvement and enhancement. ١١-be continually or periodically re-assessed.

In any organization when the risk is recognized and set the principle of risk management the next step is assessment risk. Once risks have been identified, they must then be assessed as to their potential severity of impact (generally a negative impact, such as damage or loss) and to the probability of occurrence. These quantities can be either simple to measure, in the case of the value of a lost building, or impossible to know for sure in the case of the probability of an unlikely event occurring.

Therefore, in the assessment process it is critical to make the best educated decisions in order to properly prioritize the implementation of the risk management plan. Even a short-term positive improvement can have long-term negative impacts. The fundamental difficulty in risk assessment is determining the rate of occurrence since statistical information is not available on all kinds of past incidents.

Furthermore, evaluating the severity of the consequences (impact) is often quite difficult for intangible assets. Asset valuation is another question that needs to be addressed. Thus, best educated opinions and available statistics are the primary sources of information. Nevertheless, risk assessment

should produce such information for the management of the organization that the primary risks are easy to understand and that the risk management decisions may be prioritized.

Thus, there have been several theories and attempts to quantify risks. Once risks have been identified and assessed, all techniques to manage the risk fall into one or more of these four major categories: ۱- Avoidance (eliminate, withdraw from or not become involved). ۲-Reduction (optimize – mitigate). ۳- Sharing (transfer – outsource or insure). ٤-Retention (accept and budget).

Risk avoidance: This includes not performing an activity that could carry risk. An example would be not buying a property or business in order to not take on the legal liability that comes with it. Avoidance may seem the answer to all risks, but avoiding risks also means losing out on the potential gain that accepting (retaining) the risk may have allowed. Not entering a business to avoid the risk of loss also avoids the possibility of earning profits.

Hazard prevention: Hazard prevention refers to the prevention of risks in an emergency. The first and most effective stage of hazard prevention is the elimination of hazards. If this takes too long, is too costly, or is otherwise impractical, the second stage is mitigation.

Risk reduction: Risk reduction or "optimization" involves reducing the severity of the loss or the likelihood of the loss from occurring. This method may cause a greater loss by water damage and therefore may not be suitable. Acknowledging that risks can be positive or negative, optimizing risks means finding a balance between negative risk and the benefit of the operation or activity; and between risk reduction and effort applied.

Risk sharing: Briefly defined as "sharing with another party the burden of loss or the benefit of gain, from a risk, and the measures to reduce a risk. "

Risk retention: Involves accepting the loss, or benefit of gain, from a risk when it occurs. True self insurance falls in this category. Risk retention is a viable strategy for small risks where the cost of insuring against the risk would be greater over time than the total losses sustained. All risks that are not avoided or transferred are retained by default.

This includes risks that are so large or catastrophic that they either cannot be insured against or the premiums would be infeasible. Also any amounts of potential loss (risk) over the amount insured is retained risk. This may also be acceptable if the chance of a very large loss is small or if the cost to insure for greater coverage amounts is so great it would hinder the goals of the organization too much.

Another part of this article is about performance based budgeting. When we want to use risk management in this matter, recognize of this matter is so important. Performance budgeting systems are viable tools for improving program accountability and performance. They guide administration and management by providing greater detail on expenditures, resources and capacity. Performance budgeting systems allocate resources on the basis of both the financial and physical aspects of a project.

They extend beyond traditional budgeting systems that focus primarily on the financial aspects of a project and incorporate elements of performance evaluation and auditing. Furthermore, performance budgeting systems not only allocate resources to project activities and programs but also measure progress of the project and the management and control of allocated resources. Four benefits of performance budgeting systems include improved communication between budget actors and beneficiaries; improved program management; informed budgetary decision-making; and greater accountability and transparency.

Program objectives, goals and targets are clear and easier to communicate to budget stakeholders, citizens and the government. Program managers have better knowledge about program goals and expectations. The budget is prepared after all program-related information is taken into account. A performance budget serves as an accountability and transparency tool for the public and the legislation by providing vital information about how resources are spent and whether program goals are met.

Inputs, outputs, outcomes, impact and budget reach are main components of a performance budgeting system Inputs are all those resources that produce outputs; outputs are the services and goods produced; outcomes measure the progress toward program objectives; impacts include goals; and reach refers to the beneficiaries of a project.

In these components of performance based budgeting all types of risk include internal-strategic and external can occur so the role and influence of risk management in budgeting planning and establishment of performance based budgeting is so important.

EXPERIMENTAL

To understanding how risk management process can work and effect on performance budgeting, we can investigate in banking sector. Risk management in banks is a relatively newer practice, but has already shown to increase efficiency in governing of these banks as such procedures tend to increase the corporate governance of a financial institution.

The days of detailed, static plans and budgets that offer only an accounting view of the business are numbered. Volatility, uncertainty and risk dictate that companies develop a set of performance management practices that allow managers to identify, understand and model risk as a continuous part of their management process. The combination of best practices and state of the art technology provides managers with the means to turn risk management into a key component of their ability to sustain profitable growth.

In times of volatility and fluctuations in the market, financial institutions need to prove their mettle by withstanding the market variations and achieve sustainability in terms of growth and well as have a stable share value. Hence, an essential component of risk management framework would be to mitigate all the risks and rewards of the products and service offered by the bank. Thus the need for an efficient risk management framework is paramount in order to factor in internal and external risks.

One of the budgeting process in each banks is performance based budgeting and The financial sector in various economies like that in China are undergoing a monumental change factoring into account world events such as the ongoing Banking Crisis across the globe. The ۲۰۰۷–present recession in the United States has highlighted the need for banks to incorporate the concept of Risk Management into their regular procedures.

The various aspects of increasing global competition to china Banks by Foreign banks, increasingDeregulation, introduction of innovative products, and financial instruments as well as innovation in delivery channels have highlighted the need for china Banks to be prepared in terms of risk management.

china Banks have been making great advancements in terms of progress in terms of technology, quality, quantity as well as stability such that they have started to expand and diversify at a rapid rate. However, such expansion brings these banks into the context of risk especially at the onset of increasing Globalization and Liberalization. In banks and other financial institution risk plays a major part in the earnings of a bank.

Higher the risk, higher is the return, hence, it is most essential to maintain a parity between risk and return. Hence, management of Financial risk incorporating a set systematic and professional methods especially those defined by the norms because a essential requirement of banks. The more risk averse a bank is, the safer is their Capital base.
Risk ratio would be defined as the ratio of the probability of an issue occurring as against to an issue not occurring. Total impact of the risk (TIR) occurring would entail as the impact. the risk would cause multiplied by the Risk Ratio. It is essentially how much a bank would be impacted in the chance that the risk did occur. This essentially helps ascertain what is the total value of their investments that may be subject to risk and how it would impact them.
The term Risk and the types associated to it would refer to mean financial risk or uncertainty of financial loss. The Reserve Bank of china guidelines issued in Oct. ۱۹۹۹ has identified and categorized the majority of risk into three major categories assumed to be encountered by banks. These belong to the clusters:

- Credit Risk
- Market Risk
- Operational Risk

The type of risks can be fundamentally subdivided in primarily of two types, Financial and Non-Financial Risk. Financial risks would involve all those aspects which deal mainly with financial aspects of the bank.
These can be further subdivided into Credit Risk and Market Risk. Both Credit and Market Risk may be further subdivided. For removing these credit – market and operational risks and set performance based budgeting, risk management new methods and plan is require.
China banks set principal strategies for above managing risk. The board's responsibilities are likely to encompass:

- ensuring that the identification, assessment and mitigation of risk is linked to the achievement of the charity's operational objectives;
- ensuring the process covers all areas of risk, including financial, governance, operational and reputational risks, and is focused primarily on major risks;
- ensuring that the process seeks to produce a risk exposure profile that reflects the trustees' views as to levels of acceptable risk;
- reviewing and considering the principal results of risk identification, evaluation and management; and
- ensuring that the risk management is ongoing and embedded in management and operational procedures.

Therefore One of new methods that used in banking sector in china to apply risk management is Positive risk management. Positive Risk Management is an approach that recognizes the importance of the human factor and of individual differences in propensity for risk taking. It draws from the work of a number of academics and professionals who have expressed concerns about scientific rigor of the wider risk management debate or who have made a contribution emphasizing the human dimension of risk.
Firstly, it recognizes that any object or situation can be rendered hazardous by the involvement of someone with an inappropriate disposition towards risk; whether too risk taking or too risk averse.
Secondly, it recognizes that risk is an inevitable and ever present element throughout life: from conception through to the point at the end of life when we finally lose our personal battle with life threatening risk.

Thirdly, it recognizes that every individual has a particular orientation towards risk; while at one extreme people may by nature be timid, anxious and fearful, others will be adventurous, impulsive and almost oblivious to danger. These differences are evident in the way we drive our cars, in our diets, in our relationships, in our careers.

Finally, Positive Risk Management recognizes that risk taking is essential to all enterprise, creativity, heroism, education, scientific advance – in fact to any activity and all the initiatives that have contributed to our evolutionary success and civilization. It is worth noting how many enjoyable activities involve fear and willingly embrace risk taking.

Therefore bank sector in china found an effective risk management plan in budgeting process that it should shows in following steps:

- reflects a wide range of views and perspectives in an organization;
- expresses the nonprofit's belief in and support of risk management;
- states that personnel at all levels of the organization play a vital role in protecting the nonprofit's mission, reputation and assets;
- incorporates the existing risk management policies of the organization;
- reflects the nonprofit's goals and aspirations for its risk management efforts;

As we know, for Performance-based budgeting to work, the organization must reprioritize fund allocations. The organization must also create a new system to rate and categorize performance to continue funding successful and completed projects.

This budgeting method requires effective and efficient accounting of money spent on projects with reliable performance information, therefore truly understanding of risk and methods of risk management can help organization to do the budgeting process efficiency.

An effective risk management practice does not eliminate risks. However, having an effective and operational risk management practice shows an insurer that your organization is committed to loss reduction or prevention.

Therefore with recognizing the risks in financial organizations like banks and the role of managing these risks in optimizing budgeting and use new methods of risk management in financial organizations and set the principal and strategies of it, we can reach and establish strong budgeting based on performance.

CONCLUSION

In this paper, attempted to propose new methodologies like positive risk management for dealing with effective of risk assessment and management in establishment of performance based budgeting as a one of optimizing approach for financial or non-financial organizations.

The goal of risk management is to assess the effect of uncertainty on the goals of the organization, regardless of whether these goals are positive or negative. Risk management involves going over the operations of the organization and identifying any potential threats, assessing the probability that the threats will occur and taking actions to minimize the likelihood of the threats.

This paper tried to show, Risk management can creates and protects value, be an integral part of organizational processes and also it can be part of decision-making in budgeting process.

By understanding and identifying different types of risks in financial and non-financial organizations and set the principals and strategies of risks management for removing these internal-strategic-external-credit-operational and market risks, and through it organization can saving resources (Time,