

PROMOTION OF CORPORATE GOVERNANCE AS ONE OF THE METHODS OF REDUCING OPERATIONAL RISK IN AN ENTERPRISE

PODPORA CORPORATE GOVERNANCE AKO JEDNEJ Z METÓD REKUCIE OPERAČNÉHO RIZIKA V PODNIKU

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Abstract

Without any doubt the development of entrepreneurship is closely related to the development of society. However, the implementation of any undertaking, also financial one, is connected with a certain degree of risk which has negative influence on entrepreneurship. Corporate governance is one of the many methods of reducing risk. The following paper demonstrates how corporate governance could be used in order to eliminate operational risk, which is illustrated by the example of Wawel plc.

Abstrakt

Bez akýchkoľvek pochybností je rozvoj podnikania úzko spätý s rozvojom spoločnosti. Avšak implementácia, vrátane finančnej, je spojená s určitým stupňom rizika, ktoré má negatívny vplyv na podnikanie. Správa a riadenie je jedným z mnohých spôsobov zníženia rizika. Nasledujúci dokument ukazuje, ako by mohlo byť „corporate governance“ (správa a riadenie spoločnosti/dobrá správa/otvorené vládnutie) použité za účelom odstránenia operačného rizika, čo je znázornené na príklade Wawel plc.

INTRODUCTION

Nowadays the situation in financial markets forces companies worldwide to do their best to reduce risks. Risk is one of the essential elements of doing business. Usually, risk is perceived as a negative phenomenon, that is why companies try to eliminate it. Reducing risk is one of the factors allowing an enterprise to develop. That is why it is so important. The aim of this paper is to prove that employing and promoting corporate governance could be used to eliminate firm's operational or other risks. Hypothesis formulated in order to achieve this goal is a claim that well-organized implementation of corporate governance in a company reduces financial risk. Both the aim and hypothesis were verified by the following literature analysis and case study.

1. DEFINITION AND ORIGIN OF CORPORATE GOVERNANCE

All the aspects connected with the decision-making process of a company as well as the relationships between a company and its stakeholders can be broadly referred to as corporate governance.

The term is by no means a new concept. It has its genesis in the antiquity, for example The Odyssey presents the consequences of separating ownership from management. A. Smith was the first one to use corporate governance as an economic concept in his work entitled "An

Inquiry into the Nature and Causes of the Wealth of Nations" when he formulated the resource-allocation theory.¹ However, the importance of corporate governance was acknowledged in the 20th century due to the dynamic development of capitalism.²

In general corporate governance refers to a system of management and control of an enterprise. This description is rather simplified. It seems there is no generally accepted definition of corporate governance.

Corporate governance could be interpreted as imposing control of owners over a board of directors. The main aim is to protect the financial interest of stockholders and maximize the value of an enterprise. As far as finance is concerned, corporate governance is defined as a method used by investors to receive return on their capital.³ There are many different models of corporate governance around the world. Either all stakeholders of a company are treated as equal participants according to the coordinated or Multistakeholder Model, or the interests of owners are given priority over the other stakeholders' interests - the Anglo-American model.⁴

Corporate governance seems to be a vital issue as since 1999 The Organization for Economic Co-operation and Development (OECD) has worked on establishing generally accepted principles around which businesses are expected to operate to assure proper governance. The dynamic development and instability of the market are main reasons for ongoing process of adjusting the principles. The most recent guidelines were released in April 2004.⁵

Principles of corporate governance recommended in the OECD report⁶:

- Providing grounds for efficient enforcement of corporate governance,
- Rights of shareholders and the functions of owners,
- Equitable treatment of shareholders,
- Role of the stakeholders in the process,
- Disclosure and transparency,
- Responsibilities of the board.

OECD defines corporate governance in two ways. On the one hand, it is understood as a system of law in a given country created by codes, acts and government orders.⁷ On the other hand, OECD recommends that corporate governance should be treated as a collection of good practices.⁸

2. MECHANISM OF CORPORATE GOVERNANCE

Functioning of corporate governance is described and analyzed with a use of many different theories e.g. the principal-agent problem or agency dilemma and transaction costs theory. As a rule, the mechanism of corporate governance is usually implemented due to the necessity of minimizing the undesirable effects of agency problem. It is the result of the fact that it is impossible to create a complete contract encompassing all possible future situations. The mechanism of corporate governance is a way to avoid misappropriation of funds. The

¹ M. Jerzemowska, *Nadzór korporacyjny*, PWE, Warszawa 2002, s. 11.

² Ibidem

³ D. Dobija, I. Koładkiewicz, *Ład korporacyjny*, Oficyna a Wolters Kluwer business, Warszawa 2011, s.17.

⁴ Ibidem

⁵ <http://www.oecd.org/dataoecd/16/32/34656740.pdf> odczyt z dnia 20 listopada 2014 r.

⁶ Ibidem

⁷ A. Peszko, *Rada Nadzorcza w procesie zarządzania przedsiębiorstwem*, Difin, Warszawa 2006, s. 208-211.

⁸ http://www.corp-gov.gpw.pl/lad_corp.asp, odczyt z dnia 20 listopada 2014 r.

mechanism can be determined by internal and external factors.⁹ The above division is depicted in Table 1.

Table 1. Mechanism of corporate governance

Mechanism of corporate governance	
Internal	External
• board audit, • internal audit, • distribution of powers between departments, • executive pay, • equity capital structure, • debt capital structure – credits, bonds and other.	• political environment, • legislation, • set of universal, regional or local rules and customs, • advocacy groups, • competition among manufacturers, • financial market: capital market and debt • market of control over companies, • mergers and hostile takeovers, • requirements concerning disclosure and transparency, • managerial labour market, • media pressure.

Source: D. Dobija, I. Kołodkiewicz, ..., op. cit., s.25.

Internal mechanism is strictly dependent on executives, whereas external mechanism is determined by market and market regulations.

3. BASIC MODELS OF CORPORATE GOVERNANCE

Corporate governance could be classified into two groups based on supervisory system, which is the most common division of all, mainly:

- two-tiered or coordinated model;
- single-tiered or unitary model.

This division takes its roots in history and culture.

The coordinated model is associated with continental European countries, including Germany and the Netherlands, and also Japan. It requires a two-tiered Board of Directors as a means of improving corporate governance. In the two-tiered board, the Executive Board is made up of company executives who generally run a company while the supervisory board is made up entirely of non-executive directors who represent shareholders and employees, and maintain control of the members of the executive board. A member of the Executive Board cannot be a member of the supervisory board. Here the role of financial market is tangential.¹⁰

The unitary system is associated with the USA and UK, that is why it is commonly called "Anglo-American model".¹¹ It relies on a single-tiered Board of Directors that should exercise both executive and supervisory functions.

In practice there are several models of corporate governance, which are combinations of the two basic ones, i.e.: German, Latin, Anglo-Saxon, Japanese.¹²

⁹ D. Dobija, I. Kołodkiewicz, ..., op. cit., s.23-25.

¹⁰ Cz. Mesjasz, *Teorie nadzoru korporacyjnego* [w:] *Ekonomiczne i społeczne problemy nadzoru korporacyjnego*, red. S. Rudolf, Wydawnictwo Uniwersytetu Łódzkiego, Łódź s. 13 – 32.

¹¹ S. Rudolf, *Nadzór właścicielski w spółkach prawa handlowego*, Wydawnictwo Naukowe PWN, Warszawa 1999, s.10 – 11.

¹² K.A. Lis, H. Sterniczuk, *Nadzór korporacyjny*, Oficyna Ekonomiczna, Kraków 2005, s. 123.

Table 2 depicts the characteristics of different corporate governance models.

Table 2. Characteristics of corporate governance models

Characteristics of corporate governance models				
Approach	Market-dependent	Environment - dependent		
Model	Anglo-Saxon	German	Latin	Japanese
The Board of Directors	single-tiered	two-tiered	single-tiered or two-tiered	single-tiered
The significance of stock exchange	Major	Average	Average	Major
Concentration of ownership	Minor	Average or major	Average or major	Average or major
Influence of banks on company functioning	Minor	Major	Major	Major
Dominant shareholder	Shareholders	Banks, employees, oligarchic groups	Financial holdings, governments, families – oligarchic groups in general	Banks, financial institutions, employees, oligarchic groups
Protection of the minority shareholders	Important	Less important	Less important	Less important
Financing	Bonds and bank credit	Mainly bank credit	Mainly bank credit	Mainly bank credit
Buying each other's shares	Small	Considerable	Considerable	Considerable
Degree to which salary depends on results	High	Low	Average	Low
Time frame for exercising executive function	Short	Long	Long	Long
Emphasis on interests of	Shareholders	All stakeholders	All stakeholders	All stakeholders
Aims in the case of bankruptcy	Focus on protecting the company against creditors	Protecting creditors	Protecting creditors	Protecting creditors
Examples	USA, Canada, UK, Australia,	Germany, the Netherlands, Switzerland, Sweden, Poland	France, Italy, Spain, Belgium	Japan

Source: Based on K.A. Lis, H. Sterniczuk, ... op.cit, s. 123 -125, D. Dobija, I. Kołodkiewicz, ..., op. cit., s.25-27

Different pace of economic development, ways of obtaining funds, historical and cultural factors are reasons for distinguishing so many models of corporate governance. Existing models are also influenced by geographical situation and cooperation between countries.

4. RISK VS. CORPORATE GOVERNANCE

Companies doing business face different types of risks.¹³ Proper organization of corporate governance is supposed to eliminate those risks. The paper presents how implementation of corporate governance can eliminate or reduce organizational risk. Organizational risk may be

¹³ <http://be.ek.ug.gda.pl/wg/wp-content/uploads/pdf/1.pdf>, odczyt z dnia 20 listopada 2014 r.

divided into risks connected with technology or human errors. Implementation of corporate governance is mainly meant to reduce organizational risk generated by employees. This kind of risk encompasses: procedural improprieties and the malfunction of internal audit, defective corporate structure hindering information flow in the company, lack of clear job description and delegation of duties, mistakes in documentation.

It is also connected with incompetence of managers and other executives, procedures concerning hiring employees, their ability to handle stress and difficult situations, their criminal activity.

The risk increases due to improper and ineffective enterprise organization that is why appropriate procedures concerning selecting prospective staff and controlling should be definitely introduced.¹⁴

In order to present the actual implementation of corporate governance used to minimize risk, the author analyzed statements of Wawel plc. Wawel plc is a manufacturer of confectionery products. It is a listed public company as a part of share index Wig-Spożyw. The company has a significant market share. Table 3 presents the influence of corporate governance on organizational risks of Wawel plc.

Areas of organisation risk	Wawel plc regulations
Internal audit and procedures for systematic recording of transactions and accounting documentation	Yes
Efficient organizational structure	Yes
Clearly expressed allocation of responsibilities to entities	Yes
Personnel qualifications	Yes

Source: own elaboration

In Wawel plc financial statements are prepared by accounting departments which cooperate closely with other departments directly responsible for data when financial data do not arise from accounting ledgers. The company declares that its employees in all departments have necessary qualifications and experience to complete their day-to-day tasks with due diligence. Financial statements should be submitted to a statutory auditor for approval. Auditors should be chosen according to principles of independence and impartiality. While conducting financial audit, a statutory auditor has all the documents and personnel of the company at their disposal. Results of the audit are summarized in an audit report that either provides an unqualified opinion on the financial statements or qualifications as to its fairness and accuracy. In 2011 Rödl&Partner Ltd carried out an audit of financial statements of Wawel plc, they did not have any reservations about their accuracy.

Factors and actions determining the effectiveness of internal audit and risk management connected with preparing financial statements:

1. Implementation of internal accounting documents, mainly: rules, directives, orders, allocation of responsibilities and procedures concerning:
 - duties, powers and responsibilities of company entities and employees,
 - principles referring to circulation of accounting documents and their audit when it comes to factual errors, formal and arithmetic accuracy,
 - accounting principles in accordance with law.
2. Highly qualified accounting department staff who are responsible for prompt completion and accuracy of financial statements.
3. Keeping accounts with a use of information technology systems.

¹⁴ Ibidem

4. Systematic monitoring of risk factors concerning law, taxation etc.
5. Performing financial statement audit by independent auditor. A supervisory board chooses a suitable auditor among independent firms that provide high standard of service. Additionally, the board of directors is personally involved in every stage of the process of auditing and control and constantly monitors the process.

Organizational structure of Wawel plc is detailed and precise. Main entities forming the company encompass a general meeting of shareholders, a supervisory body and board of directors. All of them fulfill distinct functions and tasks. This type of structure enables the company to avoid overlaps between competences and shifting responsibility on other entities.

Wawel plc applies strict criteria for selecting members of the board of directors. Additionally, all entitlements, qualifications and powers of executives are specified in the document.

Wawel plc obeys the law concerning publication of corporate governance statements, presents its organizational structure in a clear manner and specifies allocation of responsibilities to entities.

CONCLUSION

The development of significance and promotion of corporate governance coincides with the development of market economy and financial markets. Corporate governance enables executives to run a company efficiently and owners to monitor the actions, policies and decisions of executives. Thanks to corporate governance, stakeholders are provided with precise information concerning the structure of an organization and competences of company entities.

Corporate governance helps to reduce various types of risk that may affect the functioning of a company. Introduction of appropriate procedures plays a vital role in decreasing organizational risk. In the case of Wawel plc organizational risk is reduced by formulation of appropriate guidelines and directives concerning methodology of internal audit, organizational structure, clearly expressed allocation of responsibilities to entities and detailed criteria for hiring staff. All the above elements of corporate governance help to reduce organizational risk in Wawel plc.

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