CORPORATE GOVERNANCE AND COMPLIANCE OF COMPANIES: CHANGES IN RISK MANAGEMENT?

Diana Stiller, Peter Joehnk

Slovak University of Technology in Bratislava, Faculty of Materials Science and Technology in Trnava

Abstract
The concept of corporate governance in enterprises is an important topic in business administration. The topic is gaining on importance in the last years through the economic and financial crisis in 2007 and the crisis of public deficit and governmental debt in Europe in 2010. This paper describes current national and international legal provisions and standards of corporate governance. A particular emphasis is placed on the differences and influence factors in risk management between Europe and the United States of America.

Key words: *corporate governance, compliance, risk management, regulation, automotive industry*

1. INTRODUCTION

The economy in the whole world was confronted in the years 2007/2008 with the breakdown of the global financial system. The reason therefor was the collapse of the US Real Estate Market which had a strong influence of the economic situation of financial institutes and insurance companies. A lot of them only survived through governmental intervention and aid. In 2009 the financial crisis had also an effect on the real economy in an unprecedented scale, but the real economy stabilized in a relatively short period. In 2010 the debt crisis or Euro crisis in the Euro area again had a negative effect on the real economy, for example the decrease of exports. In the following some member states of the Euro area couldn't meet their payment obligations from acquired debts without support of others; in some European countries this situation still lasts on.

The most of these financial institutes, insurance companies or companies in the real economy market were "SOX-compliant", these means institutes or companies, which have implemented a risk management according to regulations like "COSO Enterprise Risk Management Framework" (USA 2004), "BS-6079-3: 2000 Project management, Guide to the management of business related project risk" (UK 2000) or Corporate Governance Codex (Germany 2003). All these guidelines and standards include requirements for an effective risk management, but obviously the measures and methods of risk management have failed in case of the last crisis.

The question is not whether risk management is necessary; the question is how risk management can be designed better. Which features are necessary for an effective risk management concept and have factors like culture and communication any influence?

This paper gives a short definition of terms, an analysis of current valid risk management frameworks in Europe and the United States of America and describes similarities and differences between those regulations.

2. DEFINITION OF TERMS IN LITERATURE STANDARDS

National and international risk management standards are not law, but a collection of „best practice" - examples how risk management should be implemented in a company.

The British Standard Institution describe standards as „...an agreed, repeatable way of doing something. It is a published document that contains a technical specification or other precise criteria designed to be used consistently as a rule, guideline or definition. (...) Standards are designed for voluntary use and do not impose any regulations. (...) Any standard is a collective work. Committees

of manufactures, users, research organization, government departments and consumers work together to draw up standards that evolve to meet the demands of society and technology (...)".[1]

Risk Management Standards for example are the following:

- IEC Guide 73: Risk Management – Vocabulary – Guidelines for use in standards (international 2009)
- IEC/FDIS 31000 Risk Management – Guidelines for priniciples and implementation of risk management (international 2009)
- COSO Enterprise Risk Management Framework (USA 2004)
- BS-6079-3: Project management, Guide to the management of business related project risk (UK 2000)

RISK

The term risk is not defined consistently in the economic literature. It is often distinguished between an effect-based definition and a cause-related definition of risk. Uncertain information and risks of entrepreneurial activity (cause) influence the business profits (effect). In the concept of risk of *Schulte* risks are a cause-related security from the uncertainty of future events result that are regularly connected with incomplete information and a negative effect relative from the target.[2]

RISK MANAGEMENT

The term risk management encloses all risks that arise from the business processes along the value creation chain, taking into account the interaction to avoid the occurrence of risks or at least to reduce it. Hence, the aims of the risk management can be conducted basically from the business objectives. All measures and risk management instruments are designed to ensure the company as a going concern.[3]

The objectives of a comprehensive and integrated risk management can be summarised in:[4]

- The early identification of risks arising from operating activities,
- Identification of the consequences of risk taking,
- Avoiding the success-endangering risks,
- Avoiding inventory-endangering risks,
- Selecting of measures for the risk coping taking into account the inherent chances

Risk management is a continuous management process to control risks and opportunities and their interactions in a company. All risks through the company's activities should be addressed – past, present, in particular and future. Risk management has to be integrated in a company's culture through an effective policy.[5]

[1] http://www.bsi-global.com/en/standards-and-publications/about-standards/what-is-a-standard/ September 2012
[2] See also Romeike/Harder (2009) p. 85-86 and Schulte (1997) p. 12.
[3] See also Oetzel (2007) p. 57-65.
[4] See also Oetzel (2007) p. 57 – 59 and Romeike/Hager (2009) p. 81 – 90.
[5] See also Ferma (2002) p. 3.

3. CORPORATE GOVERNANCE IN EUROPE AND THE UNITED STATES OF AMERICA

Corporate governance as term includes all legal and institutional principles and frameworks at a national and international level, which have a directly and indirectly influence of management decisions and the corporate success. Corporate Governance is a complex process with a lot of obligatory and voluntary measures for a responsible corporate management. Corporate Governance is a generic term, which includes Compliance and Risk Management. Compliance means the attention of legal and regulatory requirements. Risk Management as a systematic process for identification, evaluation and controlling the risk situation of a company is more than compliance legal requirements.[6]

3.1. CORPORATE GOVERNANCE IN EUROPE

In 2004 the OECD, an organisation of industrial countries, has published Corporate Governance Principles. The principles include recommendations for enterprise risk management, such as risk policy in companies and disclosure and transparency of a risk situation.

Corporate Governance in Germany

In 2002 the German Corporate Governance Code was passed. The target is to create transparency by applicable rules for the companies in order to increase confidence in the management of German companies, because the most critical aspects of German management of companies were:[7]

- Inadequate focus on shareholder interests,
- Lack of transparency of German corporate governance,
- Lack of independence of German supervisory boards,
- Limited independence of auditors.

According to this code risk management is a task of the management board and the supervisory committee.[8] The obligation to implement a risk management system as a high level management task traces back to the German law „Gesetz zur Kontrolle und Transparenz im Unternehmensbereich (KonTraG)“ from 1998. It is in addition to law on stock companies and the German commercial code.[9]

Studies[10] show that in the past a lot of companies have already implemented a risk management system due to legal requirements. The problem is that only particular risk areas or individual risks will be considered, for example the treasury process or the development of commodity price risks. The main target is to avoid the failure of the company, but only with the view on past events and not with a foresight into the future. Conclusion of these studies is that the legal requirements are maintained, and the focus of formal aspects of risk management is too strong. The recommendation is that the risk management process should be organized at the corporate strategy and corporate goals. Corporate vision and culture have to be considered. Individual risks and there interactions should also be considered. A particular characteristic of a successful risk management system is an open-minded approach for risks, which were not identified in the past.

Compliance includes all principals and measures in a company, which are necessary to ensure a rule-consistent behaviour. This means not only the observance of legal requirements but also the consideration of rules and standards, which are created from the company itself such as a code of conduct or ethics.[11]

[6] See also Kampfmeyer (2009) p. 8 f.
[7] http://www.corporate-governance-code.de/ September 2012
[8] See also German CG-Code p. 4f.
[9] See also Brühwiler (2012) p. 15.
[10] See also Herre/Sandmann/Wehking/ Winefeld (2012) and Kirchhoff/Bartels (2011)
[11] See also Stehmann (2011) p. 7.

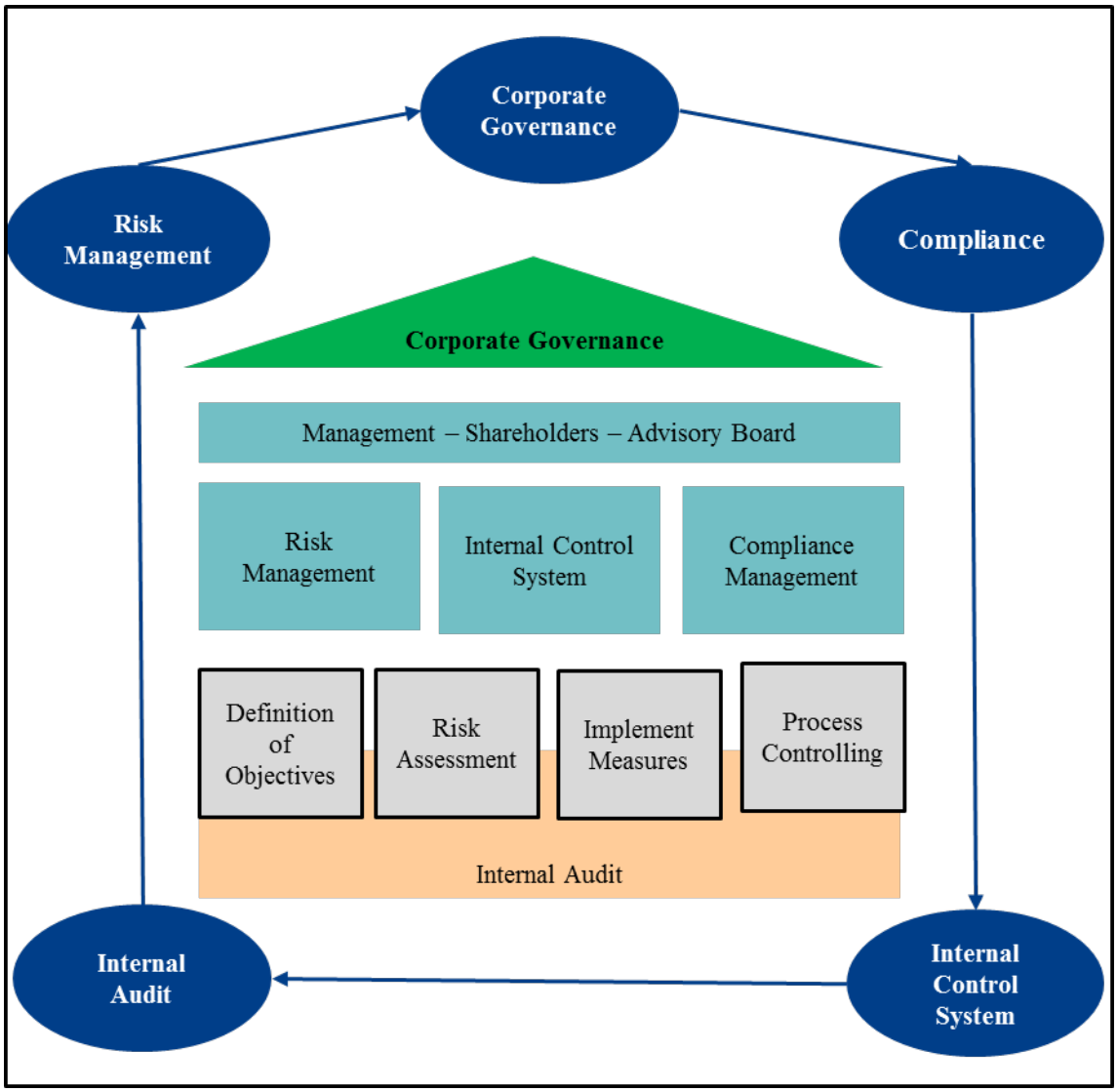


Figure 1: Corporate Governance in Germany[12]

Corporate Governance in other European Countries

The classification of risk management in other European corporate governance rules is similar to the German Corporate Governance Code.[13] Only the "Swiss Code of Best Practice for Corporate Governance" represents another concept of risk management. In this code risk management is more a part of operative management. The board of directors has to report about the risk assessment and the risk management is part of the internal controlling system. The focus is on financial and operational risks with an impact of the annual financial statement.[14]

[12] Own representation based on http://www.industrieplatz-hessen.de/dynasite.cfm?dsmid=17349
[13] The corporate governance codes of UK, Austria and Switzerland was analysed.
[14] See also Swiss Code of Best Practice for Corporate Governance Article 19 and Brühweiler (2012) p. 18f.

3.2. CORPORATE GOVERNANCE IN THE UNITED STATES OF AMERICA

In 2001 the US American economy was characterized through a series of economic scandals and corporate failures. The result was a loss of confidence in corporate management and so new regulations and concepts for corporate management were created. In 2002 the Sarbanes- Oxley-Act was implemented; a law, which changed the US American regulations about corporate governance and financial reporting fundamentally.[15]

The aim of this act is to restore confidence in the accuracy and reliability of published financial data. The law applies to U.S. and foreign companies whose securities are trades at the U.S. stock exchange. The main sections are:

- SEC. 302. Corporate Responsibility for Financial Reports,
- SEC. 404. Management Assessment of Internal Controls,
- SEC.906. Corporate Responsibility for Financial Reports.

Summarized is the statement, that CEO´s and CFO´s have to confirm in every anual or quarterly financial report, that all datas are correct and the described economic situation of the company is conform with the real economic situation. The management is responsible for the design and effectivness of the internal control system. Infringements will be punshid with high fines or even prison.

The Sarbanes – Oxley – Act is supplemented through the COSO Enterprise Risk Management Framework, which is portrayed with its main aspects in the following figure. „The four objectives categories – strategic, operations, reporting, and compliance – are represented by the vertical columns, the eight components by horizontal rows and an entity´s unit by the third dimension. This depiction portrays the ability to focus on the entirety of entity´s enterprise risk management, or by objectives category, component, entity unit or any subset thereof. “[16] The picture illustrates that risk management is part of an internal controlling system with focus on financial reporting and compliance.[17]

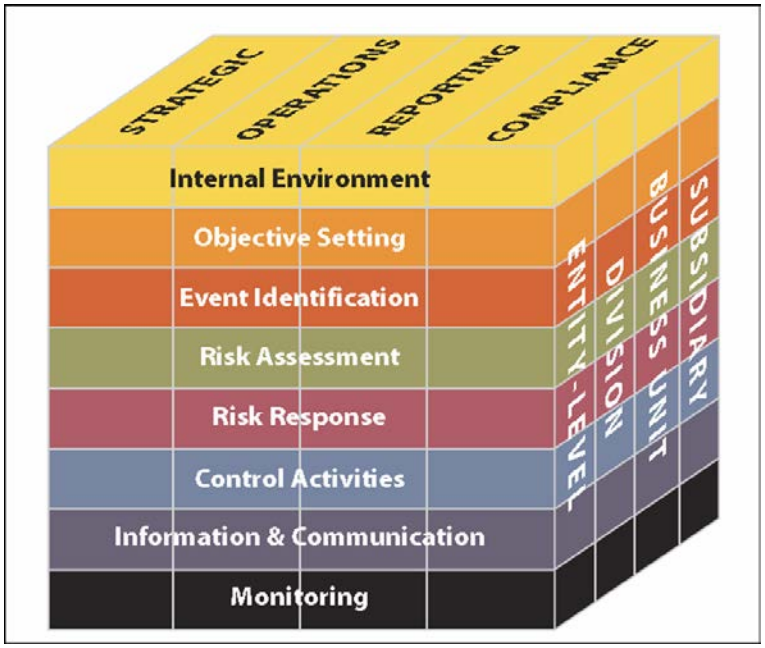


Figure 2: COSO Enterprise Risk Management Framework.

[15] See also Brühweiler (2012) p. 20.
[16] See also COSO Enterprise Risk Management Framework (Executive Summary) p. 11.
[17] See also Brühweiler (2012) p. 21.

4. STATE OF THE ART

According to the European Corporate Governance Rules risk management is an essential part of successful corporate governance, because it to administer on corporate decisions, to generate more scope of actions and to optimize the opportunities of a company. In most European Corporate Governance Rules risk management is a task of the top management level and has to consider the corporate targets and strategies, so it is an important part of a company´s strategic management.

Risk Management in the United States of America and in Switzerland is more integrated in the operative management level; it is a tool of the internal controlling system with the task of financial reporting and compliance of legal rules. The top management level is responsible for the design of the internal controlling system and the risk management, but the focus is more on financial data in the financial reporting.

5. HYPOTHESES

Cultural differences have an influence of risk perception, risk awareness and risk preferences.

In the decision theory a market participant is risk obverse, if he chooses the opportunity with the lowest hazard; in case of choosing the option with the most profit and more uncertainty it is risk taking. Are US-American market participants less risk obverse than Europeans through their historical development?

This general view isn´t supported by scientific evidence. Rather in the literature are represented three hypotheses:[18]

- Precautionary principles are more represented in European countries through cultural and social reasons,
- Behaviour in risk management has been changed over the time („Flip-Flop-Hypotheses),
- There are no differences in the risk behaviour in the last 40 years only other variables determine the risk behaviour.

These three different hypotheses lead to the assumption that risk behaviour is not only influenced by cultural factors. Rather a variety of factors influence the risk behaviour of a country like economic interests, political situations, lobbyism or convictions about the role of state in the economy.[19] The task is to close this scientific gap through further investigation.

6. OUTLOOK

In a survey in 2014 it will be examined in the field of automotive industry whether the past crisis had an impact on the risk and crisis management of the industry, especially on the tools and methods of reporting and controlling. The sector automotive was chosen because

a) Automotive industry is a sector of considerable importance to economy and prosperity in several European countries. In particular the economic factors growth, export, innovation and employment are strongly influenced. Accordingly the automotive industry makes an important contribution to the gross domestic product of the European Union.[20]

b) Automotive industry was hit particularly strong by the financial and economic crisis. The situation was characterized by the simultaneous collapse of all relevant automotive markets. Other compensating factors were not available in contrast to other economic downturns.[21]

[18] See also Mair/Mildner/Wiebke in SWP-Zeitschriftenschau (2012).
[19] See also Mair/Mildner/Wiebke in SWP-Zeitschriftenschau (2012).
[20] Vgl. EU-Kommission (2009) S. 2.
[21] Vgl. Wissmann (2009) S. 227ff.

Automotive industry is characterized by global competition, products with a high technology related and complex production process by production with high volume. In addition to the automobile manufacturers a variety of other actors in production and marketing is involved – suppliers, raw material producers and service companies. [22]

The financial and economic crisis had an impact on the automotive market through:

- decreasing of demand as a result of the loss in purchasing power,
- liquidity shortages caused by the reduction of credit rating.

The consequences of the crisis could be reduced by governmental subsidies.[23] The development of companies in the automotive industry is still affected by sutructural problems within the sector. These problems are independent of the financial and economic crisis. A global and strong competition causes a considerable price, cost and productivity pressure.[24]

In the years 2012 und 2013 the automotive industry was characterized by a significant growth and forecasts predict a further continous growth. The growth is highly dependent on the development in the different markets. For example the Chinese automobile market and the markets in emerging countries are growing faster than the markets in Europe and the United States of America, where a certain level of saturation is reached. It must be decided between an increase in exports or the transfer of production abroad. In addition the industry is facing technological challenges that ar linked to climate policy and production technologies like FACTORY 4.0.[25]

Cultural and social differences will be observed in comparison with the European car manufacturing country Germany and the Slovak Republic.

REFERENCES

BRÜHWEILER, B.: Risikomanagement nach ISO 31000 und ONR 49000 Mit 13 Praxisbeispielen, 2. Auflage 2012, Austrian Standards plus Gmbh

HERRE, U. / SANDMANN, T. / WEHKING, J. / WINEFELD, CH. Risk-Management-Benchmarking 2011/2012, PricewaterhouseCoopers AG, 2012

KAMPFFMEYER, U.: Dr. GRC – Governance, Risk Management & Compliance p. 8 – 23, in IBM Whitepaper 2009.

KIRCHHOFF, A. G. / BARTELS, P. Dr. Risikomanagement 2.0 Ergebnisse und Empfehlungen aus einer Befragung in mittelständischen deutschen Unternehmen, BDI und PricewaterhouseCoopers AG 2011

MAIR, S. / MILDNER S.-A. / WODNI, W.: Risikofreudiges Amerika, risikoaverses Europa? Aus amerikanischen und europäischen Publikationen 2001-2012 in SWP-Zeitschriftenschau 2, Stiftung Wissenschaft und Politik Deutsches Institut für Internationale Politik und Sicherheit, Mai 2012OETZEL, H.: Risikocontrolling im Führungssystem aus funktionaler und instrumentaler Perspektive – Ein begrenzt-führungsgestaltender Koordinationsansatz Verlag der GUC 2007

MEIßNER, H.-R.: Die Bedeutung der Automobilindustrie für die deutsche und europäische Wirtschaft, Gastbeitrag in Blick Log 31.10.2013 http://www.blicklog.com/2013/10/31/die-bedeutung-der-automobilindustrie-fr-die-deutsche-und-europische-wirtschaft/ (28.12.2013)

ROMEIKE, P. / HAGER, P.: Erfolgsfaktor Risiko-Management 2.0 Methoden, Beispiele, Checklisten Praxishandbuch für Industrie und Handel, 2th ed., Wiesbaden: Gabler Verlag 2009, p. 81 – 173.

[22] Vgl. Meißner, (2013) S. 1ff.
[23] Vgl. Grigolon / Leheyda / Verboven (2012) S. 4.
[24] Vgl. EU-Kommission (2009) S. 4.
[25] Vgl. PwC (2013) S. 2ff.

SCHULTE, M.: Bank-Controlling II: Risikopolitik in Kreditinstituten; 2th ed., Frankfurt/Main: Bankakedemie e.V. 1997 p. 12.

STEHMANN, J.: Compliance – Management in mittelständischen Unternehmen – Eine Analyse aus der ressourcenorientierten Sichtweise, Diplomica Verlag, Hamburg 2011

WISSMANN, M.: Die Wirtschaftskrise und die deutsche Automobilindustrie. Auswirkungen und Auswege in zfo 04/2009.

Ferderation of European Risk Management (FERMA) Der Risikomanagement-Standard (2003).