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The Determinants of the Adoption of a Political Risk Assessment Function in Czech International Firms: A Theoretical Framework

Abstract

This theoretical paper seeks to conceptualise a new approach to the identification of the factors influencing the adoption of a political risk assessment (PRA) function. First of all, we identify political risk (PR) as any host government action and/or inaction or an action against a host government that could threaten business activities of firms; and PRA as the process of analysing and evaluating such risks. The research population will comprise a convenience sample of Czech international firms. The information whether or not a firm has set up a PRA function will be obtained via a questionnaire survey. Previous studies aimed at PRA were concerned with firm's size, degree of internationalization, ownership and industry. By making use of firm value maximization and risk aversion and considering the rationale for risk management activities: (i) reducing the expected costs of financial distress; (ii) reducing the risk premiums payable to various partners; (iii) increasing investment possibilities; and (iv) reducing expected tax payments, we develop a number of determinants which can be employed in PRA studies; namely firms' complexity, location of subsidiaries, leverage, auditor type and investment opportunities. In addition to the above mentioned theories this concept makes use of the enterprise risk management (ERM) theory, and the determinants of the adoption of an ERM function.

Key Words

Czech Republic, international firms, investment, political risk assessment, political risk

JEL Classification: D72, D73, D81, F64, P20, P48

Introduction

Any firm is subject to "political exposure", whether directly or indirectly, and political risk (PR) is an ever-present threat. Just like any other risk, PR is magnified in the context of the international business environment and in globalized markets. Given the recent developments in the global business arena, after the global economic downturn in 2007, it has been suggested that the post-crash period is a new era for PR with new threats and increased uncertainties [1].

Since PR is closely linked to and in many cases affects directly all social, cultural, financial and economic risks, there should be a greater emphasis on PR in the academic literature. This argument is also supported by the fact that there are a growing number of companies engaged in international economic relations, including trade and foreign

direct investment, with emerging markets. One of the main characteristics of these regions is unstable political and economic environments [2], [1], [3].

Since the existing literature on risk focuses predominantly on risk management in general or, more recently, on enterprise risk management (ERM) in which PR is already implemented in a risk management conceptual framework (e.g. [4], [5]), we know only a little about the role of PR itself within firms. There have been some studies conducted which are concerned with PR and PRA (e.g. [6], [7], [8]). However, the outcomes of these studies have identified a limited number of determinants of PRA adoption e.g. firm size [8]; degree of internationalisation [6], [8]; ownership [8]; or industry type [7], [8]. We believe that an expansion of the determinants of PRA adoption and a more in-depth analysis of the PRA function are necessary.

In order to develop further the determinants of PRA adoption, we make use of the firm value maximization theory and the theory of risk aversion which are linked closely to the theory of shareholder value maximisation and profit generation as a rationale for risk management (RM) and by extension political risk management (PRM). Although these theories usually underpin studies aimed at corporate risk hedging (e.g. [9], [10]), since hedging activities are included within RM activities in the majority of firms, they can be used to identify some of the determinants of PRA adoption [4].

The above mentioned arguments have been used to determine the factors which influence the adoption of enterprise risk management (ERM) in a firm. Even though ERM is a broader concept than PRA and PRM we argue that, as part of ERM, the determinants of PRM and by extension PRA adoption can also be examined using the theories of risk aversion and value maximization hypothesis under which the activities of risk management in general are justified by (i) reducing the expected costs of financial distress; (ii) reducing the risk premiums payable to various partners; (iii) increasing investment possibilities; (iv) reducing expected tax payments. This allows us to use a more quantitative approach to the determinants of PRA adoption and we propose to use a model enabling us to predict the likelihood of a firm having a PRA function implemented within its risk management activities; which – to our best knowledge – has not been done in any of the previous studies of PRA.

1. Literature Review

The terms uncertainty and risk sometimes are used interchangeably. There is however a clear distinction between the two. Uncertainty is the state of knowing that something might happen in the future but not knowing what exactly is it going to be and risk provides the information on its degree [5]. While uncertainty is not measurable, risk can be defined using a simplified model as the probability of an adverse event occurring times its magnitude. In terms of political risk assessment, it is the process of converting the uncertainty arising from politics into ‘quantifiable’ risk.

1.1 Political Risk

The concept of a quantified risk in the field of political risk is often employed in studies aimed at political risk in the context of FDI or portfolio returns [11]. In these studies, political risk usually overlaps with country risk. However a distinction between political risk and country risk needs to be made [8]. Whereas country risk is often referred to as all social, cultural, political and economic risks faced by a firm when operating in that country; a political risk is linked directly to government actions or to actions aimed against a government. This is however a very simplistic delimitation of PR. The exact definition depends on many factors; the insurance industry for example divides PR 'into (i) currency convertibility and transfer, (ii) expropriation, (iii) political violence, (iv) breach of contract by a host government, and (v) the non-honouring of sovereign financial obligations [and is only aimed at the host country]' [1, p.28]. In management research, PR is usually defined as the likelihood of deterioration in the political climate in a host country or simply as an action of a political institution – both voluntary and/or involuntary – that would threaten the objectives of a firm. Given that the priority of a profit making firm is profit generation, a description of PR as an action and/or inaction of a host country government threatening firm's profitability seems to be an appropriate one for the purpose of this research.

Although the exact definition of PR is sometimes unclear, the determination of the elements constituting a political risk is an even more 'controversial' topic. Even after more than four decades of intense discussion, academics still struggle to determine what exactly PR consists of and to what extent it influences other risks faced by firms. Nevertheless, they agree on the fact that given the nature of political risk, due to which PR is part of all risks which firms face, it should be of major concern to any firm and its management that they should benefit from the implementation of a PRA function within their risk management activities [12], [7].

1.2 Political Risk Assessment

Political risk assessment (PRA) is the process of analysing and evaluating political risk while undertaking international business activities; it has been suggested that it should be one of a number of risk management activities. The extant literature suggests that there has been a low standard of PRA undertaken by international firms; which indicates either a lack of political risk awareness by international firms or their resistance to the perception and/or experience that political risk can be adjustable to analysis. However, political risk is assessable and helps the decision maker to avoid or decrease the chance of various material losses by the use of appropriate management tools. The literature also suggests that international firms are aware of their exposure to political risk and often consider political risk to be one of the most important risks for their international business activities [12], [7], [8].

The diversity of potential risks and the differences in a firm's exposure to risk may lead to different approaches to PRA. A firm's exposure to political risk is related to its characteristics. The literature on political risk suggests that the extent to which international firms are involved in PRA is correlated with a number of organizational characteristics such as firms' size [8]; firms' degree of internationalization [6], [8]; firms' industry [7], [8]; and firms' ownership [8].

Firms benefit from the adoption of PRA by decreasing the uncertainty arising from the political environments in which they operate. They can also, by adopting effective and appropriate mitigation tools, increase a firm's stability; hence leading to a decrease in the volatility of a firm's performance and its cash flows. Therefore, in this article we build upon the concept of PRA adoption in firms. In view of the theory of firm value maximization and risk aversion we attempt to contribute to the existing literature on the determinants of PRA adoption by enlarging the number of these determinants of the PRA adoption decision, i.e. the decision whether or not to assess formally a firm's political risks.

2. Determinants and Hypotheses Development

The literature on both risk management implementation and the determinants of firms' hedging behaviour suggests that the most important determinants are firm size, industry and complexity, the level of a firm's internationalisation, liquidity, managerial ownership, institutional ownership, past performance, location of headquarters and subsidiaries, liquidity, growth options, cash flow volatility, tax losses, return on assets, CAPEX, dividend yield, industrial diversification, type of auditors, independence of board of directors, assets' opacity and stock price volatility [13], [10], [14], [5].

Given the nature of the Czech business environment and, in particular, the fact that not all the firms in our sample are publically listed, we propose the following determinants to be employed in our study: 1) firm size; 2) firm complexity; 3) level of internationalisation; 4) ownership; 5) location of subsidiaries; 6) leverage; 7) growth options; 8) auditor type; and 9) industry. We already have the information about whether or not a firm has adopted the PRA function; hence we use a dummy variable to indicate the use of PRA. The proposed determinants will enable us to explain such a decision at a firm level and each will be explained and developed below.

2.1 Firm Size

Firm size influences the nature and the extent of risks threatening business as well as the structure of a firm. It is one of the variables included in almost every study where firm-specific determinants are tested. As [12] suggested, the bigger a company is the more likely it is to identify any potential risks and also the more resources it has to mitigate its risks. However there is an argument that managers may be overwhelmed by their workload and hence not have the capacity to conduct PRA [8]. Moreover, smaller firms are also much more adaptable and flexible and therefore in the event of an

emergency are likely to deal with these situations much more quickly [8]. In addition large firms have a greater volatility in operating cash flows and risk of financial distress; due to which the likelihood of PRA adoption is greater [5], [15].

2.2 Firms' complexity

The 'complexity' variable is usually employed in studies of ERM implementation (e.g. [15], [5]). Firm's complexity can be measured by the number of its business segments; the more segments a firm has the more complex it is. In line with previous studies, we argue that the more segments a firm has, the more difficult it is to align its activities, and hence the more likely it is to implement a risk management unit and, by extension, a PRA function.

2.3 Level of internationalisation

The more activities a firm has abroad the more it is exposed to host-country risks including political risks [7], [8]. In line with previous studies the indicators of firms' level of internationalisation are 'number of years in international business', 'number of countries of functioning' and 'percentage of revenue from international business activities'. Although these methods are all used to determine and indicate firms' level of internationalisation, their relationship with PRA adoption is not explicit.

For example, in the case of 'years in international business', higher values would suggest higher levels of exposure; however it has been pointed out that the experience will result in a reduction in risk perceptions over time. The results for 'number of operating countries' and 'foreign revenues' suggest a significant positive relationship with PRA implementation for both of these variables [8]. However, the diversification of firms' activities across multiple markets can lead to the offsetting of losses and gains by portfolio diversification in which case the effect of the 'number of operating countries' may be arguable. Nevertheless previous studies have found that both the 'international revenues' and the 'number of countries of operating' are positively correlated with PRA adoption [6], [8].

2.4 Ownership

In the Czech Republic, where the 'German' model of financing applies, rather than the 'Anglo-Saxon' one, the Czech stock exchange has not developed significantly. Our sample consists of both publicly listed and private firms. Therefore we intend to use a dummy variable to indicate the legal structure of a firm rather than the percentage of managerial and/or institutional ownership. The studies of [4] and [15] identified that more formal risk management is implemented in firms with a higher percentage of ownership by external stakeholders who require information about a firm's activities and the amount and nature of its risks. This trend is expected to be magnified by the events of 2007. We

intend to test for the 'ownership' variable twice: a) according to firms' ownership, i.e. state-owned versus private firms; and b) according to firms' legal structure, i.e. publicly listed versus private firms.

Firms owned by government are usually more risk-averse than private ones. This is caused mainly by the different objectives of their managers since the primary goal of private organisations is to generate profit whereas the public ones need to ensure that they serve the public interest in the first place [16]. The ownership structure of publicly listed versus private firms appears to influence how companies perceive and tackle risks. Publicly traded companies need to ensure that they will not only generate profit but will also meet their shareholders' expectations which – in most cases – are profits. Therefore these companies are much more likely to monitor and assess potential risks stemming from the environments in which they operate – including the political ones [8].

2.5 Location of subsidiaries

Given that our whole sample is based in the Czech Republic or in Slovakia, we do not need to control for the location of firms' headquarters (with the exception of a comparison between Czech and Slovak firms). However, it has been suggested by [5] that firms from more developed countries seem to be more risk-averse than those from less developed countries and do not want to be 'caught unprepared'; and therefore the standard of risk management in these countries will be higher. In addition, the fact that the ERM frameworks have been invented and developed in the UK, and adopted mainly in the US, Canada, Australia and New Zealand is instructive [4], [17], [5]. The fact that these countries have rules and regulations in their legal systems which put an emphasis on corporate risk management (e.g. the 4360 standard or the Sarbanes Oxley Act) pushes firms operating within these countries towards a more responsible approach to risk management and risk in general. Therefore firms with subsidiaries in these countries will be more inclined to adopt risk management approaches and they will be more likely to adopt PRA than firms whose subsidiaries are located elsewhere.

2.6 Leverage

Leverage is linked directly to the costs of financial distress. A firm with a large percentage of debt compared to its assets will face issues relating to its ability to repay its debt. In order to ensure that a firm will have enough resources to cover its liabilities, it will need to ensure steady cash flows; i.e. such a firm will seek to reduce the volatility of its cash flows. However reducing cash flow volatility is only one of the justifications for the adoption of a risk management function. The 'hedging literature' (e.g. [9], [18], [10], [14]) also suggests that the more a firm is leveraged, the more likely it is to hedge. From the financial management perspective, leverage brings great risk in the form of an interest rate risk to a firm linked – directly or indirectly – to politics [19]. Although it has been pointed out that firms from more stable economies are generally more likely to be

leveraged [20]; the Czech and Slovak economies are very similar and therefore this variable should not impose any bias on the analysis.

2.7 Investment opportunities

The rationale behind making use of investment opportunities as a means of PRA adoption is identical to the one for leverage – reducing cash flow volatility. In firms with more opportunities for investment, such as research and development or expansion, managers need to make sure that the firms will be able to finance these investments. In line with previous studies where the investment opportunities variable has been employed, we use ‘expenditures on research and development’ as a proxy for firms’ investment opportunities [9], [14].

2.8 Auditor type

Auditor type is – to the best of our knowledge – a new variable in the literature of PRA. It has been suggested that the type of a firm’s auditor affects a firm’s risk management [17]. [5], having followed this hypothesis in their study of ERM implementation, found that the presence of a ‘Big Four’ (KPMG, Deloitte, Price Waterhouse Coopers, Ernst & Young) auditor increases the likelihood of ERM implementation. The “Big Four” acknowledge PR as one of the major threats for firms and suggest that PRA should be undertaken by all firms, especially those operating internationally. It is logical to assume, therefore, that the presence of one of these auditors will be influential in the process of PRA adoption [1].

2.9 Industry

The existing literature on PRA suggests that there are significant differences between companies which are tightly linked to the host-country governments in which they operate, such as construction, military or extracting companies, whose activities are of a contractual nature; whereas sectors over which the host-country governments have only little control would probably not worry about the potential risks stemming from the host-country political environment as much as the previous group. We do not suggest that companies from ‘low-profile’ sectors are not exposed to political risks at all. However the nature of the PR to which these sectors are exposed is macro environmental, rather than industry-specific [7], [8], [21].

Many approaches to the treatment of this variable have been developed in previous studies; these mostly distinguish between a) primary, secondary and tertiary sectors; and b) industrial and manufacturing, service and financial companies; c) many specific industrial branches. We use the following sector classification: ‘manufacturing’, ‘service’, ‘military’, ‘extracting’, ‘construction’ and ‘financial’.

From the discussion above of the proposed variables some tentative research hypotheses were developed. These are summarized in Tab. 1 below. It needs to be pointed out that these hypotheses will all comprise a predicative model, and therefore the higher number of the developed hypotheses will not impose any obstacles on the research model itself.

Tab. 1 Hypotheses Overview

Variable	Hypotheses
Size	Larger firms are more likely to adopt PRA function.
Complexity	More complex firms are more likely to adopt PRA function.
Internationalisation	Firms that are more internationalised are more likely to adopt PRA function.
Ownership	Publicly owned firms are more likely to adopt PRA function than private firms. Publicly listed firms are more likely to adopt PRA function than private firms.
Subsidiary	Firms with subsidiaries in UK, US, Canada, Australia or New Zealand are more likely to adopt PRA function.
Leverage	The more leveraged a firm is the more likely it is to adopt a PRA function.
Investment Opportunities	Firms with more investment opportunities are more likely to adopt a PRA function.
Auditor Type	Firms are more likely to adopt a PRA function when employing a Big Four auditor.
Sector	The adoption of the PRA function varies between sectors.

Source: Developed by authors

3. Research Contribution and Limitations

The rationale behind this proposed research is twofold. From a theoretical perspective, this study will enrich the literature on firm-specific determinants of PRA adoption. None of the previous studies of PRA has used variables such as the presence of a Big Four auditor, firm complexity or leverage, which are expected to influence significantly the decision whether or not to adopt a PRA function. In addition to a number of 'new' variables, the methodology is also innovative. In line with previous PRA studies, primary data will be obtained via questionnaires; however the analysis of PRA adoption and its determinants will make use of secondary data to identify the firm-specific determinants. The geographical context of the study will also contribute to the existing PRA literature. No previous PRA research has been conducted in Central Europe. This is a significant omission given the specific post-socialist transition market context. In addition to the specific market characteristics, it has also been pointed out that the differences between well-developed western markets and the Central and Eastern European ones are diminishing; hence the time left for studying the PRA function in this particular context is running out [22].

Given the nature and the scope of the study, there are some limitations that need to be pointed out. First of all, due to limited time and resources, the dataset is cross-sectional and therefore it will not allow us to map the historical development of the PRA adoption time. To produce a longitudinal dataset for our sample would be particularly difficult given the manner in which information is stored in the Czech Republic which makes it difficult to gather comprehensive historical data. Moreover, rules and regulations in this region are still not a strong enough incentive for firms to publish complete financial information. Additionally, this research investigates both public and private companies.

It would be particularly interesting to test for the determinants of PRA adoption among a sample of only publicly traded firms. This would allow the inclusion of determinants such as dividend pay-outs, managerial and/or institutional ownership, past performance and stock price volatility; and secondly, the information available for these firms would be more complete and accessible.

Conclusions

In conclusion, the aim of this paper is to provide a new approach to the examination of the determinants of PRA adoption. From a review of appropriate literature on political risk and its assessment, risk management, ERM adoption and corporate hedging incentives, the following determinants of the adoption of a PRA function were identified: firm size, complexity, industry, leverage, investment opportunities, type of auditor, ownership, level of internationalisation and location of firms' subsidiaries. A theoretical model for predicting the likelihood of firms being PRA adopters was developed based on these determinants. Although there are still limitations of the study, we believe that by further development of a predicative model the use of the proposed approach has the potential to contribute significantly to the PRA literature.

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