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The Empirical Determinants of the Adoption of a Political Risk Assessment Function in International Firms

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ABSTRACT

This paper seeks to conceptualise a new approach to the identification of the factors influencing the adoption of a political risk assessment (PRA) function. The research population will comprise a convenience sample of Czech and Slovak international firms. The information whether or not a firm has set up a PRA function will be obtained via a questionnaire survey. 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 to be employed in PRA studies; and we propose a model for predicting the PRA adoption decision.

THE EMPIRICAL DETERMINANTS OF THE ADOPTION OF A POLITICAL RISK ASSESSMENT FUNCTION IN INTERNATIONAL FIRMS

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 (MIGA 2009).

Since PR is closely linked to and in many cases directly affects 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 (Bilson et al. 2002; Nganga and Curo 2008; MIGA 2009; Rao 2012).

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. Lai and Samad 2001; Liebenberg and Hoyt 2003; Altunas et al. 2011; Golshan and Rasid 2012; Yazid et al. 2012), 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. Hashmi and Baker 1988; Hashmi and Guvenli 1992; Stapenhurst 1992; Wyper 1995; Pahud De Mortanges and Allers 1996; Jenney 2001; Kettis 2004; Al Khattab et al. 2008). However, the outcomes of these studies have identified a limited number of determinants of PRA adoption e.g. firm size (Hashmi and Baker 1988; Stapenhurst 1992; Kettis 2004; Al Khattab et al. 2008), degree of internationalisation (Hashmi

and Baker 1988; Hashmi and Guvenli 1992; Al Khattab et al. 2008), ownership (Al Khattab et al. 2008), or industry type (Stapenhurst 1992; Wyper 1995; Pahud De Mortanges and Allers 1996; Jenney 2001; Kettis 2004; Al Khattab et al. 2008). 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 shareholders' value maximisation and their ultimate goal of 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. Nance et al. 1993; Ephraim and Amrit 2008; Ameer 2010), 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 (Liebenberg and Hoyt 2003; Dionne and Garand 2003).

The above mentioned arguments have been used to determine the factors which influence the adoption of enterprise risk management (ERM) in a firm (e.g. Lai and Samad 2001; Altunas et al. 2011; Golshan and Rashid 2012); and 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 a model enabling us to predict the likelihood of a firm having a PRA function implemented within its risk management activities; which – to the best of our best knowledge – has not been done in any of the previous studies of PRA.

LITERATURE REVIEW

The terms uncertainty and risk sometimes are used interchangeably. There is however a clear distinction between these 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 (Vaughan and Vaughan 1995; Fabozzi and Peterson 2003; Golshan and Rasid 2012). While uncertainty is not measurable (McLean and McMillan 2003), risk can be defined using a simplified model as the probability of an adverse event occurring times its magnitude (Pinheiro et al. 2011). In terms of political risk assessment, it is the process of converting the uncertainty arising from politics into ‘quantifiable’ risk.

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 (e.g. Guerin and Manzocchi 2009; Haksoon 2010; Krifa-Schneider and Matei 2010; Palacios and Griffin 2011; Jimenez 2011; Meon and Sekkat 2012; Vadlamannati 2012). In these studies, political risk usually overlaps with country risk. However a distinction between political risk and country risk needs to be made (Al Khattab et al. 2008). 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 directly linked 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]’ (MIGA 2009, p.28). In management research, PR is usually defined as the likelihood of a deterioration in the political climate in a host country (Rios-Morales et al. 2008) or simply as an action of a political institution – both voluntary and/or

involuntary – that would threaten the objectives of a firm (Howell 2001; Nawaz and Hood 2005). Given that the priority of a profit making firm is profit generation, the definition provided by Inkster (2008, p.162) who describes PR as ‘threats to profitability that are external to the business and which arise from government action or inaction’ 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 (Blank et al. 1980; Kobrin et al. 1980; Kobrin 1981; Kobrin 1982; Hashmi and Baker 1988; Rice and Mahmoud 1990; Stapenhurst 1992; Wyper 1995; Pahud De Mortanges and Allers 1996; Burmester 2000; Hood and Nawaz 2004).

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 political risk literature has suggested a low standard of PRA undertaken by international firms; this indicates either resistance by firms to the notion that political risk is amenable to analysis, or a lack of awareness of political risk by business participants. Nevertheless, the political risk literature suggests that political risk is assessable and helps the decision maker to avoid or decrease the chance of both property and income losses by the use of appropriate management tools; and that international firms are aware of their exposure to political risk and consider political risk assessment to be one of the

most important risks for their international business activities (Blank et al. 1980; Kobrin et al. 1980; Kobrin 1981; Kobrin 1982; Hashmi and Baker 1988; Rice and Mahmoud 1990; Stapenhurst 1992; Wyper 1995; Pahud De Mortanges and Allers 1996; Burmester 2000; Hood and Nawaz 2004; Al Khattab et al. 2008).

The diversity of potential risk 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 (Hashmi and Baker 1988; Stapenhurst 1992; Kettis 2004; Al Khattab et al. 2008); firms' degree of internationalization (Hashmi and Baker 1988; Hashmi and Guvenli 1992; Al Khattab et al. 2008); firms' industry (Stapenhurst 1992; Wyper 1995; Pahud De Mortanges and Allers 1996; Jenney 2001; Kettis 2004; Al Khattab et al. 2008); and firms' ownership (Al Khattab et al. 2008).

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.

Determinants and Hypotheses Development

The literature on both risk management implementation and the determinants of firms' hedging behaviour suggests that the most appropriate 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 (Allayannis and Ofek 2001; Dionne and Triki 2004; Ameer 2010; Khediri and Folus 2010; Altunas et al. 2011; Benesova 2011; Golshan and Rasid 2012).

Given the nature of the Czech and Slovak business environments 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. Since this paper will extend our survey research into PRA practices 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. In the initial stage of our analysis the determinants will be tested for Czech and Slovak firms separately; and another analysis will be run for aggregate data after determining the differences between these two countries.

Firm Size (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 Kobrin (1982) 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 (Albright 2004; Al Khattab et al. 2008). 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 (Al Khattab et al. 2008). 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 (Golshan and Rasid 2012; Pagach and Warr 2011). In line with previous studies we intend to use “number of employees” and “logarithm of firm’s total assets”.

H1: Larger firms are more likely to adopt PRA function.

Firm’s complexity (COMX)

The ‘complexity’ variable is usually employed in studies in ERM implementation (e.g. Gordon et al. 2009; Pagach and Warr 2011; Golshan and Rasid 2012). Doyle et al. (2007) suggest that a 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, PRA function.

H2: More complex firms are more likely to adopt PRA function.

Level of internationalisation (INTER)

The more activities a firm has abroad the more it is exposed to host-country risks including political risks (Blank et al. 1980; Kobrin 1982; Hashmi and Baker 1988; Rice and Mahmoud 1990; Wyper 1995; Pahud de Mortanges and Allers 1996; Keillor et al. 1997; Keillor et al. 2005; Oetzel 2005; Al Khattab et al. 2008). 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 by Kobrin (1982) and Oetzel (2005) 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 (Al Khattab et al. 2008). 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 disputable (Iankova and Katz 2003). Nevertheless previous studies have found that both the ‘international revenues’ and the ‘number of countries of operating’ are positively correlated with PRA adoption (Hashmi and Baker 1988; Hashmi and Guvenli 1992; Keillor et al. 1997; Al Khattab et al. 2008).

H3: Firms that are more internationalised are more likely to adopt PRA function.

Ownership (OWNER)

In the Czech and Slovak Republics, where the ‘German’ model of financing applies, rather than the ‘Anglo-Saxon’ one, the Czech and Slovak stock exchanges have 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 Liebenberg and Hoyt (2003) and Pagach and Warr (2011) 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 (Yazid 2001). 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 (Jensen 2002; Freeman et al. 2004; Sundaram and Inkpen 2004). 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 (Al Khattab et al. 2008).

H4: Publicly owned firms are more likely to adopt PRA function than private firms.

H5: Publicly listed firms are more likely to adopt PRA function than private firms.

Location of subsidiaries (SUBS)

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 Golshan and Rasid (2012) 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 (Liebenberg and Hoyt 2003; Beasley et al. 2005; Golshan and Rasid 2012). 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.

H6: Firms with subsidiaries in UK, US, Canada, Australia or New Zealand are more likely to adopt PRA function.

Leverage (LEVER)

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. Nance et al. 1993; Heaney and Winanta 2005; Ameer 2010; Khediri and Folus 2010) 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 (Shapiro 2010). Although it has been pointed out that firms from more stable economies are generally more likely to be leveraged (Brown and Toft 2002; Ephraim and Amrit 2008); the Czech and Slovak economies are very similar and therefore this variable should not impose any bias on the analysis.

H7: The more leveraged a firm is the more likely it is to adopt a PRA function.

Investment opportunities (INVOP)

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 (Bishop 1996). 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 (Nance et al. 1993; Bishop 1996; Khediri and Folus 2010).

H8: Firms with more investment opportunities are more likely to adopt a PRA function.

Auditor type (AUDITOR)

Auditor type is – to our 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 (Beasley et al. 2005). Golshan and Rasid (2012), 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” acknowledges PR as one of the major threats for firms and suggests 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 (DiPiazza and Bremmer 2006; Ernst & Young 2009; MIGA 2009).

H9: Firm is more likely to adopt a PRA function when employing a Big Four auditor.

Industry (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 (Stapenhurst 1992; Wyper 1995; Pahud De Mortanges and Allers 1996; Jenney 2001; Kettis 2004; Al Khattab et al. 2008; McKellar 2010).

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’.

H10: The adoption of the PRA function varies between sectors.

SAMPLE AND METHODOLOGY

The methodology has been designed in order to examine the hypotheses which have been developed regarding the relationship between the adoption of PRA and a number of firm-specific determinants. The sampling method we propose to implement will make use of the random selection of about three hundred companies from the ‘Albertina’ database – a database including all companies operating either in the Czech Republic or Slovakia. These companies will need to be ‘filtered’ in order to sample only those operating internationally with their headquarters in the Czech or Slovak Republics, to the exclusion of the other firms.

In the first stage of our analysis the sample will be split into two groups: firms which have adopted PRA and firms which have not. The differences between these two groups will be described with regards to the determinants developed in this paper. In the second stage, only firms which have already adopted PRA will be selected for analysis; we will test the effect of

the firm-specific determinants on this sample. In order to determine the likelihood that a firm would adopt a PRA function, a logistic regression will be used. While controlling for firms' ownership, location of subsidiaries, type of auditor and industry, we propose using the following equation:

$$\text{Log}(p/1-p) = \beta_0 + \beta_1*\text{SIZE} + \beta_2*\text{COMX} + \beta_3*\text{INTER} + \beta_4*\text{LEVER} + \beta_5*\text{INVOP} + \varepsilon;$$

where 'p' equals the probability of a firm being a hedger; ' β_i ' are the predictor coefficients; and ' β_0 ' a constant of the equation; ' ε ' represents the residuals in the model. We intend to calculate the strength and direction of the proposed determinants (' β ' coefficients) and provide a simple model for predicting the likelihood that a firm will be an adopter of the PRA function, based on its firm-specific factors.

RESEARCH CONTRIBUTION

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 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.

Secondly the geographical context will contribute to the existing PRA literature. No previous PRA research has been conducted in relation to Central European firms. 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 (Wieners 1996; Djankov and Murrell 2002; Makhija 2004).

LIMITATIONS OF THE RESEARCH

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 and Slovak Republics which make it difficult to gather comprehensive historical data. Moreover, rules and regulations in these countries are still not a strong enough incentive for firms to publish complete financial and company information.

The research uses 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.

Finally it is necessary to mention that the Czech Republic and Slovakia are small countries and there are very few countries on which the proposed model could be applied, in terms of the predicative value of the ' β ' coefficients, i.e. which have similar characteristics. However, by testing for the statistical significance of the determinants, these could be possibly used in future studies in other countries; thereby providing some information about the importance of each of these variables.

CONCLUSION

The aim of this paper was to provide a new approach to the examination of PRA adoption determinants. 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 some limitations of the study, we believe that by further development of the model the use of the proposed approach has the potential to contribute significantly to the PRA literature.

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