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THE RISK - REFERENCE ELEMENT OF CORPORATE GOVERNANCE

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Abstract *Implementing a risk management process, in the economic entities is required firstly since there occurs the uncertainty on the nature of the threats that may affect the achievement of objectives and the environment where the entity operates, and secondly since the risk management is the cornerstone of corporate governance.*

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Corporate governance, audit, control, management, compartment
JEL Codes:
G32, G34

1. Introduction

The overall objective of risk management is to manage risks and to ensure an effective and an efficient use of resources and protection of the public interest and employees by minimizing threats and attending the objectives. According to this objective, a risk management process implementation is due to the following:

a) risk management is part of the entity's management and accountability;
b) risk culture must be positive;
c) threats that hinder the objectives must be managed;
d) priority in risks decisions implementation.

To achieve these requirements, the public entity establishes responsibilities, measures and reporting systems implemented in the departments. The implemented measures on risks and risk management are designed to limit their impact on the entity's objectives.

2. Risk management

In the same context, we specify that the purpose of risk management is to identify risks associated to objectives and to evaluate and assess the internal control system's ability to keep risks within acceptable limits.

Designing and implementing an appropriate risk management process provides the following:

a) an efficient and an effective use of funds;
b) change of leadership style that besides risk treatment measures will design and implement internal controls and devices to limit their level;
c) objectives achievement in terms of efficiency and effectiveness;
d) building a sound internal control system, with appropriate and functional control measures.

Regarding the *risk*, we specify that in its evolution it has experienced several meanings according to experts in the field, for example:

- James Tobin and Harry M. Markovitz, *Separation Theory* followers argue that the risk must be addressed by separating assets in risk-free assets and risky assets;
- Nicklas Luhman, a German sociologist, notes that *"risk is a general form that society decides its future,"* so he thinks that *"the future is totally dependent on present decisions."* In this context, risk is a problem that may be related to the decision-making process.
- K. H. Spencer Pickett consideres that the risk is *"a choice, not a destiny"* and that *"we are constantly at risk, and it is important to have control over it".*

Given the different views of the concept of risk, so far failed to formulate a definition of risk, generally acknowledged to be unanimously accepted by all specialists in the field. Thus, in practice there are used many concepts regarding risk:

Risk is anything that can interfere with the objectives being to some extent a cause of failure and, in terms of financial loss (Cohen, 2005). The risk regarded by the objectives of disadvantages, in that, its existence implies a possible loss, depending on the impact it has on activities.

Risk is the threat to an event or action with a negative impact on the entity's ability to successfully achieve its objectives (Vicenti, citated by Renard J., 2008). Definition emphasizes that risk is a threat that something might happen, that an event will occur if not adequately controlled and it will have an impact on the entity.

Risk is the threat that an action or event will adversely affect an organization's ability to achieve its objectives *and to successfully execute strategy [2].* This fairly understood concept considers risk as the change that a positive or negative event might happen influencing the objectives achievement.

Risk is the possibility or chance of something happening that will have an effect on the achievement [3]. The concept emphasizes that risk can have a negative impact on the achievement, if they pose a threat, but can also have positive connotations which can be exploited.

In our country, entities practise the accepted and adopted definition of risk is as follows [5]: *risk is a problem (situation, event, etc..) which has not yet appeared, but may occur in the future, in which case the results obtained previously fixed threatened or potency.* From this analysis we establish that risk may represent a threat or opportunity. Risk is also uncertainty about the desired results and should be regarded as a combination of probability and impact.

Probability is the measure of each risk and it can be estimated as high, medium or low. *High probability* exists when the risk is not controlled and its occurrence cannot be prevented by the public entity. *Low probability* can be assigned to a given risk that when well managed by the entity that internal controls implemented to maintain risk levels accepted.

Risk impact is the consequence of the results (objectives) if the risk materializes. If the risk is a threat, the consequence is negative, and if the risk is an opportunity, the result is positive. Risk impact can be appreciated by high impact, medium impact and low impact. *High impact* assumes that materializing risk involves a high degree of severity. *Medium impact* involves a moderate level of risk for the entity. *Low impact* involves low gravity where risk passes.

At the same time, on risk analysis concepts, we can state that, risk management is generally a process of identification, assessment, management and control of threats aiming at making sure that the public entity objectives will be achieved.

From the analysis we can identify some key features of risks, namely:

a) risk is the uncertainty which relates to a possible event;

b) risk occurrence affects the company's objectives;

c) risks affects both the present impact on managerial decision making and the future impact on the decision implementation;

d) once risks occurred, the consequences or effects cannot be stopped.

As stated before, we find that the risk is a result of the vulnerability of the entity, namely its inability to adjust to the working environment.

In practice, the most important aspects regarding risk are related to the type of risks that companies are facing and how they are managed so that the probability of occurrence, the gravity of the consequences and duration of their maintaining are minimized if the risks occur.

In practice, entities face a variety of risks and complexity, but they differ from one entity to another. Management should be concerned with the identification and classification of risk based on the sameness of events and their impact on the entity if they occur.

Factors determining exposure to the entity can be identified as follows: *(a) the transformation of the public entity, structural changes, major changes produced under internal decisions; (b) compliance with the financial resources available, which are becoming more and more restricted; (c) limited training of staff and lack of motivating programs; (d) determining the tasks to employees that are not consistent with the nature and job qualifications requirements and (e) inadequate procedures or lack thereof.*

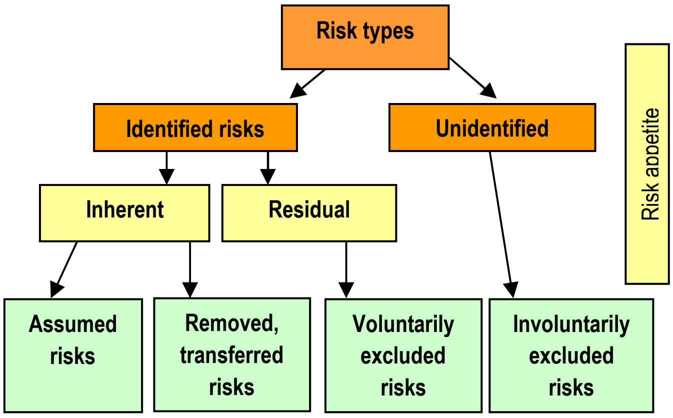
From the research it was found that although risks are identified in the entity, the limitations in aiming the objectives are due to the following realities: *(1) the manager's judgment in making decisions, which is not in all cases grounded; (2) risks arising from simple mistakes or misconducts; (3) decisions about risks that do not take into account costs and benefits; (4) the frequent of necessary and appropriate internal controls implementation.*

On the local public entity level there are also several risk categories, controlled or uncontrolled, that influence objectives achievement. The identified risks in the entity may be classified into two categories, namely the inherent risks and residual risks.

Inherent risks are the risks that normally exist in any activity and are defined as *"risk present before the implementation of the internal control measures to its reduction"* or "*all risks to the entity/organization and can be internal or external risks, measurable or non-measurable[5]".* Thus, the inherent risk is the possibility of errors or irregularities occurrence in the management and financial statements before the internal controls impacting effectiveness.

Residual risks represent "*the exposure caused by a specific risk after there has been taken action to mitigate it. Mitigation measures belong to internal control. Due to this, residual risk is a measure of internal control effectiveness, which is why some countries have replaced the term residual risk with risk control".* So, residual risk is considered as the remaining risk after the internal controls implementation. Internal control measures should have the effect of limiting the inherent risk to an acceptable level to the public entity. Residual risks are monitored and followed if they are kept at acceptable levels.

Figure 1. Risk types



Source: personal projection

Considering that the residual risks are those remaining once control measures were implemented, they are not subject to the evaluation and treatment, but are they monitored in case they changes, or modify their level or structure and thus become uncontrolled.

Inherent risks and residual risks are considered as two facets of the same risk. Thus, there are inherent risks before introducing internal control tools and residual risks exist after the introduction of internal control instruments.

As we can see, the entity generally identifies the risks associated to objectives, but there are some risks that cannot be identified. The degree of risk identification is influenced by several factors, including: organizational culture towards risk, the specific field preparation and the knowledge, the methods and tools used to identify and assess risks or complexity and volume of the activities.

Control risk is the risk that the entity's internal control system fails to prevent or detect errors in due time, irregularities or fraud. These risks may occur in an account balance or class of transactions and may be significant individually or together with other information. Control risks are associated to the irregularities and errors that are discovered during the inspection.

Detection risk is the risk that a particular threat cannot be identified and managed. These risks are involuntarily excluded by the entity because it is not aware of their existence. However, the management of the public entity has the responsibility to monitor the activities attached to objectives and track whether new risks occur, particularly in the context of changing activities.

Risk appetite (level of tolerance) is considered as risk exposure that an entity is willing to accept. This is different from one entity to another, from one functional department to another or from one activity to another, depending on the organizational environment, quality and employee involvement.

Risk tolerances levels is set by the entity and must be known by all employees, so that they could work towards activities empower, keeping the risk within acceptable limits.

Considering the fact that risks cannot be avoided or eliminated, the specialists in the field opinion is that *"entities must to be concerned with risk assessment and keeping them within which they can accept that they can tolerate"*.

Related to the nature of the generated operations the risks can be classified as follows.

In our opinion the risk characteristics can be classified as follows:

a) *exposure to risk*, there are various ways of exposure of the entity, such as personnel, assets or organizational environment;

b) *risk factors* related to the characteristics of the entity, the political system and legal framework applicable to the entity. Risk factors increases the risk exposure in certain conditions that can lead to the occurrence of risk;

c) *potential financial impact*, is the consequence for the entity, due to risk occurrence. The consequences can be quantified by *direct losses* which cannot be assessed with certainty, *property damage* or *loss of life*.

Taking into account that the risk is *"the threat that an event or action adversely affects an organization's ability to achieve the objectives set"*, we consider that objectives aiming set by the public entity may be uncertain if management decisions and actions taken to their implement disregard the realities and risks.

3. Conclusions

We may conclude that as the risk is assessed based on probability and impact management's responsibility is to identify, assess and considers risks by results and establish appropriate control tools necessary to be implemented in order to limit risks or their continuing acceptable levels. Effective risk management requires balancing between residual risk and the risk that the public entity is prepared to tolerate.

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