CONTEMPORARY TRENDS IN MANAGEMENT AND FINANCE. THEORY AND PRACTICE

Edited by
Maria SIERPIŃSKA & Piotr SZCZEPANKOWSKI

UNIVERSITY
OF FINANCE AND MANAGEMENT IN WARSAW

University of Finance and Management in Warsaw

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Summary

This study aims at an attempt to present the impact of corporate governance on the valuation and financial ratios of organizations (in the light of the major findings of international and domestic studies). International studies show that very often there are positive and statistical relations between corporate governance indices presented in differentiated forms and financial ratios companies. The results of Polish studies are not explicit. It may result from an initial stage of implementation of corporate governance standards or low effectiveness of a capital market. The results of studies depend on a number of researched companies, type of data, type of applied measures of corporate governance (simple or indices and a manner of establishing of the index) as well as the adopted type of variable (corporate governance – endogenous or exogenous variable), the applied econometric model and the method of estimation of a model. A lack of explicit results in the studies relations may result from the complexity of corporate governance. Specific elements of the index (mechanisms, principles, corporate governance provisions).

Agnieszka Herdan
UNIVERSITY OF GREENWICH, GREAT BRITAIN

Chapter 6
THE ROLE OF INTERNAL AUDIT IN CORPORATE GOVERNANCE WITHIN BANKING SECTOR. THE CASE OF UK BANKS

INTRODUCTION

The formation of corporation involves several investors or shareholders who elect the board of directors to represent their interest in the organization. The board of directors in turn appoint managers whose task is to run efficiently daily activities of the corporation. It is also the responsibility of the board to ensure that managers act to the best of shareholders interest. The maximization of shareholders wealth is the ultimate objective of the board of directors.

Last decade however proved that corporations lacking of proper corporate governance and primary objective of shareholders – wealth maximisation – has been compromised several times by managers who often pursue their own interests[1]. That is why shareholders are afraid to give total control to managers as they fear that this will leave them with no influence in running the organization.

There are many mechanisms that have been used to enforce and encourage the management to act in the best interest of shareholders. Amongst them, the internal audit is believed to play an important role.

In this paper, the concept of corporate governance is discussed in relation to the internal auditing function in UK banks. Areas such as internal audit independence, activities performed auditor qualifications as well as relationship with audit committee has been examined.

1. IMPORTANCE OF CORPORATE GOVERNANCE:

Holm & Laursen [2007: 322–333] points out that good corporate governance involve having effective organisational management that enables the company to achieve its objectives.

[1] Examples: Enron, WorldCom, Parmalat, Lehman Brothers.

Good corporate governance permits efficient utilisation of the company's assets and leads to high rate of return on the company's investments and therefore contributes to increasing its market value. A well developed corporate framework also offers a greater access to finance and lower the cost of capital [Claessens et al., 2002: 2741–2771]. According to Mohamed [2004] effective corporate governance improves the confidence of both foreign and domestic investors thereby attracting their investment and gives beeter opportunity for raising capital.

According to European Corporate Governance Institute (ECGI)[2] good corporate can significantly contribute to prevention and malpractices by ensuring the relevant interest of stakeholders of the company business are fully protected.

UK has a long history of developing good corporate governance practises. Corporate governance regulation in the UK emphasise the importance of strengthening financial controls and the accountability of the board of directors. The Combined Code of best practice suggests improving the systems of internal controls and encourages establishing internal audit functions [Spira & Page, 2003: 640–661].

2. PRINCIPLES OF EFFECTIVE INTERNAL AUDIT FUNCTION (IAF)

Internal audit is "an independent, objective assurance and consulting activity designed to add value and improve an organisation's operations. It helps an organisation accomplish its objectives by bringing a systematic, disciplined approach to evaluate and improve the effectiveness of risk management, control, and governance processes"[3].

The current financial crisis has been blamed on inadequate corporate governance and financial reporting. Hughes [2009: 17] emphasise that "...auditors are struggling to do their job, given the deteriorating economic conditions and turbulent markets, and they are about to come under the sort of media scrutiny they have not seen in years". The Institute of Internal Auditors (IIA) highlights important area that need to be analyse when evaluating efficiency and contribution of internal audit[4].

Firstly in order to improve corporate governance of the organization the internal audit unit should have organizational independence to allow the auditor to be completely objective when performs his/her duties. Only full independence gives auditor works full credibility. The biggest challenge for internal auditor is the ability to carry out its duties without any interference from major stakeholders within the

[2] www.ecgi.org
[3] www.iia.org.uk [accessed August 2010].
[4] www.iia.org.uk [accessed September 2010].

organisation. As determine by KPMG survey to maintain full independence internal audit should functionally report directly to the audit committee chairman and administratively to the CEO of the organisation [KPMG, 2008].

Secondly if internal audit aim to contribute to enhance corporate governance it is absolutely vital for auditor to have unrestricted access to all relevant information. This includes records of business activities, transactions, employee and property records, etc. [KPMG, 2008]. This information will be only valuable if companies ensure efficient, reliable documentation of their day-to-day activities.

Thirdly as pointed out by Belay [2007] the availability of competent and experience staff determines the quality of the audit work carried out within an organisation and plays major role in audit contribution towards improvement of corporate governance. According to the Basel Committee on Banking Supervision [2001], it is the responsibility of senior management to provide adequate staffing to enable internal audit achieve its objectives.

There are various ways of assessing auditors' competency such as academic qualification, skills, experience, development programs one has undertaken etc. The responsibility of the head of the internal audit unit is to assure that all members of the unit are competent and knowledgeable to efficiently perform allocated duties.

The specific role is assign to audit committee. As emphasis by Bhuiyan [2007: 5–16] although audit committee does not have decision making powers and often does not report directly to the shareholders, it play very important role. Especially within banking institutions as it offers assurance to management and the board. As stated by Pickett audit committee by ensuring that internal audit function efficiently provide "another layer of stakeholder comfort in search for good corporate governance" [Pickett, 2005].

Bariff [2003] stress that appropriate support provided by audit committee help internal auditor gather evidence on inappropriate accounting practices, inadequate internal control as well as ineffective corporate governance.

If internal audit should enhance good corporate governance it should have acceptance and support of major stakeholders of the corporation. This includes shareholders, the board of directors, senior management, the audit committee as well as employees. In a wider perspective also general public as banks activity is mainly based on public trust.

KPMG [2008] highlights that relevant resources are considered as crucial for internal audit to function properly. Rapid changes in global environment have challenge auditors activity and require additional resources. Apart from the availability of adequate manpower it is necessary to have access to new technology, expertise and adequate funding.

3. ROLE OF INTERNAL AUDIT IN CORPORATE GOVERNANCE

The challenges that organization face in current business world has strongly influence the changes of the role of internal audit. According to Whittington and Pany [2003: 722] the subsequent expansion of the role of internal auditors is " a result of demands by major stock exchanges and the Securities and Exchange Commission for more management responsibility for the reliability of published financial statements".

The roles of internal audit often focus on „three pillars". These pillars are fundamental to internal audit function and are;

- governance processes,
- control,
- evaluation and improvement of risk management.

Asare [2009: 15–25] stress that these three elements encompass the policies and procedures established to ensure the achievement of objectives and also include the appropriate assessment of risk, as well as the reliability of internal and external reporting and accountability processes, and the compliance with applicable laws and regulations. This means that internal auditor has to provide independent and objective appraisal on the appropriateness of a company's governance structure and specific governance activities. Although the board of directors is responsible for establishing the governance structure, internal auditor should occasional conduct the review to determine if the structure is working properly and meeting the set up objectives. In addition an internal auditor plays the advisory role in improving and enhancing the governance practices in the organisation. One of the main duties of internal auditor is to ensure the existence and the effectiveness of internal controls within the organisations.

As stress by Sarens [2004: 10–106] the role of internal auditor in regards to corporate governance is to observe and inspect the related execution plans as well as the outcome of those plans. Although the goals set by management may have been achieved, internal auditors need to identify any new or existing risks possibly resulting from operational inefficiencies, budgeting issues and employee attrition.

Secondly, it is also internal auditor duty to detect and prevent fraud. The occurrence of fraudulent activities within organisations over the last decade years led to catastrophic distress on the market. Although ensuring effective control and accountability is without doubt extremely complex and time consuming, it is crucial to ensure corporate wellbeing.

The third „pillar" requires form internal auditors to evaluate and improve risk management of the organisation. Allen [2008: 1–4] points out that expect the obvious risks internal auditors need to pay attention to risks with low probability but with

a high impact if they do occur[5]. The responsibility for recent corporate malfunctions such as RBS or Lehman Brothers has been related not only to the greed of directors but mostly to weak risk management.

4. METHODOLOGY, AREA OF INTEREST AND DATA COLLECTION

This research follows the qualitative approach and incorporates questionnaires to obtain the inside of internal audit activities. As stressed by Saunders [2003] questionnaires are more effective, direct and robust in proving the view of the respondent. The administration of standard questionnaires across the board also gives the researcher the ability to easily measure the responses from the respondents. It also allows the participants to freely express their views on relevant issue in question as in most cases the questionnaire are anonymous. In addition most of previous studies in this field employed qualitative research techniques [Belay, 2007; Cattrysse, 2005; Baker & Owsen, 2002].

Data was obtained from respondents through self administered questionnaires. The questionnaire was partly based on Belay [2007] study in public sector. As benchmark to measure effectiveness of the internal audit function the IIA characteristic has been considered. The areas that have been looked at are essential for supporting corporate governance responsibilities and contributions towards the achieving organisational goals. The following areas have been considered when assessing internal audit function:

- internal audit independence,
- human resource capacity,
- knowledge and scope of internal audit function,
- information access,
- adequate funding and technology,
- existence of audit committees,
- stakeholder support,
- Implementation of audit recommendation.

Each questionnaire contained 25 questions broadly grouped under major principles of effective internal audit function as a measure of its contribution to corporate governance within the organisation. The questionnaires were administered to both senior and junior level staff members in the internal audit units of five UK banks.

50 questionnaires has been send and 27 have been received back. The respondents of the study are members of the internal audit units with at least 3 year of bring within the organization.

[5] Example of this is natural disasters, computer virus outbreak.

Data collected through the administration of questionnaires has been analysed using the SPSS.

5. FINDINGS

Achieving the aims and objectives by internal audit is only possible if the unit is fully independent. This means that the following areas need to be considered:

- the strategic position of the IAF within an organization,
- audit objectivity and consistency,
- the freedom to undertake internal audit tasks,
- freedom to report audit findings without interference,
- the funding of internal audit functions.

In the study, 80% of the respondents believed the internal audit is positioned strategically to contribute effectively to organizational performance. At the same time 75% believe that the current structure of internal audit promoted business understanding as well as consistency and objectivity of operations. Further 80% of respondents across the five banks were convinced that the internal audit unit has freedom to conduct necessary tasks in any department or unit across the organisation without being restrained by management. This however, is not in line with the possibility of freely reporting the outcomes of internal audit task. Less than 50% of the respondents believed that they had the freedom to report their audit findings. The investigated staff feels that management is more likely to prevent the official reporting of the internal audit findings if they feel that it may be damaging to the banks reputation especially if those findings are made public.

Regarding the independence of audit activities, 73% of respondents reported that there were existing rules in their organization to ensure the independence of the internal audit from the activities being audited. It is established that the independence of internal audit activities is essential for many reasons including such as preventing conflict of interest and facilitating the exposure of any potential fraud.

The issue underpinning good functioning of internal audit unit is access to financial resources. The major concern that can threaten the effectiveness of internal audit function is lack of funds for internal audit operations. According to KPMG [2008] survey proper funding of internal audit activities allows to maintain the consistency and objectivity in terms of the quality of service it delivers across the organisation. Among the respondents, a significant percentage of 69% say their operations are being well-funded compared to 18% of respondents who believed that their operations are underfunded.

The second criteria when assessing internal audit efficiency is the human resource capability. This means looking at staffing of Internal Audit, the qualification and experience of the members of internal audit unit, their competence in relation to audit roles and the accessibility of professional training. The study shows that human resource capacity available for the internal audit function across the organisations appears overstretched. The respondents acknowledge that the internal audit unit within the banking institutions is often very small. They stress that it is usually the result of management attempt in trying to cut cost on its operations. This is why very often the tasks of internal audit are delegated to their legal team. In all, only 45% of respondents thought that their internal audit units are sufficiently staffed. Despite lack manpower resources the personnel of internal audit unit are in most cases is well qualified and posses the necessary experience for their respective roles (90% of respondents are in favour of this statement). In terms of matching the core competencies of staff with the internal audit function, a substantial proportion of respondents (91%) were convinced that the staff possessed good degrees of competences for the job. To maintain this high degree of expertise the auditors need to be able to undertake training on regular basis. Although the budgets of internal audit units has been significantly cut in the last few years 67% of respondents admitted to had the opportunity to participate in professional training over the past three years.

The essential factor for retaining internal audit personnel is remuneration package. 42% of respondents acknowledge that remuneration packages was not enough to retain existing staff and does not even look attractive to new staff. As stress by participants of the survey the staff is willing to move to other organizations which are prepared to offer them more attractive remuneration packages. Indeed this could be a worrying sign not only to the individual banks but also across the banking industry, since it stands the risk of losing most of its competent staff to other industries offering attractive packages.

The third area that determines efficiency of internal audit is the knowledge and scope of IAF. This consist of planning of audit functions in advance, staff briefing on IAF and the various audit functions that is performed within the banks. To utilise internal audit function in full, it is crucial to plan the audit work in advance. The plan for the audit should incorporate among others the duration of the specific audit function, its specific objectives and any potential obstacles and how to handle them. 85% of respondents are convinced that the schedules for every audit function within their respective banks are always planned by the head of the internal audit unit. 80% of the internal audit staff confirmed that they were briefed by the head of the unit about the specific ways to carry out a particular internal audit function. IIA stress that the major task for internal audit is overlooking[6]:

[6] www.iia.org.uk [accessed July 2010].

- corporate governance practices,
- operational and financial performance,
- existing risk and internal control,
- accomplishment of organisational objectives,
- reliability of data,
- reliability of financial information,
- economic effectiveness and efficiency in the use of organisational resources.

Figure 1 presents the frequency in which tasks are performed. It shows that the activity of the audit unit is focused on risk exposure and assuring that relevant internal control procedures are in place.

55% of respondents reported that the review of existing risk management processes within the organisation is part of their audit functions. This is consistent with point made by Allan that the review of risk management process is one of most important functions to be performed by internal audit in discharging its corporate responsibilities [Allen, 2008: 1–4]. It was however surprising to note that as many as 20% of respondents were not aware if the review of existing risk processes was part of their duties.

Performing efficiently auditors' duties is not possible without access to reliable information. While 51% of respondents reported that they always had unrestricted access to information whenever the need occur, 20% of respondents acknowledged that it is always difficult to access relevant information for the auditor. Furthermore, only 22% of the respondents said that they trusted the information they were provided with.

If internal audit should contribute to the well being of the corporation it is essentials that relevant resources such as technology, funding, expertise assistance should be

Figure 1. Internal Audit Activity

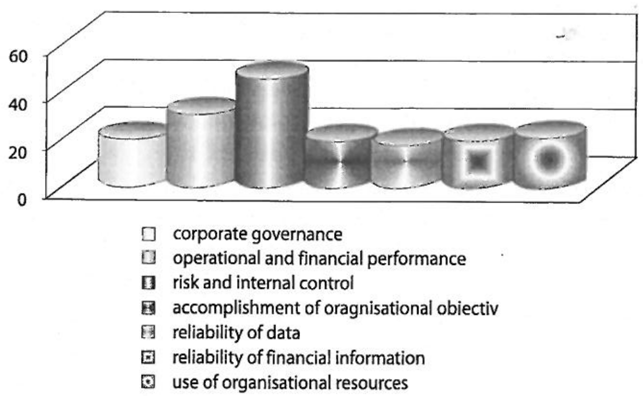
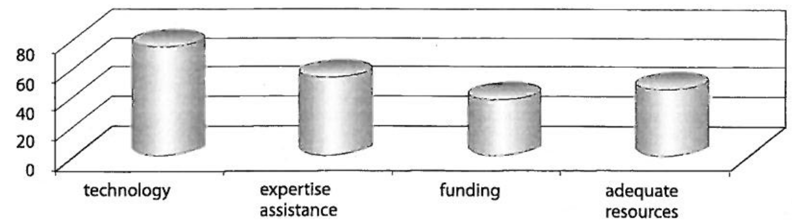


Figure 2. Acces to resources



available. The respondents have the best access to technology resources. 75% of participants confirmed they have easy access to all technology they need (see: Figure 2). 65% has sufficient access to experts' assistance when carrying out their audit functions, while less than 50 % thought that the internal audit unit in their banks is adequately resourced. Unfortunately only 40% of internal audit units have adequate funding to perform all duties impose on auditors.

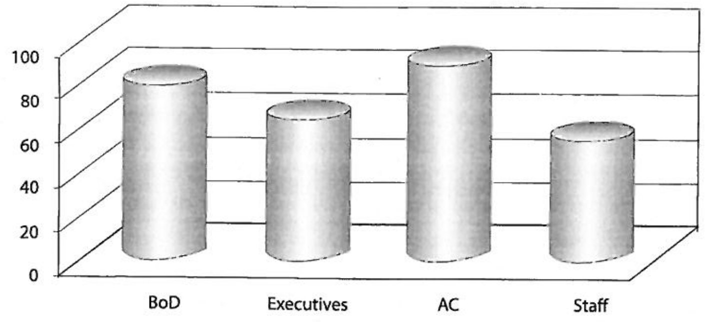
The existence of audit committees is obligatory for most of listed companies in UK but especially for entities in Financial Services. All respondents confirmed the audit committees are incorporated in banks structure. Furthermore, 70% of the respondents are satisfied with the knowledge and expertise of the members of the audit committees. This represents a healthy proportion since it will not only enhance the credibility of the audit report, but also influence the level of confidence placed on it by external auditors.

The support of stakeholders of any corporation is essential for an effective internal audit function and brings credibility to the work of the internal audit unit. Stakeholders include Board of Directors (BoD), management executives, audit committees (AC), and other members of staff. The responses from the survey participants show that there is a significant stakeholder support for internal audit in the banks under investigation. Figure 3 demonstrate that 80% of respondents were convinced that their internal audit duties have the support of the Banks Board of Directors, 65% feel that management is in favour of internal audit activity, 90% the recognise strong support from audit committees, but the support of other staff members is rather low at 56%.

To ensure benefits of internal audit activities the recommendations internal audit have to be put into practice. Implementation may involve introducing new procedures, instituting sanctions, proper enforcement of existing rules etc.

70% of respondents believe that actions are taken in their banks to avoid repetition or reoccurrence of weaknesses exposed by internal auditor, while only 48% of acknowledge that the head of the internal audit unit actually monitors management action in ensuring the implementation of audit recommendations.

Figure 3. Stakeholders support



CONCLUSIONS

Developments in corporate governance over the past decade including the post Enron auditing reforms across the globe have in no doubt contributed to the increasing awareness of the importance of internal audit activates within efficient corporate governance.

The study examined the role of internal audit in corporate governance among UK financial institutions by using case study of five banks. Areas of particular concern to this project concentrate on what internal audits activities are establish, how are this activities performed and can internal audit enhance better corporate governance of banks.

Allen [2008: 1–4] describes internal audit as being the „lighthouse" whose work serve as a point of reference in allowing companies to know where they are and how to navigate into the future. Internal audit duties are regarded as crucial if the banks are to achieve their corporate objectives. This empirical study shows, that internal audit function in UK banks largely contributes to its good corporate governance. Internal audits activities within the banks are in large extend focused on helping management deliver its ultimate goal of maximizing the wealth of its shareholders.

The findings of this research indicated that, apart from the internal audit promoting the objectivity and consistency of operations within the banks, audit staffs in large extend have the autonomy to carry out their audit work anywhere within the organisation and freedom to report findings without management interference. Most activities are relatively well funded to ensure that every aspect of work can be covered and also not to compromise on the importance of the internal audit activities. The review of operational and financial performance as well as ensuring the appropriate

use of organisational resources and seeing to the accomplishment of organisational goals are also pursuit.

It should be noted that in current economic climate and market instability efficient internal audit can help banks faced challenges and help resume the confidence of all stakeholders.

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Summary

This paper examined the role of internal audit in corporate governance within banks in five UK banks. Data for this research was collected through the administration of structured questionnaires to staff within the internal audit units. Questionnaires are based on the key principles of internal audit. This allowed to evaluate the contributions of internal audit towards enhancing the corporate governance. The results shows that financial institution in full utilise the opportunity given by internal audit in strengthening good corporate governance. The function of internal audit is regarded as being crucial to achieve corporate objectives. The study suggests that the biggest obstacle to overcome is to ensure full independence of internal audit unit and provide sufficient resources for auditors.

Anna Korombel
TECHNICAL UNIVERSITY OF CZĘSTOCHOWA, POLAND

Chapter 7
PROCESS OF RISK IDENTIFICATION IN INTERNAL AUDIT

1. RISK AND ITS CHARACTERISTICS

Risk accompanies all decisions taken by a human being. It is a very objective and common phenomenon, which results from implementing new undertakings or investment projects and the lack of reliable and complete information.

Risk is a complex notion with many meanings, thus it is impossible to create an unequivocal definition of it [Kaczmar, Ronka-Chmielowiec, 1996: 3; Wilimowska, 2001: 19]. According to P.L. Bernstein [1997: 19], the word risk comes from Old Italian *risicare*, which means to dare, face, therefore risk should be understood as a choice rather than an inevitable fate.

In the last decades, the interest in the notions of risk and uncertainty has significantly increased. German and English-speaking literature, as well as Polish economists, including T.T Kaczmarek [1999: 13], M. Sierpińska and T. Jachna [1996: 232], P. Buła [1994: 19], limit the notion of risk to the possibility of sustaining a loss. A broader notion of risk can be found in the American literature, with some economists, including M.J. Ahn, W. D. Falkon [1991: 117], seeing risk not only as a possible threat of a negative departure from an objective set but also as a chance of attaining some profit. These different attitudes allow us to distinguish two categories of risk: pure risk and speculative (dynamic) risk. Pure risk is connected with a potential occurrence of losses, whereas dynamic risk involves the possibility of occurrence of both loss and profit [Bizon-Górecka, 1998: 18–19][1].

The literature of the subject contains many classifications of different types of risks based on various criteria. One of the classifications distinguishes the following types of risks [Korombel, 2007: 153]:

- technical risk consisting of the risk of project completion and the risk of use,
- market risk covering the supply risk (connected with the change of prices) and the risk connected with obtaining assumed income,

[1] More on the history of the evolution of the definition of risk, see: [Wilimowska, 1998: 5–7].