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Financial Risk Management in Enterprises

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Abstract. *In modern conditions, of particular interest are the fundamentally new possibilities of financial analysis, in which financial risk assessment is an important part of financial management. One of the main aspects of assessing financial risks is the choice of an appropriate methodology for assessing the degree of a specific type of risk, which predetermines the correctness of analytical calculations to determine the degree of riskiness of transactions. In this regard, the article discusses methods of financial risk management, as well as the possibilities of their application in modern economic conditions.*

Keywords: *risk, financial risk, risk management, solvency, financial risk, operational risk, interest rate risk.*

1. INTRODUCTION

The topic of financial risks and their management remains relevant in the context of emerging markets, including our country. In the context of the formation of civilized market relations, factors such as increased competition, technological changes, computerization of accounting, and constant changes in legislation create new challenges for enterprises.

Financial analysis plays a key role in understanding the financial sustainability of enterprises, especially in conditions of uncertainty and risk. Financial risks, which are the potential for loss of income or capital, are important to stakeholders because they can have a negative impact on a business's performance and value.

Methods for assessing and managing financial risks are being developed to reduce their impact on enterprises. The basic principle of risk management is that you can only manage what you can measure. Consequently, the development of quantitative methods for analyzing financial risks becomes a priority.

Problems of financial risks are actively studied in the scientific works of many authors, which indicates their importance for the practice and theory of finance. Fundamental research in this area offers an understanding of the nature of financial risks and ways to manage them, which is the basis for developing effective business strategies.

2. THEORETICAL ASPECTS

Problems of financial risks are reflected in numerous scientific publications, which are associated with economic activity as one of the decisive factors in increasing the efficiency of business entities.

The word “risk” has Spanish and Portuguese roots. In these countries, this word sounds like “danger” or “pitfall.” Risk is a concept comparable to the probability of deviation from the expected (planned) result.

Financial risk from the point of view of the economic category can be defined as the ratio of borrowed funds to the equity capital of an organization.

At the same time, the more a firm depends on external creditors, the higher the level of financial risk.

In modern economic literature, the concept of “risk” is characterized by most authors by the following general features:

- risk is always associated with decision making
- the above decisions are made under conditions of uncertainty.
- the entire list of decisions made is probabilistic in nature.
- any of the known types of risk can cause losses to the organization in question.

It is worth noting that risk represents not only the probability of loss, but also carries the possibility of receiving unplanned profit. This pattern has two sides with a direct and reverse meaning.

Direct understanding is victory after making a decision, reverse understanding is the financial and material losses incurred.

It is also important to note that an uncertain situation does not always create risk. A risk situation may arise for individuals or groups of decision makers where probable future events will influence the outcome of their decisions. From the above, we can conclude that risk is the uncertainty of consequences, in the event of which the enterprise can either win or lose.

Accordingly, the main characteristics of risk are inconsistency, alternativeness and uncertainty.

In any enterprise, financial risks have a large degree of diversity, and their effective management is classified according to a number of characteristics. Next, it would be advisable to consider the most well-known risk classifications:

1. Financial risks:

- risk of decrease in financial stability (equilibrium). This type of risk arises from imperfections in the structure of existing capital as a result of an imbalance of negative and positive cash flows by volume.
- risk of insolvency of the organization. This type of risk occurs when the level of liquidity of current assets falls. Based on the type of consequences, this risk is considered one of the most dangerous. It plays a leading role in financial risk management.
- investment risk (characterizes the possibility of financial losses when carrying out investment activities of an enterprise). It also belongs to the group of the most dangerous risks.
- Investment risks include the following types of risks:
- risk of lost profits (the occurrence of indirect financial damage (lost profits) as a result of the event.
- risk of falling profitability - arises as a result of a decrease in the amount of interest and dividends on existing portfolio investments, loans and deposits. This type of risk includes credit and interest rate risks.
- the risk of direct financial losses is a combination of the following types of risks:
- election risk, currency risk, bankruptcy risk and credit risk.

Inflation risk is a kind of risk with the possibility of depreciation of the real value of existing capital (in the form of its financial assets), including the expected income from financial transactions within the framework of developing inflation. Due to the fact that this type of risk is constant and typical for almost all financial transactions of an enterprise, special attention is paid to financial management.

Interest rate risk (consists in an unforeseen change in the interest rate in a constantly changing financial market). This risk arises due to the fact that the situation in the financial market is constantly changing under the influence of government policy and a number of other factors.

Currency risk is a type of risk inherent in enterprises engaged in foreign economic activity. This is reflected in the inability to achieve planned income due to the direct interaction between the foreign exchange rate in which foreign trade transactions are conducted and the expected cash income from these transactions.

Deposit risk – the possibility of returning deposits using certificates of deposit. This is quite rare and has a direct correlation with incorrect assessment and unsuccessful selection of the bank involved in the implementation of deposit transactions.

Credit risk occupies an important place in the financial activities of an enterprise when providing commercial or consumer loans to buyers of the products of the corresponding enterprise. This manifests itself in missing payments or late payments for products sold on credit, and may also exceed the estimated budget for debt collection.

Tax risk is a kind of financial risk with a number of the following manifestations: the likelihood of introducing new taxes and fees on certain aspects of economic activity in the country, the possibility of increasing the rates of current fees and taxes, the possibility of canceling existing tax benefits in the economic activity of the enterprise.

Being unpredictable for an enterprise (as evidenced by modern internal fiscal policy), it has a significant impact on the results of its financial activities.

Structural risk. This type of risk arises from ineffective financing of the company's operating expenses, which leads to a significant portion of fixed costs in their total amount. A high operating leverage ratio in the event of unfavorable changes in the product market and a reduction in the gross amount of positive cash flow from operating activities generate a significantly higher rate of decline in the amount of net cash flow for this type of activity.

Crime risk. In the sphere of financial activity of enterprises, it manifests itself in the form of declaration of fictitious bankruptcies by its partners; forgery of documents ensuring the misappropriation of money and other assets by third parties; theft of certain types of property on their own, and others.

Other types of risks. The group of other financial risks is quite extensive, but in terms of the probability of occurrence or the level of financial losses, it is not so significant for the enterprises mentioned above. These include the risks of natural disasters and other similar “force majeure risks”, which can lead not only to the loss of expected income, but also to part of the assets of the enterprise.

2. For the characterized object, the following groups of financial risks are distinguished:

- risk of various types of financial activities,
- risk of the financial activity of the enterprise as a whole.

3. Based on the totality of the instruments studied:

- individual financial risk, characterizing the general risk inherent in certain financial instruments,
- risk of an individual financial transaction,
- financial risk of the portfolio (for example, the loan portfolio of an enterprise, its investment portfolio, etc.).

4. According to the complexity of the study:

- simple financial risk - a type of financial risk that is not divided into its individual subtypes (for example, inflation).
- complex financial risk - it characterizes the type of financial risk, which consists of a complex of considered subtypes (for example, investments).

5. Based on their sources, the following groups of financial risks are identified:

- external, systematic or market risk - characteristic of all participants in financial activities and all types of financial transactions (the enterprise cannot influence in the course of its activities).
- internal, unsystematic or specific risk (the negative consequences of which can be largely prevented through effective financial risk management).

6. For financial consequences, all risks are divided into the following groups:

- risk associated only with economic losses (financial consequences may be negative).
- the risk that entails lost profits characterizes the situation when an enterprise, due to existing objective and subjective reasons, cannot carry out a planned financial transaction and cannot obtain the necessary loan and use the effect of financial leverage.
- a risk that entails both economic losses and additional income.

7. Based on the nature of their manifestation over time, two groups of financial risks are distinguished:

- constant financial risk, characteristic for the entire period of a financial transaction and associated with the action of constant factors.
- temporary financial risk characterizes the risk that arises only at certain stages of a financial transaction.

8. Regarding financial losses, risks are divided into the following groups:

- acceptable financial risk - characterizes the risk for which financial losses do not exceed the estimated amount of profit on the financial transaction.
- critical financial risk - characterizes the risk for which financial losses do not exceed the estimated amount of gross income for the financial transaction.
- catastrophic financial risk - characterizes the risk, financial losses are determined by partial or complete loss of equity capital.

9. If possible, financial risks are divided into the following two groups:

- predictable financial risk - characterizes those types of risks that are associated with the cyclical development of the economy, changes in the stages of financial market conditions, predictable competition.
- unpredictable financial risk - characterizes types of financial risks that are characterized by complete unpredictability of manifestation.

If possible, insurance risks are divided into:

- be transferred as external insurance to the relevant insured financial risk includes risks that can insurance organizations.
- uninsured financial risk, they include those of their types for which there is no offer of corresponding insurance products on the insurance market.

The composition of the risks of these two groups is very flexible and is associated not only with the ability to predict them, but also with the effectiveness of the implementation of certain types of insurance operations in specific economic conditions in the prevailing forms of state regulation of insurance activities.

3. METHODS FOR FINANCIAL RISK ASSESSMENT

Presently, there are two main approaches utilized for evaluating financial risks: qualitative and quantitative methods. In qualitative analysis, emphasis is placed on identifying the sources and reasons for risk, as well as the processes and stages where risk emerges during implementation.

Among the techniques for qualitative analysis are:

- Expert assessment method,
- Risk source checklist method.

The expert assessment method is widely favored due to its systematic approach, involving logical and mathematical procedures to obtain opinions from experts on various project-related issues. This method entails providing a group of experts with a list of factors impacting the project's outcome, each assigned a specific weight. Experts then use a point rating system to assign scores to these factors, typically ranging from 1 to 5 or 1 to 10 points, to determine their significance.

On the other hand, the risk checklist method relies on historical information, drawing insights from past projects or lists of risk factors. This method involves analyzing past events and the resulting losses. The checklist is continually updated with each project completion, though there's a risk of losing control over time, potentially leading to overlooked risks. Nonetheless, this method proves valuable in detecting risks and facilitating problem-solving by maintaining a comprehensive list of risk sources.

4. FINANCIAL RISK MANAGEMENT

The cornerstone of a company's resilience and its foundation for maintaining a steady position lies in its sustainability, which encompasses various dimensions including overall, price, and financial stability.

Financial stability, in particular, stands as the primary component ensuring the enterprise's overall sustainability. It denotes the condition of the enterprise's financial resources, their allocation and utilization, aimed at fostering enterprise development through profit generation and capital growth, while simultaneously upholding solvency and creditworthiness within an acceptable level of financial risk.

Hence, the role of the financial manager is to synchronize the different aspects of the enterprise's financial stability with the overall risk level. The objective of financial risk management is to mitigate losses associated with such risks, quantifying them in monetary terms and evaluating preventive measures. The financial manager must strike a balance between these assessments and devise strategies to minimize risk exposure.

Broadly, methods of guarding against financial risks can be categorized into two types: physical and economic protection. Physical protection entails employing measures like alarms, safe acquisitions, quality control systems, data security protocols, and hiring security personnel. Economic protection involves predicting additional costs, assessing potential damages, and leveraging the financial framework to mitigate risk or its repercussions.

Moreover, four widely recognized risk management methods include:

1. Abolition: Involves refraining from engaging in risky events. However, in financial endeavors, avoiding risks often means sacrificing potential profits.

2. Loss prevention and control: Encompasses a range of proactive and reactive measures aimed at averting negative consequences, protecting against mishaps, and managing losses if they occur.

3. Insurance: This method entails investors willingly relinquishing a portion of their returns to eliminate risk, essentially paying to reduce it to zero.

Large firms typically resort to self-insurance, a process in which an organization that is often exposed to the same risk sets aside funds in advance that eventually cover losses. This way, you can avoid a costly deal with the insurance company.

The insurance premium is the payment of the insurer's insurance risk to the insurer. The sum insured is the amount of money for which the tangible assets or liability of the insurer are insured.

Absorption consists of recognizing the damage and refusing to insure it. Acquisitions are used when the amount of expected damage is insignificantly small and can be neglected.

When choosing specific ways to solve financial risk, an investor should proceed from the following principles:

- the firm cannot risk more than its own capital,
- the company cannot risk a lot for the sake of a little,
- the consequences of the risk should be provided for.

The application of these principles in practice means that it is always necessary to calculate the maximum possible loss for this type of risk, and then compare it with the capital of the enterprise exposed to this risk, and then compare all possible losses with the total amount of its own financial resources. And only after the last step can you determine whether this risk will lead to bankruptcy of the enterprise.

The high degree of financial risk of the operation leads to the need to find ways to artificially reduce it.

Reducing the degree of risk - reducing the likelihood and volume of losses. Various methods are used to reduce the risk.

The most common are:

- diversification,
- acquiring additional information about choices and results,
- limitation,
- self-insurance; insurance,
- insurance against currency risks,
- hedging,
- monitoring activities in related areas,
- accounting and assessment of the share of the use of specific company funds in its general funds, etc.

Diversification is the process of allocating capital among different investments that are not directly related to each other.

Diversification allows you to avoid some risk in the distribution of capital between different activities. For example, an investor purchasing shares of five different joint stock companies instead of shares of one company increases the likelihood of receiving average income by five times and, accordingly, reduces the level of risk by five times.

Diversification is the dispersion of investment risk. However, it cannot reduce investment risk to zero. This is due to the fact that an economic entity and the investment activity of an economic entity depend on external factors that are not related to the choice of specific objects of capital investment, and therefore they are not affected by diversification.

External factors influence the entire financial market, that is, they affect the financial activities of all investment institutions, banks, financial companies, and not individual economic entities.

External factors include processes occurring in the economy of the country as a whole, military actions, civil unrest, inflation and deflation, changes in the discount rate, changes in interest rates on deposits, loans from commercial banks, etc. The risk caused by these processes cannot be reduced through diversification.

Thus, risk consists of two parts: diversified and non-diversified risk.

Diversifiable risk, also called unsystematic, can be eliminated by dispersing it, that is, diversification.

Non-diversifiable risk, which is still called systematic risk, cannot be reduced by diversification.

Research indicates that diversification of capital investments, which entails spreading risks across various assets, offers a straightforward and significant means of risk reduction. Hence, the primary focus should be on mitigating non-diversifiable risks.

In pursuit of this goal, economists have devised portfolio theory, which includes models like the Capital Asset Pricing Model (CAPM), linking systematic risk with security returns.

Information assumes a crucial role in risk management. Financial managers often face decisions fraught with uncertainty and based on limited information. Enhanced information availability could lead to more accurate forecasts and risk reduction, rendering information a valuable commodity for which investors are willing to pay.

The cost of complete information is determined by the disparity between the expected value of an acquisition or investment with full information and that with incomplete information.

Another risk reduction strategy is imposing limits, such as capping costs, sales, loans, etc. Limitations are vital tools employed by banks in loan issuance, overdraft agreements, credit sales, lending practices, and capital investment determinations.

Self-insurance involves entrepreneurs opting to self-hedge instead of purchasing insurance from external providers, thereby saving on insurance capital costs.

Self-insurance represents a decentralized approach to establishing natural and insurance reserves directly within a business entity, particularly those facing operational threats.

Entrepreneurs establish separate compensation funds within their businesses to mitigate potential losses incurred during production and trade, encapsulating the essence of self-insurance.

The primary objective of self-insurance is to swiftly navigate temporary financial and commercial challenges. During self-insurance practices, various reserve and insurance funds are established, which can be in kind or in cash, depending on their intended purpose.

Reserve funds are primarily designated to cover unforeseen expenses, accounts payable, and business entity liquidation costs. Their creation is obligatory for joint-stock companies, with these entities also allocating profits to the reserve fund, representing the difference between the sale and par value of shares sold at prices exceeding par value. This amount remains untouched unless shares are sold below par value.

Joint-stock company reserve funds are utilized to finance unexpected expenses, including bond interest payments and dividends on preferred shares if profits prove insufficient.

Businesses and individuals can form mutual insurance companies to safeguard their property interests through insurance. Risk insurance stands out as the most common method of risk reduction.

In insurance, investors are willing to forgo part of their income to mitigate risk, effectively paying to minimize risk to zero.

Hedging, prevalent in banking, stock exchange, and commercial practices, involves various methods to hedge against currency risks. Contracts designed to hedge against price fluctuations are termed “hedges,” with the item being hedged referred to as the hedger. There are two types of hedging transactions: upside hedges (buy hedges) and downside hedges (sell hedges), used to protect against potential price increases or decreases, respectively.

5. CONCLUSIONS

Financial risk management is essential for enterprises due to several reasons. Firstly, it helps protect the financial health and stability of the business by identifying potential risks and taking proactive measures to mitigate them. This is crucial for ensuring the continuity of operations and safeguarding against unexpected financial losses.

Secondly, effective risk management enables enterprises to make informed decisions about investments, financing, and other financial activities. By understanding and quantifying risks, businesses can allocate resources more efficiently and pursue opportunities that offer a favorable risk-return trade-off.

Moreover, managing financial risks enhances the credibility and reputation of the enterprise in the eyes of stakeholders, including investors, creditors, and customers. Demonstrating a proactive approach to risk management can instill confidence and trust, which is vital for attracting investment and maintaining strong business relationships.

Additionally, in today's dynamic and unpredictable business environment, where economic conditions, market trends, and regulatory requirements constantly evolve, financial risk management provides a framework for adapting to changes and navigating uncertainties effectively. It allows enterprises to anticipate potential challenges and implement strategies to mitigate their impact, thereby increasing resilience and competitiveness.

Overall, financial risk management is imperative for enterprises to achieve their strategic objectives, protect their assets, and sustain long-term success in an increasingly complex and volatile business landscape.

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