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General principles of financial risk management in business organizations

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ABSTRACT

Information about how to manage financial risk are made available because of the desire to show the stability and proper monitoring of the risks in order to fulfill the given economic tasks, which has a direct impact on the economic effects (financial result). Therefore the aim of article is classifies financial risk and main strategic components to manage it in order to maintain stable economic conditions.

***Keywords*:** financial risk, risk management, economic conditions, strategic management

1. INTRODUCTION

Recent failures in companies from the public and private sector all around the world resulted in an increased interest in effective risk identification and, most importantly, risk management. In many companies there are regular processes related to risk management, including periodic (e.g. monthly) reports for regulatory bodies. However, it turns out that such periodic reports are not sufficient for management bodies to prevent risk effectively. This is of particular importance in the public finance sector, where there is a high degree of legislation and hierarchy. Now, given the changeability of the economic situation caused by globalization processes, among other reasons, this method is no longer sufficient. This method of management can be applied only in units which do not take numerous activities or

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when such activities do not generate unacceptable risk which may significantly deteriorate the situation. This is why risk should be considered in the tasks performed by units from the public finance sector. The possibilities of a public finance unit in terms of risk management in the course of its activities should be defined. Knowledge on how to use risk management tools will contribute to effectiveness in achieving goals, i.e. higher and more secure financial results. Thus, efforts should be made so that all employees could fully understand the idea of risk management, which is not fighting risk or using it to achieve better results, but managing it in line with the policy pursued by the management. It is, therefore, necessary for managers to learn appropriate financial risk management methodology. The aim of this article is to present the necessary steps in the financial risk management process.

2. DEFINITION AND CLASSIFICATION FINANCIAL RISK

Risk is an objectively existing possibility of failure, loss or damage as a result of an activity [2]. As a consequence of making wrong economic decisions, there might be a decrease in potential profits, loss of financial liquidity, bankruptcy of an organization (an enterprise or a public institution) and even huge debt which entails legal liability. Risk cannot be eliminated, it can only be limited by appropriate economic, legal, organizational and HR-related prevention [11]. The size of risk depends on numerous interrelated factors, the majority of which is independent of the activity of an organization. These include: general economic, social, political, demographic and technical factors.

Financial risk is a danger which results from making a profit whose amount is different than expected. Risk is, therefore, inherent to each and every economic activity. Moreover, risk is taken intentionally in order to make a higher profit because there is a close link between the level of income and risk [4]. A higher risk gives the possibility to achieve a higher return on investment. Taking risks, we expose ourselves to bigger losses, but at the same time we have a chance to make a higher profit, so the spectrum of both advantages and disadvantages is wider. Risk is defined as a negative deviation of the achieved result from the previously planned figure. Therefore, when striving to optimize profit, it is unavoidable to accept certain levels of risk, which are usually related to an increase in the volume of income. Each organization operates in a state of uncertainty of future events. Information which is available when making a decision is usually incomplete and inaccurate and predicting how events will unfold is not always possible.

In general terms, it is impossible to avoid risk. This results from the fact that within the general approach the term risk refers to everything that is uncertain. It is beyond any doubt that life was, is and will be unpredictable as far as future events are concerned, i.e. risky. This is why in this paper is present suggestions in terms of risk management and to identify deterministic activities, i.e. activities which enable determination of the consequences and scope of risk. Each activity involves risk, which is to a large extent undefined, complex and undergoes dynamic changes. The term "risk" is ambiguous and defies a clear and synthetic definition [3]. Risk itself follows from the very fact of making decisions concerning the future. This is because it refers to situations in which a company does not have a 100% certainty as to the course and final results of its activity. Phenomena which influence an entity operating business activity but which are beyond the scope of its will are usually referred to as uncertainty. Risk, however, is defined as merely a possibility of failure, in particular a possibility of occurrence of events which are beyond the control of an entity and which are impossible to predict and prevent. As a consequence, a particular activity may turn out to be less effective or less beneficial. Both notions, i.e. "risk" and "uncertainty", are often treated as equivalent although they denote something entirely different. One could quote a number of definitions which define mutual relations between these categories. According to Willet "risk is the objectified uncertainty concerning the occurrence of an undesirable event. Risk changes together with uncertainty and not with the level of probability" [18].

Braig, Gebre and Sellgren define risk as "a combination of elements of hazard and it is measured with probability, whereas uncertainty is measured with the level of faith. "Risk is a state of the world and uncertainty is a state of the mind" [6].

Being convinced of the result of an action, one can decide not to perform such action and not to take a risk. In order to specify a general and universal definition of risk, one can refer to the dictionary of foreign terms, according to which risk is an undertaking whose result is unknown; the possibility that something either works or not as well as the decision to conduct such undertaking. The meaning of the word "risk" is derived from the Italian word "risco", which means reef, which ships should stay away from. The notion of risk is frequently and incorrectly equated with danger. There is a significant difference between these two terms, which should be taken into consideration. Danger is rather a direct threat, whereas risk occurs in a situation when the consequences are uncertain. Within this meaning, a certain loss is not a risk. There are many other definitions of risk as well. The approach to the category of risk varies depending on the author and it proves how complex phenomenon it is and how difficult it is to define and measure it. As it is the case with defining risk, classifying it is also very problematic. Current categories are not unanimous and disjunctive, which means that one type of risk can be a specific example of another risk. Generally, there are the following basic types of financial risk:

1. Trade risk – risk following directly from commercial activity. It comprises:

- liquidity risk – manifests itself in the necessity to adjust maturities of assets and liabilities to make sure an entity is able to meet its obligations.

- credit risk – related to the failure on the part of a business partner to meet their liabilities towards a particular entity. Currently, over 80% of global trade is conducted with a deferred payment term. The term of trade credit depends on the type of goods. It is shortest for consumer goods (ca. 30 days), whereas investment goods are at the other end of the scale with payment terms of at least one year. Due to an increasing competition and the need to fight for clients, companies will extend the terms even more.

2. Market risk – concerns the probability of changes in the value of market instruments i.e. the possibility of change of financial conditions as a result of changes in market prices, including:

- commodity risk, i.e. goods price fluctuations directly affecting the financial result of an economic organization.

- interest rate risk – results from the fact that the value of a part of assets and liabilities depends on interest rate changes (e.g. a loan bearing a variable interest rate). This results from interest rate fluctuations.

- foreign exchange risk – related to an unsecured open foreign currency position and unfavourable movements in exchange rates.

There also exists a market risk which exerts indirect impact on financial results, i.e. resource risk, price risk, business cycle risk and technological risk. More specific areas of risk are identified depending on the specific nature of a particular business activity. Although not all of the risks enumerated above can be predicted or controlled, one should be aware of their existence and limit their occurrence and impact on organization to the greatest extent possible. Since there are so many factors causing risk, it is simply impossible to avoid it. Moreover, some of these factors are beyond the control of an enterprise.

3. GENERAL RULES OF FINANCIAL RISK MANAGEMENT

The main objective of financial risk management is, on the one hand, the improvement of business results of an enterprise and on the other hand – providing conditions in which an institution does not incur bigger losses than initially anticipated. In practice, the above consists in limiting risk to the biggest possible extent and make provisions against its consequences. Risk management concerns identifying the type of risk which a company may be exposed to, measuring and controlling such risk with the use of available methods. Therefore, risk management may be defined as a logically arranged set of principles and rules which are applied with respect to all company activities in a uniform and continuous manner.

Risk management is one of the basic processes (elements of managing a unit) and its primary aim is to increase the probability of achieving objectives. In order to manage risk successfully, objectives of particular units should be established in order to identify risks which may prevent achieving them. Risk management is a continuous process [12].

According to financial control standards, the head of a unit systematically identifies both internal and external risk related to the achievement of the unit's objectives, concerning the whole unit as well as particular programmes, projects or tasks separately. When there is a change of conditions in which a unit operates, identification of risk should be performed again. Each identification of risk should be analysed in terms of potential consequences and the probability of their occurrence. A manager will perform ongoing assessment of task completion with the use of qualitative and quantitative indicators or with the use of other established criteria. Each economic organization should develop and implement a method of identifying and analysing risk [14]. The implemented programme must enable identification and understanding of all types of risk which a unit is exposed to when providing services and achieving its goals. A risk management system is of particular importance in this process. Risk management can be defined as a logical and systematic method of creating context, identifying, analysing and assessing risk, action, supervision and informing about risk in a way which enables an organization to minimize loss and maximize opportunities [7].

Thus, the process of financial risk management includes:

- identifying risks related to operational activities as soon as possible,
- assessing the degree of influence of risk on a particular organization's results and objectives,
- implementing adequate risk control measures,

- risk management structures, including organizational plans, policies and procedures concerning risk management, data on all teams and individuals responsible for risk, documentation concerning risk.

In today's world, risk management seems indispensable. Moreover, the increased level of economic uncertainty in the context of the current crisis changed the way financial markets operate [8]. Thorough insight into the nature of risk and the scope of potential risk allows one to choose preventive measures at the right time to minimize its impact and consequences. It may be stated that risk should be limited by means of well-thought-out management, because it leads to optimum use of an enterprise's resources and possibilities.

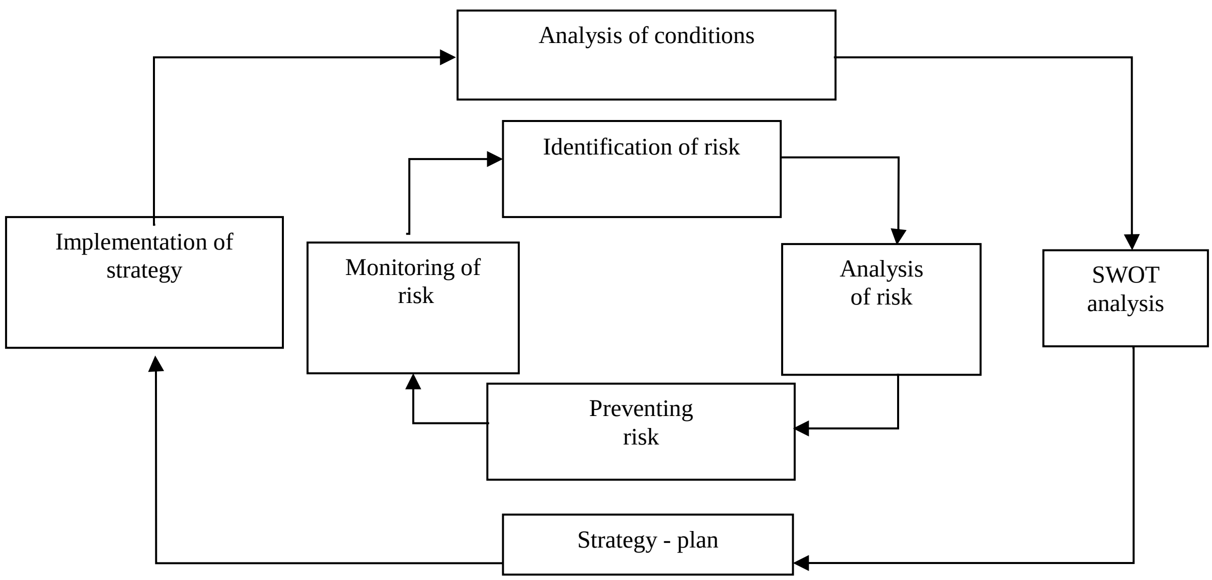

Fig. 1. Strategic management and financial risk management cycle
Source: own work based on: Andersen T.J., Garvey M., O. Roggi, Managing risk and opportunity, Oxford University Press, Florence, 2014, p. 112.

Risk management is an implemented system of procedures and rules, which is used to identify, analyse, assess and monitor risk [11]. It allows not only to reduce risk but also to take advantages of any opportunities that may appear. A correct system is supposed to improve results in the future and support decision making on an ongoing basis.

Therefore, it should comprise a planned, logical, comprehensive and documented strategy. Such strategy includes instructions, plans and procedures which will function in everyday work of a particular office or its organizational units in order to manage risk [12]. Therefore, risk management should be subject to a strictly defined process which comprises the following elements:

1. Establishing objectives and understanding the context of a particular field.

2. Identifying risk.

3. Analysing risk:

- probability of the occurrence of risk,
- consequences of certain events (measurement and assessment of consequences of risk exposure).

4. Estimating and prioritizing risk (high and low risk).

5. Assessing risk (whether it is acceptable or not).

6. Methods of dealing with risk (assessment of costs and benefits of using the available methods):

- acceptance of risk (resulting from the fact that costs of prevention exceed potential losses related to the occurrence of a particular phenomenon),
- withdrawing from certain activities,
- counteracting risk (creating and implementing action plans),
- transfer of risk (e.g. taking out insurance policies, relying on guarantees of correct performance of contracts).

7. Assessment of effectiveness of the applied methods.

4. CONCLUSIONS

The organization should have a process of supervising the probability of the occurrence of risk. The manager should receive reports from a register of risk to be able to react to various levels of risk. Reporting on risk should be integrated into currently existing processes of internal reporting. Frequency of reporting should be adjusted to the organization and measures related to high risk should be monitored on an ongoing basis. The importance of risk management is due to the requirement of the European Union to implement risk management systems in units from the public finance sector [5]. During talks on EU accession, one of the requirements was to develop and implement financial management systems and control in units from the public finance sector and develop standards of financial control in self-government units [10].

Risk management standards are based on the COSO (Committee of Sponsoring Organizations of the Treadway Commission) model. Risk management helps to protect the population and ensure efficiency of public administration in the event of a financial crisis or other threats. Thanks to such an approach the system of procedures in an organization is adequate to its current needs. The process of risk management must be a continuous process, adjusted to a particular organization, rather than a one-off endeavor. Adequate organization of risk management constitutes perfect assistance in increasing the level of a company's financial safety. Due to their immense usefulness, methods for safeguarding against risk have become a permanent element necessary in running a business. With the development of this area in recent years, the scope of available services was additionally expanded, which led to the development of classical methods of safeguarding against risk. Dedicated departments in a company, which are responsible for risk management, constitute a vast source of information describing and warning against the changing economic reality.

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