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Thorough Financial Analysis for a better Risk Management

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Abstract

In recent years, the significance of financial risk management has been progressively highlighted by the organizations, especially after the financial crisis of 2007-08. Due to inadequate information or negligence in identifying the risk, several investment companies face higher risks associated with their investment, which leads to financial distress or bankruptcy. This article aims towards finding measures for the identification, evaluation, analysis, and monitoring of risks that can be implemented by the various firms to cope up with their internal financial risks. It is because to generate higher returns on investment it is important for the organization to understand the risks associated with the investment and manage them accordingly. Therefore, to manage the financial risks associated with the investment, the organization needs to go through the risk management process which involves risk identification, risk analysis and evaluation, risk response and risk monitoring. Moreover, we will be discussing on the three categories of risk named as profitability, solvency and liquidity, which are one of the most important internal financial risks that medium sized investment company experiences.

Keywords: Financial analysis; risk management; internal financial risk; investment firms; risk factors.

1. Introduction

The investment without identifying and evaluating risks can expose investors to several financial risks ranging from multiple events and scenarios.

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Several consequences can result from the poor investment (which is done without analysis) such as downfall of the company, industry and even currencies also. To make a good investment, it is important for the organization to understand the risks associated with the portfolio and manage them accordingly. Nowadays, we can see that the demand of investment risk management is highly increasing because every company wants a better return on the investments. Therefore, to improve returns, traditional asset managers are highly investing in various classes of riskier assets whereas the alternative asset managers and hedge funds are looking to attract institutional investment. However, the common between both is that there is immense burden on companies to improve reporting, control and transparency due to which firms are incorporating risks in their investment strategy. The risk management analyzes whether investment bank or client during trades or transactions accounts the credit and market risks into the balance sheet or not. The credit risks involve capital activities of the market such as bond issuance, loan syndication, leveraged finance, and restructuring. Capital market transactions, exit financing, debt structuring, project finance, portfolio hedging, leveraged buyouts, and loan amendment are some of the credit risk solutions. On the other hand, market risks involve a review of trading and sales activities with the help of VaR model and assist portfolio managers regarding hedge funds. Several risk groups are also involved in investments, such as counterparty risks, operational risks, and country risk.

2. Internal Financial Risk

The internal financial risk is both the inner weakness as well as strength that an organization holds. The internal factors of the company play a major role in meeting its objectives. When the internal factors show the favorable output for the company then they can be considered as strengths whereas the same internal factors have a harmful effect on the organization then they are considered as weakness. Lesser instability in the earnings or cash flows and deterrence in losses help organization for better planning of the liquidity needs. Moreover, this helps by avoiding the shortcuts for the availability of funds as well as consumption of equity [1]. To continue as the financially liquid organization and avoidance of period losses the company needs to identify the maximum tolerated risks. Therefore, the management of risks should be in accordance with the company's actual financial condition. The management of the financial risk depends on the duration of the assets and their financings.

2.1. Investment Firms' internal risk influencing characteristics

The internal risks involved with the investment firms are Liquidity risk, Solvency risk, Profit risk, Financing risk, etc.

2.1.1. Liquidity risk

Liquidity measures the ability of the firm to cover its' expenses, and therefore it also shows whether the company is able to cope with some losses due to risk occurrence [2]. Lacking in the financial funds reduces the capability of the organization or individual to pay off its debts, which in return increases with time [3]. The problem of liquidity or conversion of an asset into cash is one of the biggest problems faced by financial investments. The type of liquidity risks is caused due to lack of cash in the hand of the financial market participant who is not able to meet the obligations within the specified period. Due to inability to meet the

financial obligation the market would lose one of the participants that might expose the higher financial problem in the market. Due to lack of liquidity, the organization rating goes down in the market that results in higher interest payments in the future financings from the investors. The fact is that due to lack in liquidity one cannot sell or purchase investments quickly at the price which is close to the underlying assets. In the small capitalization stocks and counter markets, the associated liquidity risk is quite high as compared to other markets. Moreover, the liquidity risk is mostly posed by the foreign investments. A number of listed companies, trading hours and size of the foreign market are some key factors that limit one's ability to sell or purchase the foreign investment. The profitability of the company also gets affected due to inadequate liquidity. Furthermore, it can also lead to insolvency of the company. Thus the main reason behind liquidity management is that it ensures that the organization is capable of meeting the contractual commitments. In order to have strong liquidity management, the company needs to maintain its key elements such as information systems, funding requirements analysis, contingency planning, funding resources and liquidity control. The major reason behind the investment firm's bankruptcy is a lack in defining important developments of its business [4]. The investment firms should be highly capable of identifying critical developments and risks along with their impact on the financial conditions such as the financial statement, cash flows and balance sheet of the firm. Doing so, the firm will be able to prevent bankruptcy, and various financial distresses. This is because negative effects on the cash flow can cause a decline in the money related assets, prompting shortages in the organization's capacity to pay its present and future bills. Moreover, the success rate of the firm is a relation to returns is very important because the losses will be resulting in a decrease in the equity of company or bankruptcy [5].

2.1.2. Solvency risk

Like liquidity risk, solvency risk is also a type of risk that needs to be considered by the investment firms. The solvency risk arises when the firm is unable to earn the profit in the entire year and due to which it fails to honor the commitments and repay debt as per the contractual agreement. The reason behind this could be varied such as an increase in cost or decreases in sales. The result is a partial or whole consumption of equity in the period and loss of solvency [6].

2.1.3. Profit risk

At the point when a company's profit is gotten from a set number of accounts, it brings about critical net income risk, which then can be evaluated. At this point, there are higher chances of income loss risk, and the firm had reached the stage of profit risk, which is not good for sustaining net income. In the case of investment institutions, the profit risk management is quite similar to that of the diversification strategies, which are majorly required for investment in assets allocations and various other techniques of portfolio risk management. Risk and return are the two important aspects of investment decisions. Investors are risk-averse and always try to minimize risks that are linked to the expected returns.

Under the possibility that financial specialists are chance loath and try to limit the danger of any level of expected return, instinct proposes that excess return must repay speculators for accepting extra hazard.

Researchers and finance related controls have committed a lot of work to refining and formalizing this instinct. A critical investment decision of the risk decision makers should be acceptable and must be demanding higher returns on the investments including higher risks. However, in common practice, important decisions are particularly important for the uncertain risks. Investment firms ordinarily set high obstacle rates in the making go or no go investment choices and apply these rates to all investment irrespective of their riskiness [7].

According to the theory proposed by one of the known economist F.B. Hawley, profit is directly related to the risk taken in the business. If there is higher risk in the company than there are greater chances of rewards for the investors. If this relationship does not exist than investors wouldn't have been investing in the startup companies rather they would have chosen the safest way to make a profit. The proposed theory of F.B. Hawley also states that without taking any risk there are lesser chances of profit for the investors. Furthermore, according to professor Knight, "Profit is the reward for uncertainty bearing and not the risk bearing." Professor Knight also regards uncertainty bearing as one of the major factors of production.

Depending on the different financial analysist, stock broker, and economist the relationship between profit and risk varies. Some of the financial analysts argue that risk should be present in terms of investment to earn a higher profit while on the other hand some of the financial analysts argue that risk should be minimum in financial decisions because higher risks work against the greater profits. The success of the financial activities is depended on the level of risk taken by the investor or the business owner. If the investor is not able to identify the level of risk and make investment decisions accordingly, then it can lead to the huge loss in the investment. On the other hand, if the investment company judge the performance of the organization only in terms of returns and not considering the associated risks then it means that they will put a bigger number of assets than justified in risky procedures, apply misinformed performance evaluation and leave profitable opportunities.

2.1.4. Financial risk

The financing risk is the risk in which organization is unable to obtain its finances or obtained at higher interest rates due to changed conditions of the capital market. Therefore, in order to reduce financing risks, the Treasury department of the organization works actively to establish loan and credit limits for short term as well as long term borrowings and ensures that organization is prepared. Due to various reasons, the firm financings can create risks for the organization. Some of these sources of risks are a choice between floating rate and fixed rate debt, the total amount of the debt and duration of the debt.

2.2. External financial risks factors

External financial risks are based on the risk factors of exchange and interest rates as well as commodity prices [8].

2.2.1. Exchange rate risk

When the firm is gets indulged in the international market, and the outflows and inflows are in the form of foreign exchange rate then there are higher chances of exchange rate risk. The concept of transaction exposure is

majorly used to evaluate the exchange rate risks.

2.2.2. Interest rate risk

Due to the certain changes in the interest rates connected to the short term financing and variable risks the interest rate risks are observed. As similar to the economic exposure of foreign exchange rate risks, the measurability and prediction of interest rate risk are also difficult; therefore, this is majorly ignored for most of the companies.

2.2.3. Commodity price risk

A commodity price risk on the procurement market is due to instability in the prices of commodities. The companies for which the commodities are highly important inputs in terms of prices and quantity for those companies the commodity price risk is one of the significant risks [9].

3. Risk Management Theory

Risk management is the process of identifying; evaluating and managing the present financial risks associated with the firm and lessen the company's exposure to the risks. In order to manage risks, the risk managers identify the risks, analyses the risks, evaluates the remedies to the risk and then implements the strategy to alleviate the risk. As a means of countering possible ramifications, various financial instruments are used to dissolve these risks. Though there are several risks which do not get identified and are impossible to prevent.

In order to manage risks, various tasks as a process are structured in the chronological order.

Figure 1: Risk management process

First of all, a company needs to understand the sources of risk it is exposed to, to be able to manage those [10]. Thus, the first step of the Risk management process is the identification of the risks.

3.1. Risk identification

Risk identification is the first phase of the risk management process. It aims towards the identification of the risks that can damage or interrupt the development of the business. Identification of risk is of great importance because only the identified risks can be handled in the further steps of risk management. In order to identify the risk factors concerned with the investment, the firm needs to understand the sources of risks and the firm's ability to overcome them. Therefore identification of the risk factors along with their evaluation and analysis is the initial step of the risk management process. Once the risk factors get identified, evaluated and analyzed, then it is important for the firm to plan strategies to handle and overcome these risk factors in the daily operations.

The critical factors of the business along with uncertainties of the firm can be easily identified by analyzing the business process concerning the risk potential. Regressive and progressive approaches are the best approaches that are suitable to identify and analyses the key risk factors. Identification of the possible plan deviation along with losses due to risk factors comes under the progressive approach. These risk factors can be originated from certain uncertainties such as certain changes in the market, financial factors, firm's internal aspects or even legal aspect. Thus, in order to overcome these problematic risk factors, it is imperative for the organization to risk management plan, which is not possible without real and complete data.

3.2. Risk analysis and evaluation

Once the risks associated with the business are identified, then it is important to analyze and evaluate them. There is no clear difference between the phase one and phase two of the risk management because both the phases are directly related to one other. Moreover, the risk analysis and evaluation phase aim towards determining the degree or level of risk and its impact on the organization. Thus it is important to analyze the manner in which risk can impact the organization. Though, in most of the cases, quantification of the risk impact on the business is difficult to determine due to which the future outputs are uncertain. Therefore, most of the companies rely on estimations in which both qualitative and quantitative means can be used. The quantitative means of estimation includes the use of statistical programs to calculate and forecast the occurrence and influence of the risks. On the other hand, the qualitative means of estimation the frequency and impact of the risks are calculated on the basis of assessment and experience of the organization's employees and management.

3.3. Risk response

According to the risk willingness, actions to handle the risk will be chosen in the third phase. These actions range from risk prevention or avoidance, risk reduction to transferring of risk and at the end acceptance of the risk [11]. In order to handle the identified risk is to decide for risk avoidance. With the help of strategies and surveillance, the probability of risks gets decreased. If the organization fails in handling the risks, then the organization needs to hand over risks to the outsourced third party.

3.4. Risk monitoring

The next and final step risk monitoring, this should be the daily part of the business unless it starts from the initial stage. In order to implement the risk management process, an organization needs to specify certain substantial objectives and expectations of the business. The fact behind it is that when there are fewer risks associated, then it might be possible that there would be lesser opportunities. Moreover, it is also required to identify the point of time or value from which the risks start problematic and prevailing in nature then from that situation the risk management process will be started again.

4. Financial risk management

Here we will be studying different types of risk associated with the organization and the possibilities of managing them.

4.1. When to use the financial Risk Management

According to the financial theory, an organization must take the risk into consideration when the organization increases the stakeholder's value. In terms of financial risk management, the cost of hedging risks of investors could not be same for the organization managers. In the international market, the concept of financial risk management changes vividly and several organizations have been failed to mitigate these risks.

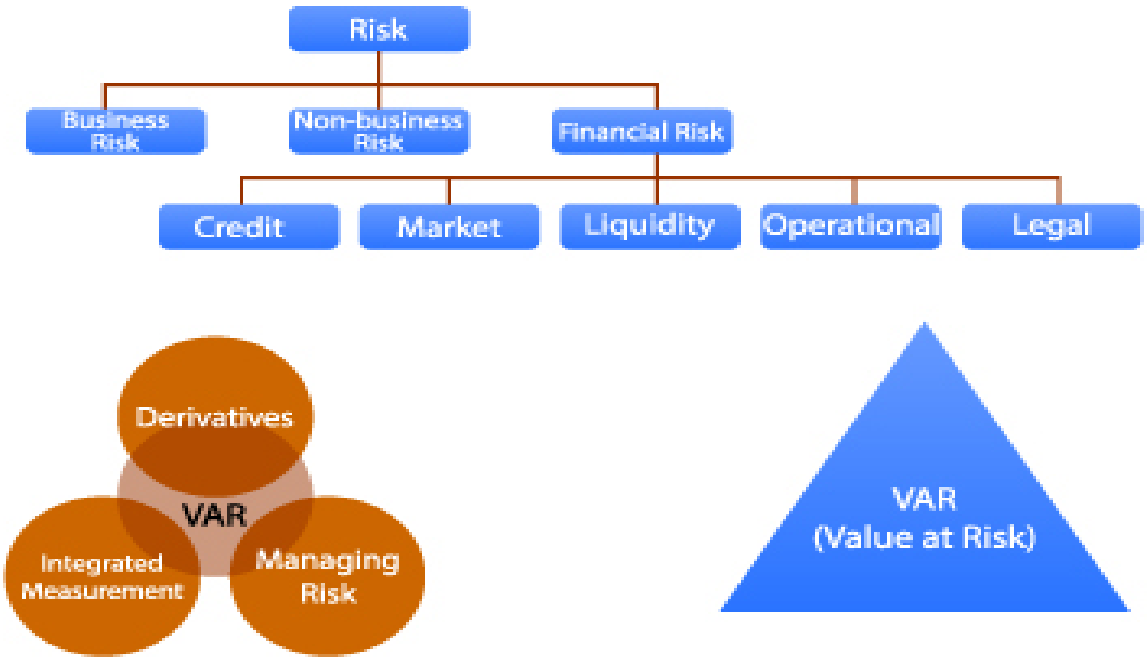

Figure 2: Foundation of risk management

Financial risk management is a process of safeguarding the value of the organization by identifying and mitigating the risks with the help of financial instruments. The financial risk management is quite same as the general risk management because financial risk management also required identifying risk sources, evaluating

them and developing strategies to address them.

5. Conclusion

Several risk factors are associated with every investment decisions that are made by the organization. Investment firms are one of the enterprises which are facing several risks due to similar reasons. In order to grow and sustain the business, investment firms need to eliminate certain risks that can lead towards bankruptcy and various financial distresses. For most of the organizations risk management has become one of the challenging tasks because they lack the necessary resources regarding human resources, knowledge, and databases resulting in partial evaluation and analysis of the risk factors. While doing business, if there is no adequate information then the outcomes of the business are rarely seen due to which the business decisions need to be constantly changing. Therefore, in order to gain maximum returns on the investments, the company needs to identify risks and prepare a strategy to deal with them. The above overview is suitable for medium sized investment firms to manage internal financial risk factors.

6. Limitations

Generally speaking, the study exhibit that a limited amount of key facts can give an exact image of investment firm's situation. However, the outcomes must not be overestimated, as the understanding of financial analysis is constrained. Below mentioned are some of the limitations of this study.

i. The financial analysis is not able to provide just a general picture of whether the business is at risk and it does not indicate where the risk exists. Therefore, this needs to be found with the help of more accurate analysis.
ii. The financial ratios can never convey a complete, reliable scenario of the firm's financial situation, despite the fact that they mean to wipe out impacts in balance sheets, which depend on adjusting decisions.
iii. The database should be from the latest period and should be partially used to determine the future aspects. Moreover, it needs to be assumed that the past developments are a legitimate indicator for future developments [12].
iv. In order to identify the risk associated with the investing firm, it is not only important to analyze key figures and ratios but also important to understand the process of business and necessary economic developments.
v. Other disadvantages of this sort of analysis are that if utilized alone it can display an excessively shortsighted perspective of the organization by refining a lot of data into a single number or arrangement of numbers.

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