Research Journal of Management Reviews. Vol., 2 (2), 97-99, 2016
Available online at http://www.rjmrjournal.com
ISSN 2149-9168 ©2016

A Review Article: Financial Risk in Companies

Mahmood Mohammad Hosein, Dr.Hamid Ravanpak Noodezh*, Dr. Mohammad Mohebbi

Department of Management, Qeshm Branch, Islamic Azad University, Qeshm, Iran

*Corresponding Author Email: hamid.ravanpakwin7@gmail.com

Abstract: The purpose of this research was to investigate the theoretical fundamentals and the studies that were done on financial risk of companies. According to the analyses, it can be said that the acceptable risk level for any organization or individual is different and it depends on financial and economic resources, on limitation of experienced human resources, on managerial decisions and on background risks like hidden risks. Organizations, generally, need systems that beside assessing the activities and their processes, are also able to help them with their risk status, specification of the criteria of tolerable risk and with the lack of accurate risk specification of their processes and depending on the activities complexity of each industry, the kind of system they would need to help them achieve their goals will be different.

Keywords: Risk Management**,** Risk Level**,** Interest.

Introduction

Regarding the nature of the activities in financial institutions, risk management is regarded as one of the most important features of financial services industry and great efforts were made by the scholars and experts of the field for the development of methods and techniques that can be used to assess and control the risk. Among the risks in financial institutions, market risk is one of the most important risks and it has a major role in firm's financial distress (Hoseini & Najafi, 2013). The importance of market risk is due to the great variety of its causes. In recent decades, there have been great developments in assessing and controlling and managing the market risk. The purpose of this research was to investigate the theoretical fundamentals and the studies that were done on financial risk of companies.

The Definition of Financial Risk

Financial risk is the risk to use debts to supply the financial assets of a company. Using fixed financial costs may lead to the overestimation of the benefit and loss and shareholders' benefit which is called financial leverage. When the company is at the risk of in ability to repay the debt which can lead to its insolvency, using financial leverage can increase the volatility in company's efficiency. This is also true about operating leverage which means a change in the operating benefit due to the change in sale size. In similar conditions, the volatility of the efficiency of common stock will increase by the increase of the operating leverage (Dastgir et al., 2012)

Aspects of Risk

Risk can be taken into consideration from different aspects. Productive and nonproductive risks; productive risk is a risk that entails added value. While, nonproductive risk lacks added value. For instance, investment on a mine exploration entails an economic risk. However, participating in a gambling which also entails the risk of losing the money in hope of obtaining more money is considered as nonproductive risk.

Controllable and uncontrollable risk: While a controllable risk can be controlled by the determiner, an uncontrollable risk cannot be controlled by the determiner. For example, a car owner can decrease the risk of theft by observing some security tips like installing security alarm. But if there still is the risk of theft, this risk is an uncontrollable risk. Financial and non-financial risk; financial risk is taking the risk in financial affairs, while nonfinancial risk is taking the social, safety and life risks.

Benefit and loss aspect of risk: risk can be classified into two categories of pure risk and speculative risk (win or lose) such that in pure risk there will only be a loss (like owning a car, that in case of accidents there will be a loss and otherwise the condition is unchanged) and speculative risk can entail both benefit and loss (like owning a factory or company). Simply put, risk can have loss (negative) and benefit (positive) aspects (Dastgir et al., 2012).

Types of Risk

The general risk of financial asset is a function of several factors which will be explained below:

1- ***Interest Rate Fluctuation Risk****:* interest rate fluctuation risk is a risk that the investor takes when buying the bonds (securities) (securities) and accepting the fixed interest rate. The price of such bonds (securities) (securities) will decrease if the interest rate increases and the bond holder will undergo losses by selling the bond before maturity. The price of the bonds (securities) (securities) has a negative relationship with interest rate. The effect of the interest rate fluctuation risk on bonds (securities) (securities) is more than that of common stock. The price of the bonds (securities) (securities) has a negative relationship with the interest rate.

2- ***Market Risk:*** is the variability in the efficiency which is due to the general fluctuations of market. Though all kinds of bonds (securities) (securities) are at market risk, common stocks are more affected by this kind of risk. This kind of risk can have different causes including stagnation, war, structural changes in the economy and the change in the preferences of the clients.

3- ***Inflation Risk:*** this kind of risk that affects all kinds of bonds (securities) (securities) is the purchasing power risk or the risk of reduction in purchasing power of invested funds. This kind of risk is related to interest rate fluctuation risk because interest rate, generally, increases due to the increase of the inflation. The reason is that, to compensate the losses due to the purchasing power, the lenders increase the interest rates.

4- ***Trade Risk:*** is risk due to trading and doing business in a specific industry or a specific environment. For instance, a steel factory in its specific industry deals with issues that are unique to its industry.

5- ***Financial Risk****:* is the risk due to using debt in a company. The more a company is at debt, the more at risk the company is. Financial risk entails the concept of financial leverage.

6- ***Liquidity Risk:*** is related to a secondary market in which bonds (securities) are dealt. Those investments whose exchange price are not high and are dealt easily enjoy a high liquidity. The liquidity risk increases if the time and price factor are obscure. The stocks out of stock exchange market are more at liquidity risk.

7- ***Currency Risk:*** all of the investors who work internationally are at currency risk exposure in changing their benefit to the currency of their country. With the increase of international trades this kind of risk also had increased among investors and the investors are forced to do international trades for more income and this, in turn, increases the currency risk. It can be said that currency rate is due to the change in the efficiency of bonds (securities) which itself is because of the fluctuation in foreign currency. Currency risk is also known as foreign currency risk.

8- ***Country Risk:*** which is also known as political risk is an important issue that investors are faced with. The investors who do investments in foreign countries must consider the political and economic stability of those countries. This kind of risk is lower in politically and economically stable countries (Setayesh & Karimpour, 2013)

Conclusion

The purpose of this research was to investigate the theoretical fundamentals and the studies that were done on financial risk of companies so far. There have been many different studies relating to financial risk. For instance, Emami (2011) in a study titled “the application of combined fuzzy assessment model of risk assessment” stated that financial risk is the operational risk of an organization in financial activities. There is a possibility that the result of financial activities may be different from the original objectives. The important issue is to know the tolerable risk for each organization so that the risk does not turn out to be a financial crisis for the company. Thus, it is so important for the managers of a company to know and assess the financial risks. Sina (2013) in her MA dissertation titled “assessing and evaluating the market risk with VaR approach before and after the financial crisis in stock exchange of Tehran, Iran” stated that value exposure risk is one of the most important models of risk assessing specially market risk. She also stated that VaR fluctuations, often, are not modeled accurately regarding the fact that VaR models use historical data from the records of the previous financial crises. Setayesh and Karimpour (2013) in a study titled “the investigation of the effects of conditional and unconditional accounting conservatism of accounting on financial insolvency risk of the companies which are accepted in Tehran Stock Exchange” concluded that there is a negative and insignificant relationship between conditional conservatism and financial insolvency risk. Kordestani and Rousta (2013) in a study titled “evaluating conditional conservatism as a risk factor” concluded that applying conditional conservatism leads to increase of the accuracy of the information and decreases the information asymmetry. The increase of information accuracy leads to the decrease of the stock price fluctuations which in turn will lower the risk and the decrease in risk also means the decrease in risk premium. Fakhari and Rasouli (2013) in a study titled “investigating the effects of conservatism and obligation action quality on efficiency of investment” concluded that there is a positive and significant relationship between future investment variable and conservatism criteria and also between investment reaction and conservatism. Today, risk evaluation methods are being increasingly used in different industries such that currently, there are more than 70 different kinds of qualitative and quantitative risk evaluation methods. These methods are mostly used to control and decrease the risk consequences. Most of these methods are reliable to use in managing decision making regarding the control and decrease of risk consequences. Different industries may use different methods for this purpose. These methods have advantages and disadvantages. Thus, one of the responsibilities of health and safety systems in each industry is to investigate all of these methods and choose the appropriate method for that industry. Generally, it can be said that by observing the kind and depth of the method used in the evaluation of in an industry, the ability of the safety system and consequently the safety management quality in that industry can be evaluated. Usually, the acceptable risk level for each organization or individual is different and it depends on the financial and economic resources, technological lack of experienced human resources, the preferences and decisions of the management and the background risks like hidden risks. Organizations, generally, need systems that beside assessing the activities and their processes, are also able to help them with their risk status, specification of the criteria of tolerable risk and with the lack of specification of the accurate risk of their processes and depending on the complexity of the activities of each industry, the kind of system they would need to help them achieve their goals will be different.

Thus, the organizations must use one of these methods. In some special cases like producing exploding and flammable products, before choosing a method, all of the methods must be investigated and one of them can be chosen with regard to financial resources, qualitative and quantitative information requirements, time limit, lack of experienced human resources, kind of risk methodology and advantages and disadvantages of each systems.

Conflict of interest

The authors declare no conflict of interest

References

Dastgir M and Saedi R and Bataqva H and Zivedar Z, 2012. Investigation of the effects of operational cash flow and the size of the company on investment decision in capital assets of the accepted companies in Tehran stock Exchange. Empirical accounting investigations quarterly. 1(3)

Emami M, 2011. Islamic Azad University - Young Research Club; University of Texas at Dallas - Department of Economics & Finance; TarbiatModares University.

Fakhari H and Rasouli, 2013. Investigation of the effects of conservatism and obligation action quality on the efficiency of investment. Accounting Researches Quarterly. 81-100

Hoseini Imeni A and Najafi AA, 2013. Epecification of efficient portfolio in different industries of Tehran Stock Exchange, financial knowledge of securities analysis quarterly.20

Kordestani Q and Asl Rousta M, 2013. Evaluation of conditional conservatism as a risk factor. Financial Accounting and Audit Researches Quarterly. 18: 31-53

Setayesh MH and Karimpour E, 2013. Investigation of the effects of conditional and unconditional conservatism of accounting on financial insolvency risk of the accepted companies in tehran stock exchange. Stock Exchange Quarterly . 24: 5-39.

Sina A, 2013. Evaluation of market risk assessment using VaR approach before and after financial crisis in Tehran stock exchange. MA dissertation, Islamic Azad University, Tehran Center Branch, department of management.