Profitability and Risk – Components of the Financial Management

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Abstract: In the context of market economy, with priority the economic category of profitableness has to be addressed with the category of risk. The investors are expecting a gain that depends on the degree of risk they are assuming. This paper is trying to put in correlation the role of the duality profitableness – risk in the financial management of a company. The purpose of this paper is to provide managers and ownership information about the main categories of risks that can occur in a company.

Keywords: profitableness; risk; market value; leverage operation

JEL Classification: D5; D53; G32

1. Introduction

A definition of the risk notion is based on changes made to profit level compared to the average profit levels achieved in previous years (this can be implemented also to the change in future profitability, revenues to obtain, results to be recorded). From one point of view the risk is illustrated as the possibility that can occur with unintended consequences. It is noted that the risk is regarded as the probability of manifestation of an event (possible to predict or not) with negative implications on economic activity of a company. Whatever the approach of risk concept, it is observed that it translates potential losses corresponding probabilities of their show, known or determined. Instead, uncertainty implies inability to estimate those probabilities.

An important issue is reflected in the need for risk management at any company level, which involves: tracking identifying factors with negative impact on work performed, quantified estimates of the consequences of event risk, substantiation of

a complex of measures to prevent risk, mitigate damage caused when realizing it, in the use of specialized units in risk management, if it is not possible by the entity.

Each manager must determine a minimum and maximum risk on the scale that is willing to accept that the results of the company are interdependent (assuming a higher risk, it but may lead to better results and corresponding losses and vice versa).

Risk is part of any activity, it can be found in the daily agenda of managers of any types of companies. One should be aware any moment of the nature of the risk and how big it is and especially whether this risk is higher or not the gain.

Currently most decisions are taken in conditions of risk and uncertainty generated by incomplete knowledge of one or more variables that are a constant in the economic activity and a reason which explains to a certain extent, the differences between the profitability of business projects. Identifying the risk which may occur in the business carried out by the company constitutes a requirement due to the sensitivity degree of the economic outcome to the operating risks turning the company into a more or less risky investment. Thus, risk assessment appears as a requirement of management to monitor risk factors and initiate preventive measures, limitations or controversy of their effects.

2. The Risk Diagnosis in the Firm Activity

Although in the specialized literature, risk has several acceptations for businesses carried out by economic agents (economic risk, exploitation risk, financial risk, commercial risk, investment risk etc.) the economic significance of risk is considered to be an important one, because it points out the inability of a company to adapt on time and at the lowest costs to environmental changes; in other words the economic risk expresses the volatility of the economic outcome under exploitation.

2.1. The Risk of Exploitation

The risk of exploitation acts due to the sensitivity of result to changes of operating conditions. The probability that the size of the enterprise's activity can not cover the total expenses generated by its support because of their structure, it involves the emergence of risk of exploitation. For any economic agent the risk level of the operation is more important, as the share of the fixed nature of costs is higher.

In order to estimate the risk of operating, the business practice is using a tool of analysis known as the threshold of profitability, for establishing the conditions needed for the microeconomic balance, with or without profits (neutral point).

Threshold yield represents the quantity of products to be made and subject to sale by the enterprise so that the receipts from the sale would cover their variable costs, involving the process of production and fixed costs as well.

On the threshold of profitability level, the business profit is ineffective. As the company's fixed costs are higher, the threshold level of profitability is higher, implying that the company increases the volume of products or goods to be sold in order to become profitable. The formula used to determine the threshold of profitability is:

$$CAPR = Ch\ F/1\text{-}v$$

CAPR represents the turnover which must to be made for the enterprise to obtain zero profit;

Ch F - size of fixed costs involved in the production of the enterprise;

v - share in variables expenses (CV) in turnover (CV / CA).

Where the desired output calculation is needed to be done in order to allow the enterprise to obtain a zero profit (QPR), the formula becomes:

$$QPR = Ch\ F/pu - cvu$$

where:

pu is the average price in unit sales of company products;

cvu variable unit cost related to production and selling of products.

In assessing the operational risk it may compute together the threshold of profitability of the enterprise, also the coefficient of elasticity (Ke), coefficient known as *coefficient of leverage operation*. It measures the relative increase in operating results arising from a change in relative production or turnover. Relationship of calculation is as follows:

$$Ke = (\Delta Re/Re)/(\Delta CA/CA)$$

Ke represents the exploiting leverage coefficient (operation leverage);

ΔRe - surplus of exploiting result;

Re - exploiting result in current period;

ΔCA - surplus of turnover;

CA - turnover of current period.

2.2. The Financial Risk

The financial risk of economic agents is associated with the method of financing of the company business, given the sensitivity of the outcome to changes in funding conditions. Thus, the more fixed payment amounts are used in a higher proportion in the total financial sources, the more important is the financial risk dimension.

The financial risk's evaluation is made similar to the exploiting risk, with the helping of the following indicators:

- the safety margin;
- the safety index;
- the elasticity coefficient.

If it modifies the return of equity, the analysis of this modification due the financial policy could be pursued with the aid of a model entitled "financial leverage effect "

The financial leverage measures the impact of credit's quantization (in order to finance an investment) over its financial profitableness.

The financial leverage effect, namely the variation of equity return depends on the correlations which exist between the return of assets and the debt cost or interest rate, on a side and the debt level on the other side.

If the economical agent analysis is profit taxation exempt, then the exercise result (Rex) could be determined as difference between the exploiting result (Rex) and the interest (Dob) paid for the borrowed capital (Dat):

$$Rex = RE - Dob$$

The exploiting result is obtained from the calculation relation of assets return (re):

$$re = RE/Ae$$

If all these dates are replaced in the calculation relation of financial return, we will obtain the following formula:

$$rf = Rex/Cpr = (RE - Dob)/Cpr = (Ae*re - Dat*rd)/Cpr$$

We may observe that the economic active is entirely financed from the equity and the lent/borrowed capital (Ae = Cpr +Dat). In this case the foregoing relation will become:

$$rf = [(Cpr - Dat)*re - Dat*rd]/Cpr = re+(re - rd)*Dat/Cpr$$

It is considered the following relationship on which, it will be build the following relation:

$Vf + Vex - Imp = 0$

$C f = Dob$

Consisting of:

Vf, V ex – financial incomes, respectively extraordinary incomes;

C f, C ex – financial expenses, respectively exceptional expenses;

I mp – profit tax.

If in the mentioned relationship there are introduced the profit tax rate (t), then the financial profitableness rate becomes:

$$rf = [re + (re - rd)*Dat/Cpr]*(1-t)$$

The indebting rate, as it is known under the title of leverage rate illustrates the influence which indebting detains over the equity rate of enterprise.

An economic agent could be in one of these three situations:

$re > rd$ – thereby the credits using will conduct to assets return ratio improvement;

$re = rd$ – credits using has no influence from leverage effect point of view;

$re < rd$ – credits using will conduct to performances reduction.

The influence factors on the financial profitableness ratio are the assets return ratio and the leverage effect.

2.3. The Risk of Bankruptcy

The risk of bankruptcy appears due to the economic agent's failure to honor its payment obligations on time. Therefore, the risk of bankruptcy is manifested in the situation in which the company is unable to cope with payments to its creditors, suppliers, state, financial and credit institutions etc. The purpose of strategies to prevent the risk of bankruptcy (to restructure companies in difficulty) is to eliminate the causes and dysfunctions that have generated a decline of the economic performance recorded by the company. The causes that can lead to bankruptcy are many, focusing on: reduction of activity; reducing of margins and rates of return; the emergence and amplification of Treasury issues, management issues; the bankruptcy of customers, reduced market outlets, etc.

Analyzing the causes of bankruptcy it can be said that it is not a savage phenomenon, but a result of progressive degradation of the financial situation of the company. In these circumstances the risk of insolvency may be predictable a few years before termination of payments. Between the methods of risk analysis of bankruptcy is calling scoring method and the indicators of profitability, along with indicators of asset structure, indicators of liquidity or an indicator of efficiency. Provided condition for the selection of indicators showing the performance of an enterprise has an interdependence relationship.

2.4. The Investment Risk

The risk in the economic agent's investment business appears as a result of the fact that the achievement of all investments involves immediate expenses, while revenues and profits will come during a future period of time.

2.5. Foreign Currency Risk

Currency risk is manifested as a consequence of the occurrence of a loss of business and financial foreign operations, as a result of variation of exchange rates between the occurrence date of the claim or debt in foreign currency and the time of cash collection or the actual payment thereof. The strategies adopted for managing currency risk are carried out through sale/purchase operations of foreign currency from banks, through operations of reception/granting of loans in foreign currency, contracts sale/purchase operations in foreign currency firm term, through sale/purchase operations of operational contracts of currency.

All these being operations for covering the open position (the open position appears in case of lack of balance of claims with debts; in case of equality the closed position is recorded), but also through operations of provision set-up for currency risk.

The importance of currency risk coverage arises from the fact that it is also present in investment businesses.

3. Conclusions

Any strategy involves a process of substantiation, elaboration and implementation. The strategy is based on both risk assessment process resulted in the identification and risk analysis also the risk management which implies the probability of event involving risk factors and developing a package of appropriate safety measures.

Since the strategy allows the identification of ways and means by which the company can progress towards the key objectives, the adopted management must take into account the possibilities offered by environment and market, such as the level of risk, restrictions and competition of the various possible options. In all these cases, management operates through decisions that can be grouped into operational, administrative and strategic decisions.

The objectives pursued through each category of decisions are: the operational decisions seek to obtain current operation with a maximum profit; the administrative decisions regard the management structure of the company and the purchase of necessary resources; development and orientation represent the objectives pursued.

Currently, due to the complexity of businesses carried out by economic agents and the risks which can influence them, economic agents solve differently the strategic formulation task. Although the strategies that can be adopted are multiple and in constant growth, the choice of a particular strategy is part of the strategic option of a company, that is to preserve its competitive advantage and to ensure its viability in internal and international competitiveness.

Regardless the financial restructuring the adopted strategy, the risk cannot be eliminated entirely, there is always left a certain irreducible level of uncertainty. Thus, the main objective is to ensure the premise of recovery characterized by obtaining sustainable economic performance.

In order to allow enterprises to impose obligations, it is necessary to establish a diagnosis of financial situations where there are illustrated the strongest points and the fable points of financial administration.

The objective is to detect eventually financial lack and to adopt new administration decision for the enterprise.

The importance of identification and quantification of risk at the economic agent's level stems from the fact that the company stability is important for managers, employees, customers, suppliers and creditors, as for the community in which it operates.

In order to improve the financial performances, the enterprise must accelerate the assets turnover, to increase the commercial profitableness and to substantiate the financial policy which could afford to make available the favorable conjunctures.

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