RESEARCH PAPERS OF WROCŁAW UNIVERSITY OF ECONOMICS No. 145
Quantitative Methods in Accounting and Finance 2010

Piotr Oleksyk
Wrocław University of Economics, Wrocław, Poland

FINANCIAL SECURITY RISK

Abstract: The efficient functioning of every economic entity depends heavily on the flow of information, both external and internal. The internal information system is the basis for strategic decisions such as investment, as well as current operational ones, often aimed at remedial measures. Accounting in the supervision of the business entity plays a key role, in fact provides a vast amount of very important information. The information derived from the accounting system is used by owners to monitor the implementation of plans for business development. Company's financial stability should be defined as the ability to maintain liquidity and ability to cover losses and inherent risks associated with the activities of the reserves and equity. The concept of coverage is contingent upon the solvency behaviour of two basic conditions: the external and internal determinants of institutional financial situation.

Keywords: risk management, financial reporting, financial accounting.

The efficient functioning of every economic entity depends heavily on the flow of information, both external and internal. The internal information system is the basis for strategic decisions such as investment, as well as current operational ones, often aimed at remedial measures. The most important part of that system is the financial information in a broad sense understood as a reflection of individual assets and sources of financing, changes in these components, and recent performance. All financial information is generated and received on the basis of records which are supposed to represent any value changes in the enterprise.

Risk is inherent in related activities carried out by each entity. The concept of risk can be used in various meanings, the most rational concept of risk is the risk of not achieving the desired objectives. The business risk is understood rather as an event or series of events adversely affecting the situation of the company, although it cannot be ruled out when the risk becomes an additional "chance" which can, and does not necessarily have to be, used, for example can be beneficial to the formation exchange rates or interest rates [3, p. 23].

The concept of risk should be distinguished from the concept of uncertainty. Risk is an objective phenomenon, correlated with the subjective uncertainty of adverse events. Reflections on the nature of risk can be reduced to two basic trends:

– the first – connected with the theory of decision-making,
– the second – related to the theory of risk management.

According to the first current, risk is measurable uncertainty, and uncertainty is immeasurable uncertainty. Risk occurs when it can be determined using a mathematical probability, statistics, and estimate. In other cases, it is not possible to quantify the results of processes or decisions, dealing with uncertainty [1, p. 32].

A slightly different interpretation is that risk is a combination of gambling and is measured by the probability, uncertainty is measured by the level of faith. The risk is state of the world, the uncertainty – a state of mind. Current theories relating to risk management concentrate on the effects of risk. As part of this trend can distinguish two ways of interpretation of risk:

– referred to as the possibility of inconsistent outcomes (better or worse) with the expected decision-taking,
– defined as the possibility of injury or loss.

Both streams are not independent of one another, which is caused by the fact that it shares a common element of uncertainty, which is treated as a threat or a possible danger in the future. Combining these two streams of theoretical considerations, the risk can be defined as:

– the danger of erroneous solutions (decisions),
– risk of action's failure,
– the danger of negative deviation from the target.

Uncertainty is a broader concept of risk. Risk may be regarded as its derivative, and is measurable. Uncertainty is informative, a barrier to information access or unreliability of information obtained is its cause. By contrast, the risk has financial dimension. It can be measured because there is information which can assess the losses and gains associated with the planned future decision.

Therefore determinant of the risk is the possibility of loss or profit which differ from the expected or assumed size. Risk applies also to situations where the information is insufficient, but it allows to estimate the probability of some situations associated with the decision. Uncertainty occurs in the absence of any information to help estimate the probability. Uncertainty is a condition in which the possible alternatives and the chances of their occurrence are unknown.

The size of the risk in economic activity is affected by many factors closely interwoven, many of which are external, independent of the actions of a company. These factors include general economic factors: the economic policy of the state, the MPC, the inflation rate, budget deficit; social factors: the behaviour of bank customers, the tendency to save or consume; political factors: the terrorist attacks, wars; demographic factors: the structure of the population, unemployment rate; technical factors: advance in information technology and telecommunications. Moreover, the risk can be affected by factors of the international nature, such as the liberalization of the functioning of financial markets, and economies, economic integration, technological advance, globalization of the markets.

In the literature on the subject at least dozens of various classifications of risks can be found. A uniform classification of the risk has not been developed yet. It is caused by the complexity of the role of modern economies. Risks can be divided into strategic risks and operational risks because of the time division [4, p. 67].

Strategic risk affects the long-term competitive ability. Strategic risk is related to the structure of the shareholders as well as the appropriate selection of board members. They are a decisive factor in the areas of action, organizational structure, planning and control system, electronic data processing, as well as participation in other companies.

Operational risk covers two areas of the entity: a financial sector and technical and organizational area. In the financial area the risk has a substantial impact on the business, we speak mainly about the liquidity risk and risks as a result. Liquidity risk can be defined as a temporary or complete loss of liquidity risk by the bank, or loss of ability to repay obligations incurred. The bank's liquidity is a comparison of its volume of assets to the value of liabilities. These figures should correspond with each other by using the criterion of their maintenance period. The main cause of the lack of liquidity is the non-payment of credit instalments on time which causes disruption in the process of "transformation in time limits". Liquidity depends primarily on the amount of equity capital and the reserves held. Risk of result is a threat of not achieving the assumed result. The influence on this type of risk have credit risk, interest rate risk and currency risk, all to a great extent. The second area of operational risk is technological and organizational risk. It includes: experience and qualifications of the staff, the managing staff mainly, the organizational structure, the rules of functioning the organizational structure individual elements (such as sales, planning, internal control, etc.) and principles of cooperation between departments, the level and technological commitment owned by the operator's technical equipment.

Legal risk is one of the distinguished subcategories of operational risk, which has no legal definition neither in the system of Community Law, nor in Polish Law. Legal risk can be defined as the probability of incurring losses of tangible and intangible assets caused by: incorrect or late development adoption of regulations, regulatory instability, changes in case law, erroneous formation of legal relationships, or bad decisions of the courts or authorities disposing of public disputes arising from the legal relations between organizations. The definition of legal risk indicates that the events which generate this type of risk can be internal and external. It means that some events can have an impact within their organization, since they take place inside and reducing the influence of these events depends on proper operation of the legal services, internal audit, compliance or cells. We cannot influence other external events which take place outside the structures of an organization (e.g. changes in legislation, case law courts created the line, supervisory policies, etc.), however, we should be prepared adequately for them.

Legal risks can be divided into the following groups because of the extent of the risk caused by unforeseen situations which extort certain additional steps taken by the operator:

– Risk contracts is associated with the dangers arising from defectively designed contracts with both the primary (supply, service, etc.) and related agreements with the remaining operating activities (warranties, guarantees, outsourcing, etc.).
– The risk of litigation is associated with events that result in both potential opportunity to initiate proceedings in all the existing modes of procedure (civil, criminal, and administrative and tax), in which the operator will be the party as well as the probability of issuing decisions unfavourable to the bank. The following situations, which may generate the occurrence of the risk of litigation, can be given as an example: an imperfect performance of the duties, lack of preparation, analysis of reliability and relevance of the evidence before the initiation of a particular case; lack of probability analysis giving adverse decision before proceedings (appeal, decision, order); improper selection of agents representing the company in a particular type of proceeding.
– The risk of incorrect interpretation results from the incorrect analysis of universally binding law. Misinterpretation can be made by the internal legal departments, as well as may arise in the purchase of legal services.
– Legislative risk has an external character where managing staff does not influence it. This risk is caused by changes in business law, prepared and adopted by both the Polish and the Community legislator. Changes in the law for all types of businesses (even changes in tax law) may cause deterioration of operating conditions affecting a significant impact on profitability of their operations. The most important tool for limiting risks in this respect is the constant monitoring of the legislative work, both at national and Community level.
– The risk of compliance can include mechanisms to support the internal control systems. The analysis consists of verifying the compliance of the provisions of domestic law, adopted and used in the company, with universally binding law regulations and standards created by external bodies. “Compliance” is a kind of internal implementation of the law in the internal regulations established within the framework of the organization (e.g., rules of procedure).
– The risk of reputation is connected with the possible loss of customer segments through strategic market information related to the improper implementation of legal acts in relation to these customers (e.g. market rumours related to the improper handling of complaints by a company).
– The tax risk is related to the improper treatment of the tax’s law because of a faulty registration, choice of tax, mode of settlement, etc., that can be disputed with tax authorities.

The most important is reducing risk and tax risk contracts from the perspective of operators in the sector of small and medium-sized companies. These are important types of risks that accompany the business every day. Other types of legal risk are possible to be reduced in a natural way, even by using the training aid of various institutions to promote business development.

The analysis of financial statements is a crucial issue for making managerial decisions. It should be done with the use of a dynamic analysis by checking changes in individual components of the subsequent reporting periods [2, p. 26]. Studying the dynamics of changes in individual components can help identify the trend of changes in the environment and is the basis for decisions restricting certain activities with groups such as customers, who may not fulfil their obligations in the future. Another example would be a decision to reduce sales of certain groups of product which may become unprofitable in the future and may expose the company to losses. Analysis of reports investigates the relationship between the individual components of assets and sources of financing it and the results of the company in a defined period of time. This analysis can often identify individual components of risk, and therefore may provide information related to the reduction of that risk.

One of the accounting policies is to draw up financial statements based on the presumption of continuing activity without changing in the size of the company. It is essential to correctly assess the individuals' ability to continue their activities. A controller should take into the consideration the following conditions:

- the entity has substantial financial difficulties, including lack of liquidity, terminating credit agreements,
- the entity has had the losses of previous years and the current year,
- the head management staff has abandoned the entity,
- the entity lost the primary market, the license, the main supplier,
- there are the judicial or administrative proceedings; if the entity gets the disadvantageous rulings, it will not to be able to complete them.

Accounting in the supervision of the business entity plays a key role, it provides a significant amount of very important information. The information derived from the accounting system is used by owners to monitor the implementation of plans for business development. The financial reporting has paramount importance for public, prepared in a fair and credible way presenting company's assets. However, financial reporting is not the only part of the accounting system that plays an important role for the control of financial security. A very important issue in this case is the principle of valuing assets and liabilities. On the one hand, the assessment causes changes to the values of individual components. On the other hand, it is referred to the financial results or changes of the size of the reserve. Both the financial result, which is partly transferred to capital reserve, and revaluation of reserve positions are crucial to risk assessment of financial security. Another important aspect of valuation is appropriate presentation of the reliable value of all components which are taken into account in calculating the metrics of an indicator. Accounting is a very special link in the security system operator.

The most important regulations result from the Accounting Act directly, and are closely related to the safe requirements. They are dedicated to all entities that are related to the regulation of individual valuation of assets and sources of funding. The principle of the safe assessment is a crucial accounting principle. This rule provides for the arrest of its application to the various components of the method for determining their value as the amount that can be derived from the sale of the asset. In the case of obligations the principle of safety requires the set value by the amount needed in the future to pay for the component.

Company's financial stability should be defined as the ability to maintain liquidity and ability to cover losses and inherent risks associated with the activities of the reserves and equity. The concept of coverage is contingent upon the solvency behaviour of two basic conditions: the external and internal determinants of institutional financial situation. Therefore, the list of threats should be extended and systematized. The basic indication of bad financial situation of the operator can include the following symptoms:

– significant changes in strategic policy (manifested in the increasing risk taking),
– drop in profit,
– the losses,
– decrease in the value of equity,
– a significant increase in liabilities,
– deterioration in portfolio quality connected with increase in overdue receivables growth in total claims,
– offering ever lower prices of products or services in order to get new customers at all costs,
– withdrawal of cooperation with the familiar and the flagship companies operating in the market for years and enjoying well-established reputation,
– resigning from office by the board of celebrities enjoying authority.

Not all of these symptoms can be seen from the reporting entity. It should be noted that the occurrence of single symptoms does not give the evidence of threat. Even the greatest players suffer sometimes losses and it is not at all the premise that in the near future it could lead to bankruptcy of the company. Also the sudden increase in liabilities is not the evidence of the approaching bankruptcy, for example, the increase in liabilities may be associated with a new strategy to achieve its market share. For sure, the deterioration in the quality of the portfolio of debts is always a negative condition. In this case the management should react very quickly to such condition by observing the deteriorating situation, and then interfere in the sales procedures and rules for credit risk management by the company. The ultimate result of these supervisory activities is to force certain actions to improve the financial situation, for example, by finding a new investor.

Business failure is not a phenomenon which can be easily observed. Usually the primary symptom of its approach is deterioration in portfolio quality receivables. It is said that the amount dues are not all of the entity's capital. Lack of flows associated with the implementation of revenue from the sale means that the principal activity becomes ineffective. At the same time the creation of depreciation charges brings loss. Reducing the financial result of the company in connection with the deterioration of the quality of receivables is manifested in two phases which in principle occur at the same time. The first is the creation of debt write-offs "at risk". The second phase of the reduction or loss due to the decline in the quality of receivables is a result of the elimination of the financial penalty and interest on outstanding receivables classified as threatened. It should be recognized that accounting is crucial for providing reliable and credible information on individual assets, liabilities and off-balance sheet items. An important role is played by the rules of valuation of assets and liabilities, these estimations have an impact on the amount of financial results, capital revaluation, the items which are the primary source of information related to the level of financial security entities.

References

[1] Jajuga K., Kuziak K., Markowski P., *Inwestycje finansowe*, Wydawnictwo Akademii Ekonomicznej, Wrocław 1998.
[2] Olchowicz I., Taczała A., *Sprawozdawczość finansowa*, Difin, Warszawa 2002.
[3] Ostrowska E., *Ryzyko inwestycyjne*, Wydawnictwo Uniwersytetu Gdańskiego, Gdańsk 1999,
[4] Przybylska-Kapuścińska W., *Zarządzanie ryzykiem i płynnością banku komercyjnego*, Wydawnictwo Akademii Ekonomicznej w Poznaniu, Poznań 2001.

ZAGROŻENIA BEZPIECZEŃSTWA FINANSOWEGO PODMIOTU GOSPODARCZEGO

Streszczenie: Sprawne funkcjonowanie każdej jednostki gospodarczej uzależnione jest w dużym stopniu od przepływu informacji zarówno zewnętrznych, jak i wewnętrznych. Wewnętrzny system informacyjny jest podstawą podejmowania decyzji strategicznych, np. inwestycyjnych, a także bieżących operacyjnych, często mających na celu zastosowanie środków zaradczych. Najważniejszą częścią tegoż systemu jest informacja finansowa w szerokim znaczeniu rozumiana jako odzwierciedlenie stanu majątku jednostki i źródeł jego finansowania, zmian tychże składników oraz bieżących wyników działalności. Wszelkie informacje finansowe są generowane i otrzymywane na podstawie zapisów księgowych, które w swoich założeniach przedstawiają wszelkie wartościowe zmiany zachodzące w jednostce gospodarczej.