

RISK MANAGEMENT – AT THE CONVERGENCE BETWEEN PRUDENCE AND CONTINUITY, A BASIS FOR AN EFFICIENT GOVERNANCE

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Abstract:

The accountancy principles are sine qua non for a faithful image, nevertheless when it is about evaluation, accountancy is considered a source of uncertainty.

The principle of being prudent is the pillar of accountancy having a view to protect the invested capital, although under the conditions of organizations development and of the desire to better results, which inevitably implies risk, this would infringe initiatives and change. Even more, prudence offers a continuity in organization activity, becoming accountancy fundamentals in the principles of corporation governance, the organization management respectively, by accepting the benefits of risk management, of financial management and internal control under the monitor of internal audit.

The activity continuity is not only an accountancy principle but also an absolutely necessary element to guarantee the financial information. The principle of continuity also confers the accountancy science a provisional role because it extends its action from a simple elaboration of financial statements to the assurance of financial information to prevent difficulties, the finding and removal of risk and offering the necessary factors for an efficient provisional management.

A good governance within a company reduces risks, increases performance, opens the way to financial markets, improves the marketing capacity for goods and services, the management style, shows transparency and social responsibility.

Keywords: *the prudence principle, activity continuity, risk management, corporation governance*

JEL Clasification: M41, M42

1. Introduction

Both the estimation and assessment of the financial health of an entity within the boundaries of a financial - accounting diagnosis require a risk assessment which accompanies the entity, some of which indicate the fragility and vulnerability of the enterprise, and others looming the bankruptcy or insolvency that threatens its survival.

The risks which affect the company are one of the key factors affecting the performance of the company. The assessment of the business risk is of utmost importance in managing business entities. The business risks may be controlled through the implementation of a business strategy, an operational and financial plan oriented towards the achievement of the business objectives.

The presence of a risk within the environmental components surrounding the enterprise/company requires that all the internal decisions shall be based by taking into account that particular risk.

2. The Risk Dimension at the Economic Entities Level

In the competitive economy, both the existence and viability of any business are closely related to risk as far as the present and future results lie under the influence of unforeseen events. The problem of risk, certainty and uncertainty has concerned of specialists in all the fields. As a rule, they assess both the risk and uncertainty as opposed to certainty. Thus, the concept of “risk” is closely linked to the concept of “uncertainty”, which expresses a state of uncertainty about the future.

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The relationship between uncertainty and risk should be reflected in the decision-making process by managing and controlling the factors that may generate different risk categories, with direct or indirect impact on the way of achieving the objectives of the entity.

The economic activity always involves a degree of risk.

“The risk – inherent to any activity – may be equated to the outcome variability under the environmental pressure.” [15]

The profitableness of any activity is assessed only in relation to the risk that it involves. The economic agents also assume the risk in performing an activity only in terms of the lucrateness which they expect to obtain from that activity. The concept of “risk” is linked to the concepts of “profitableness/lucrateness/return”.

An entity’s activity outcomes depend on random factors that occur at all times of the provisioning process - production - sales.

In the economic theory, the concept of “risk” is often related to that of work flexicurity”. “Flexicurity is defined by the company’s ability to adapt and effectively respond to the environmental changes”.[15]

The risk becomes an obstacle in the development and expansion of any activity, whereas it makes the decision-making process difficult. Any efficient activity may run effectively on condition that those who achieve it are protected by the negative effects of the risk.

“The variability of the outcome is as controlled by the economic agent as it exhibits a greater flexicurity. The risk represents the inability of the company to adapt in time and at the lowest cost, to the variations of the environmental, economic and social conditions.” [4]

Some authors consider that, for any economic activity, the risk is an exogenous variable, opposed to profitability and also that “the risk translates into the profit variability towards the return average of the last years” [13] or “into the outcome variability, affecting the economic return, and, consequently, the invested capital.”[12]

As some may foresee, the risk expresses the profit’s estimated variability compared to the hope of return. The risk measure is given by the variance and the profit’s square standard deviation in terms of the volume of.[22]

The risk arises from the inability of an entity to adjust in time and at the lowest cost to the changes in the economic and social environmental conditions and may be viewed from two points of view:[18]

- that of the enterprise as socio-economic organisation which aims to increase the owners’ property in view of proper remunerating of inputs;
- that of external capital contributions, interested in achieving the best investment in terms of particular financial markets with different advantages and risks.

The enterprise’s risk analysis consists in both identifying the present risks and assessing their economic and financial, direct and indirect outcomes. Following the enterprise’s risk estimation, the managerial corpus will have to find effective solutions to reduce it and, if possible, to reduce or eliminate it.”[5]

Some authors consider that the main risk forms an enterprise may face can be grouped into the following categories [2]:

1. Economic risks - arising from developments in the enterprise’s contextual background and the quality level of the economic activities displayed within it. The most common risks that fall under this category are: the rising inflation risk, the risk of increasing the interest’s rate on loans; the risk of modifying the exchange rate, the investment risk.

2. Financial risks - the risks occurred due to the obtaining and using own and borrowed capital: the risk of lacking liquidities; excessive leverage risk, the risk of failure to return as a result of bankruptcy and large expenses.

3. **Commercial risks** - associated to supplying and selling operations on domestic and foreign market: the price risk, the transport risk, the sale risk.

4. **Manufacturing risks** - arising from technological and organizational failures within the context of production activity: the risk of not-obeying the prescribed quality level; the risk of failure to achieve in quantitative terms, the production envisaged, the risk of exceeding the specific consumption norms; the risk of occurring of scraps and implicitly of denying to comply with orders because of quality inobservance, the risk posed by the possibility of labour accidents.

5. **Political risks** - arising from changes in strategy, tactics and current actions of policy makers in their own country or in countries which the enterprise has direct and indirect contact with: the risk of restriction of imports and / or exports, the currency transfer restriction risk; the risk of denying the enterprise's products on the territory of particular states.

6. **Social risks** - arising from the relations built with the enterprise's staff and its behavior: The risk of staff de-motivation; the risk of increasing the expenses with the personnel above the maximum required limit; the risk of losing managerial positions by managers; the risk of shaping an counter-economic organizational culture.

7. **Legal Risks** - arising from the incidence of the domestic law and, more rarely, of the international law on the activities of the enterprise: the risk of losing or destroying goods and products, the risk of not collecting the due amounts for the economic transactions which have been carried out, risk of property loss, the risk of paying duties and additional or increased taxes, the economic or criminal penalty risk, the risk of business-blocking.

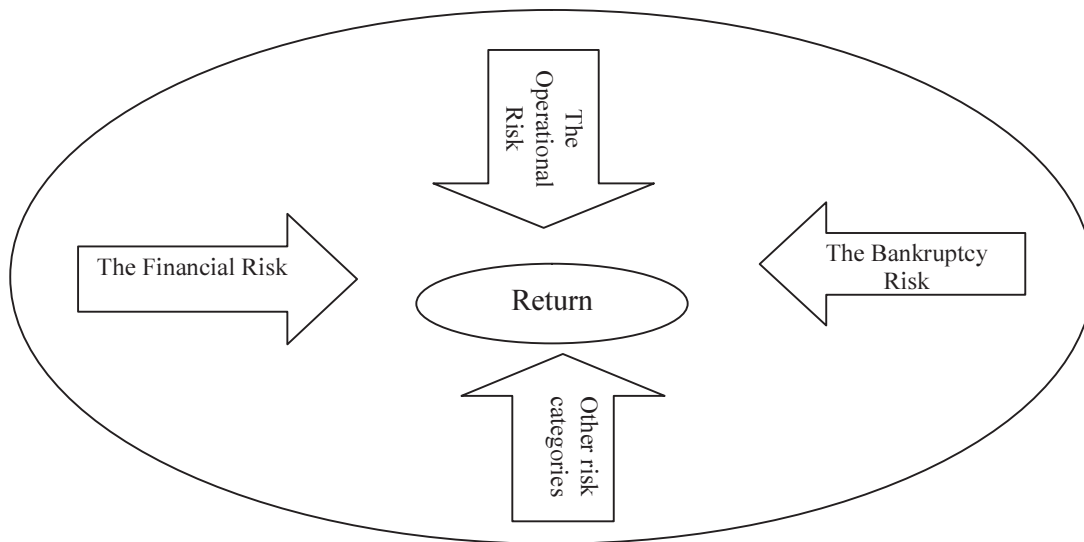
8. **Natural risks** - caused by natural disasters or other induces causes in which natural factors have a decisive share: the fire risk, the earthquake risk, the flood risk, the storms risk, the volcanic eruptions risk.

Phil Griffiths, an English theoretician, considers that the most common risk categories are the following [20]:

- **Strategic risks** – comprise: political risks, economic risks, social risks, risks concerning customers.
- **Operational risks** – in which there are: competitive risks, physical / material risks, contractual risks.
- **Financial risks**
- **The risks concerning reputation or brand**
- **Informational risks related to IT** – encompass: technological risks; the physical risks related to IT .
- **Risks concerning the personnel**– comprise: professional risks; leaders and managers.

Next we shall focus on the analysis of the most significant risks that arise at the micro-economic level, i.e. the economic or operational risk, the financial risk, the risk of bankruptcy.

Figure no. 1. The main risk categories having influence on the enterprise's rentability



The Economic or Operational Risk

In the French thematic literature, "the economic risk is most commonly defined as being the enterprise's inability to adapt in time and with the lowest cost at the environmental variations".[4] This definition has been cited in the Romanian literature by many specialists such as: M. Coșea and L. Nastovici in "Risk Assessment – Methods and Analysis Techniques at Micro and Macro-Economic Level", p. 30, as well as by M. Niculescu in the paper entitled "Global – Strategic Diagnosis", p. 397. The economic risk also represents the profit variability towards the average gross profitability in recent years. In addition, it is said that the operational risk expresses the economic outcome's volatility expressed in terms of operational conditions.[21]

In his paper entitled "Financial Administration", Ion Stancu analysed the economic risk from two perspectives:[22]

- that of the enterprise as socio-economic organisation spirited by the intention of increasing the shareholders' property and the staff's wages;
- that of financial investors who are interested in achieving the best investment in a financial market with more profitable sectors and risk levels.

M. Coșea and L. Nastovici in the paper entitled "Risk Assessment – Methods and Analysis Techniques at Micro and Macro-Economic Level" define the economic risk as being "the potential harm which the patrimony, interests and entrepreneurial activity are exposed being caused imposed circumstances, such as natural disasters, acts of reckless management, damage, or circumstances resulting from the competitive nature of the market." [3] The authors also consider that the economic risks are: the foreign currency risk, the risk of increasing manufacturing costs of the products being exported and the risk of interest rate fluctuation.

Some specialists consider that the outcome of an enterprise is sensitive to a number of events such as: improving competition in the market, the rising of wages, the advancement in science and technology.

"The variability level of the outcome determines each firm to be more or less risky investment. The risk does not only depends on general factors (sales price, cost, turnover), but also on the cost structure, their behavior towards the volume of activity. In this context, in the terms of the economic theory, the cost - volume – outcome analysis has been

imposed, being also called a breakeven point analysis as a way of effective operational and risk analysis.” [15]

“The sensitiveness of the outcome is determined by calculating a correlation coefficient between the variation of a factor and the variation of the operating result. The more these correlation coefficients are higher, the more likely the company is liable to risk. The risk does not only depend on cost determinants but also on the cost structure, which may be based on the volume of production and sales.”[12]

The breakeven point is also called “critical turnover” or “operational dead point”. This indicator considers the flexibility of a company in relation to its business fluctuations, thus measuring the risk that is associated to the respective activity. The breakeven point also highlights the point where the operating costs are equal to the turnover, therefore, the result is zero, and after its cost overrun, its work becomes profitable.

The operational risk assessment may be done by using a “position indicator” towards the breakeven point. This indicator, in absolute form, shows the enterprise’s capacity to change its production and adapt to the market requirements. It is also known as the “flexibility/flexicurity.” [17]

The more the position indicator in absolute value is higher, “the higher the enterprise’s flexicurity, respectively the more reduced the operational risk”.[15] The flexibility of an enterprise depends on its technical equipment, human potential and its organizational structure.

In relative size, the position indicator is called the coefficient of volatility and shows the enterprise’s ability to adapt its production to the market requirements.

The economic or operational risk is particularly important not only for the economic assessment of an enterprise, but also for the adoption of the most appropriate funding measures in the view of the economic growth of the respective enterprise.

The Financial Risk

Many specialists consider that “the financial risk characterizes the variability of the outcome indicators under the financial structure of the enterprise” [3].

The equity and borrowed capital make up the capital of an enterprise. These are fundamentally different in the cost that it entails. An undertaking which resorts to loans must be aware of the associated financial costs. "The leverage of the firm, by its size and cost, involves a variability of the results, thus changing the financial risk”. [3]

The financial risk arises when an enterprise resorts to loans to finance its operations. The financial risk depends on the financial structure of the enterprise, and its indebtedness.[16]

For the developing of any activity, an enterprise needs financial resources that may be owned or borrowed. The equity capital that belongs to shareholders is paid by means of dividends and the borrowed capital is remunerated by the paid interest. The financial leverage occurs only if the financial return obtained from resorting to loans is higher to the economic return.

The financial risk is considered to be an additional risk borne by shareholders, following the enterprise’s decision to resort to loans. Theoretically, the firm has a certain degree of risk inherent to its activities, which represents the business risk, and when it resorts to loans, an additional risk to shareholders, also entitled the financial risk, may occur. [21]

The financial risk may be assessed by measuring the variability of the return rates from the past towards the average rate of return. The financial risk is thus measured by means of the dispersion or average square deviation of the rates of return previously observed.

“The leverage risk is also known as financial leverage and is expressed within the indebtedness of the enterprise on return on equity capital.” [5]

The financial leverage effect or the financial efficiency increase, also called the return on equity rate variation depends on the economic rate of return and the cost of committed credit or the interest rate.

For an enterprise that resorts to credits in order to increase its return on equity capital, the return on assets should be higher than the interest rate paid to the engaged credit. Otherwise, if the paid interest rate is higher than the return on assets' rate, the result is decreased, which results in the decreasing of the return on equity capital, i.e. of the financial return, which becomes lower to the return on assets. In this situation it is said that the borrowing has the effect of "bludgeon" since it determines the decrease of the financial return. [21] Thus, the financial leverage effect is underlying the financing decision of any enterprise's activity.

If the return on assets is higher than the interest rate, the situation is favorable for shareholders and the financial return is an increasing function of the leverage of the firm. Conversely, when the credit cost is higher than the economic return, the financial return is a decreasing function of the enterprise's leverage. The leverage deteriorates the economic performances of the enterprise, therefore, it is necessary to minimize the ratio between debt and equity capital. When the return on assets' rate is equal to the interest rate, the enterprise is characterized by the financial structure's stability. If the financial leverage is high, this allows shareholders to obtain a high economic return, but at the same time exposed to a higher risk of major losses if the return on assets is low. Calling on credits may lead to the limitation of the management's independence of the respective enterprise. Lenders are interested in the indebtedness of the enterprise aiming that the ratio between the debt and equity capital shall be as low as possible.

Lenders are interested in the financial history of the enterprise in question, and its liquidity and less in its circulating funds. Therefore, both the current assets and short-term commitments have a greater importance than information concerning the values of fixed-term commitments.

Also, lenders are interested in results, because the actual ability to create profit influence s current operations and future profits.

For a company to register a win situation for shareholders, with a greater economic return than the interest rate and a rate of financial return greater than the economic one, measures are required from the management equip to enter new markets, create new and more competitive products.

The Bankruptcy Risk

"The bankruptcy risk is related to the difficult situation of the enterprise which is considered to be a permanent situation of financial crisis. From the legal point of view, a firm is considered to be in difficulty when it is in a state of suspension of payments, not being able to cope with outstanding debts, the law providing in this case, the reorganization or liquidation of the enterprise." [5]

The bankruptcy risk is of great interest to both investors and company managers. The bankruptcy risk is the probability that an enterprise to record losses, and not to be able to honor its obligations due to its creditors, that is, to be insolvent.

The diagnosis of the bankruptcy risk consists in assessing the enterprise's ability to meet assumed commitments to third parties, so the enterprise's solvency assessment.[22]

S. Daigne mentions in his paper entitled "Entreprise en difficultes" that any financing of a company in difficulty, through grants or loans, has the same effect as a drug. [21]

The bankruptcy risk assessment may be performed both by statistical methods of analysis of the state, by using the financial balance sheet analysis and statistical methods of analysis of the dynamics, by means of the funding streams highlighted by the financing panel.

The analysis of the bankruptcy risk is based on patrimonial or functional balance. When using the patrimonial balance, the net assets of shareholders and overall economic

activity is envisaged, these actually representing the warranty offered to creditors. The state analysis which is based on the functional balance has in view the assembly of all resources and their allocation on different financial cycles, namely running, financing, investment in order to better understand how the enterprise operates.

Regarding the analysis of the bankruptcy risk's dynamics, it allows diagnosing and explaining the financial imbalance established by the state analysis. Thus, the two types of analysis are complementary, both achieving their goals at the same time. The dynamics' analysis starts by determining the dynamics of the financing flows, arising from capital transactions highlighted in financing picture. The dynamics' analysis of the bankruptcy risk operates with a number of concepts such as: the operating cash surplus, the capacity of self-financing and the cash flow. These being the basics, there are calculated a series of installments such as the repayment capacity rate, the rate of financial autonomy and the operating cash surplus.

3. The continuity ensured by the prudence and risk management results

In business, the going concern assumption is not just the accounting principle, but an absolutely necessary element in ensuring financial information. For users of financial information it should be clear why it is considered that an economic entity will continue to operate, which are the assumptions that have led to this conclusion and the risks that actual events differ from the estimates. For a rigorous assessment of this principle by the economic entities it is necessary to study and analyze some relevant indicators to the identification and review of the risks arising from the entity, namely: the dynamics of liquidity, solvency, balance indicators and financial performance. Thus, the continuity of the activity of the economic entity is ensured if the risks are properly prevented and managed.

Prudence - lies in carefully assessing the assets and liabilities, expenses and income to avoid overstatement of earnings. According to this principle is admitted overstatement of assets and income, respectively undervaluation elements debts and expenses, taking into account depreciation, risks and possible losses arising from current year or previous activity.

It remains to discuss the idea of anticipating risk is less clear than the realization of gains. Risk is pervasive in economic activity: to what extent should be cautious? Findings of "reasonable" enjoy a real bias, influenced by factors of the most diverse. Applying the precautionary principle aims to events that occurred during the year and closing financial year and subsequent events that may impact on annual financial situations. It is a rule of thumb, but not indestructible, if we think that this rule of individualization of risk can be "inverted" to the provisioning of statistical risks, where it is an event rather than a probability, not limit risk anticipation clearly specified. Romanian accounting privileged not attach importance of prudence. Instead, all the traditions, customs and above all professional rules make it occupy a privileged place, appearing as an interesting and at the same time, the dominant compared to the other, without abusing it by "reserving latent or occult".

According to the *International Standard on Auditing 315* "Identifying and assessing the risks of material misstatement through understanding the entity and its environment" [24], the business risk is defined as "a risk resulting from significant conditions, events, circumstances, actions or inactions that could adversely affect an entity's ability to achieve its objectives and execute its strategies, or from the setting of inappropriate objectives and strategies".

In carrying out its activity, the economic entity is subject to multiple risks. Given the complexity of risks, the specialists have affected a distinct field of their study, respectively *risk management* done in a sequence of steps [13], such as risk identification, risk analysis and assessment, determination of priority interventions to limit risk and risk treatment.

In the specialized literature and in economic tradition there are different classifications of risks, the analysis being conventionally structured on three types of risk: economic or operational risk, financial risk and bankruptcy risk.

It is known that the profitability of the activity of the economic entity should not be dissociated from the risks to which it is subject to, namely economic or operational risk and financial risk. *Financial risk* deepens *economic risk* (in addition to the reimbursement of loans the interest expenditure needs to be paid), and finally generates a default of the company that may lead to the *risk of bankruptcy*.

Analyzing the economic or operational risk, the main indicator measuring the risk is *the profitability threshold*.

The profitability or breakeven threshold of an economic entity is the point where revenues equal expenditures. It is also called “critical point” or “critical turnover”. So at this point the profit is zero. This threshold is considered to be the threshold of “cost efficiency” and is used in the analysis of economic and financial risk. The indicator can be calculated at the product level and at the total turnover level. [11]

The information supporting the analysis of the economic or operation risk represents the balance sheet as well as a series of data provided by the management accounting. The results fundament the strategies regarding: supply, management of the technical capital, production and commercialization.

4. In conclusion - corporate governance risk management solution

Corporate governance has emerged as a response to a series of spectacular failures in the private sector in a relatively short time, that rocked through their scale, investor confidence in how they were conducted both large corporations.

Corporate governance provides a higher degree of assurance that the entity is implemented an effective control system, thereby ensuring that business is conducted in the interest of investors (Shareholders) and stakeholders (stakeholders). So if corporate governance is a prerequisite for transparency of the activities of the company, in order to protect the interests of the social partners, to achieve security objectives is the audit. While the shareholder model aims to maximize shareholder value, stakeholder model objective is achieved, rather defensively overall interest of the parties involved, in one way or another, in the life of the company (employees, business partners, shareholders, managers) .

The purpose of corporate governance is provided by the following:

- facilitating the globalization of business by increasing investor confidence in the methods and principles of organization and management of companies. This requires, first, a better balance between the various leaders decision-making powers, so that no person can abuse the position he holds;
- avoid future economic crises and financial scandals that have affected large corporations in recent decades in America, Europe or Asia;
- large companies tend to provide more and more information to the general public (media) in order to increase confidence in the brand of these companies, in order to attract new investors or business partners.

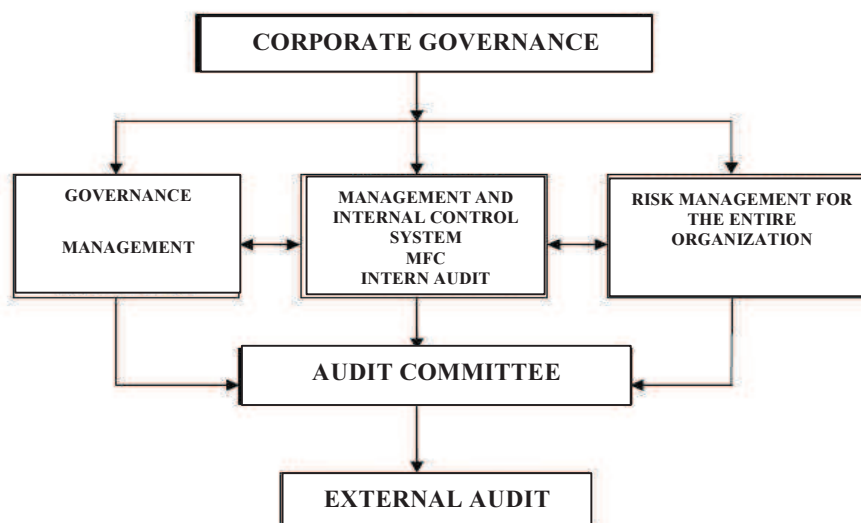
Components of corporate governance

Corporate governance - means overall leadership of the entire organization by accepting all internal components, operating together, which ultimately will be integrated management and implementation of the organization's risk management (ERM) and the financial management system and internal control (MFC) including internal audit (Fig. 2).

Corporate governance includes the following elements:

- Managers responsible for the accuracy of the information in the financial statements;
- the existence of very tight deadlines for financial reporting;
- communication and full transparency on financial results;
- transparency of internal audit and external audit processes.

Figure no. 2. Components of corporate governance



Source: M. Ghiță (coord), Guvernanță corporativă și audit intern, Ed. Tipo Moldova, Iasi, 2009, p. 12

Good corporate governance ensures improved economic efficiency and establishing an interactive investment climate. Among the most important benefits of implementing high standards of management companies include: resource efficiency, low capital cost, increase investor confidence due to the slight decrease discretionary attitude of managers and reducing corruption. In contrast, poor corporate governance distorts the efficient allocation of capital in the economy, hampering foreign investment, reduce equity holders trust and fosters corruption.

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