THE NEED FOR DETERMINING AND ASSESSING RISK IN ECONOMIC ACTIVITY

Marius MILANDRU

“Nicolae Bălcescu” Land Forces Academy, Sibiu, Romania
mmilandru@yahoo.com

Abstract: *In modern terms, risk management is a concept applicable to economic agents, which represent a factor that generates economic and financial performance. In this respect, I appreciate that it is obvious that risk management is a necessity in the activity of any organization regardless of the field of activity or its objectives. Additionally, observing the procedural elements specific to the identification, analysis, quantification and assessment of the economic risk will lead to the company being correctly diagnosed and facilitates the identification of solutions for its elimination, or mitigation within the parameters of a controllable area.*

Keywords: economic activity, economic risk, risk management, risk factors, analysis and evaluation

1. Introduction

One of the most interesting areas of research and investigation conducted over history, in general, and economic history, in particular, regards the *risk*, although the first consistent results of its understanding, evaluation and management emerged only during the Enlightenment, at the end of the seventeenth and early eighteenth centuries. The instruments used today in the field of risk management and decision-making, under conditions of uncertainty, have their roots in the theoretical developments that occurred between 1654 and 1760, with a remarkable exception. This exception concerns the elaboration of modern theory specific to this field by the 1990 Nobel laureate Harry Markowitz, in the 1950s. The direct, though somewhat delayed, effect of Markowitz's theory consisted in revolutionizing the manner in which financial decisions - both investment and financing - are taken at corporate and

investment levels. From that point onwards, investors have had a coherent investment assessment framework based on two fundamental elements: “the expected risk and gain” [1].

The post-war period registered a significant increase in the international business component, with international economies intensifying their cross-border business relationships, which involved, besides goods and services, both production factors and financial assets. These developments were possible due to the regulation and liberalization of international trade and financial flows, the reduction of the cost of communications and the reduction of transportation costs.

Consequently, investment opportunities are no longer restricted to national markets, with financial capital looking for fairly easy rewards for risks undertaken across national borders. The accentuation of international

competition has led to a large increase in international flows of financial assets.

By definition, risk is “a certain degree of probability of happening”. If it happens, that state affects the business environment to the maximum extent of bankruptcy of the economic agent.

The often-invoked legislative inconsistencies and especially the arbitrary way of interpreting normative acts that govern the business environment are other risk factors that can lead to losses for companies, frequently resulting in financial collapse or in other unwanted situations.

Through a faulty risk management, incorrect economic and financial information have led to wrong decision making, with the worst consequences for companies.

It is considered that, by rigorously and efficiently managing the risks to which the company is exposed, the costs of prevention are much lower than those with the correction, respectively, of removing or minimizing the effects.

International statistics show that poor management of business-related risks makes 5 out of 10 businesses endure during their first year of existence, while only one of them reaches 5 years of activity. Therefore, effective risk management is undoubtedly a prerequisite for business success [2]. It is well-known that any economic agent is at risk regardless of its size or the sector in which it operates and that the determination and assessment of the risks to which it is subjected is not only a particularly important stage in the continuation of the business, but also an essential condition for success. Furthermore, mismanagement of risks can generate disastrous future results, and may go as far as bankruptcy.

At the same time, the activity of risk analysis and management, in all its complexity, is a prerequisite for maintaining a firm at long-term performance.

2.The Typology of Risks Specific to Economic Activities

Economic risk refers to those events that, if they occur, generate certain changes in the operating activity of an enterprise. As the risk management and the complexity of economic activities developed, various assumptions were made regarding the characteristics, components and effects of economic risk.

Different authors who have studied the issue of risk have proposed various “definitions or assessments” of economic risk, depending on the degree of development of the economy at a specific time, as follows:

- “This type of risk is more complex and refers to the impact of the exchange rate change on the long-term profitability of the exporting company and not on the short-term effect on a transaction” [3].

- “The economic risk includes everything that causes uncertainty in the balances and the costs of technological operations in the quantities and prices of the company’s products. Economic risk causes uncertainty in the operation of profit, it is caused by changes in economic activity “if the economy is in recession, in expansion” [4].

- “Economic risk is the company’s inability to adapt in time and with the lowest cost to environmental variations. More specifically, it expresses the volatility of the economic result to the operating conditions” [5].

- “The (economic) exploitation risk derives from the fluctuations of the operating result according to its position against the profitability threshold (the deadweight) and is related to the structure of the operating costs (in fixed and variable values) and depends directly on the higher weight or lower fixed costs in total expenditure” [6].

Understanding the risk as the probability of obtaining a real outcome different from what is expected, financial theory considers that the economic operators are willing to take risks in the hope of obtaining a reward, materialized in gain.

A broad classification divides sources of risk as follows:

➤ *General economic risk (operating risk)* - refers to the possibility that the firm's activity may be influenced by the general state of the economy or by governmental decisions regarding taxation, investments, and so on, making these investors optimistic or pessimistic in what regards the future of the economy. Economic optimism or pessimism is reflected in aversion or risk aversion, resulting in changes at the level of the expected earnings.

The economic risk expresses the possibility of the firm to timely adapt to the variations of the economic factors at a minimum cost. This risk is related to the structure of operating costs (fixed and variable) and depends directly on the higher or lower share of fixed costs in total expenditure.

➤ *Risk of inflation and deflation.* Inflation increases the risk of pricing and resource costs. It also leads to increased fiscal pressure. There are firms that win and also firms that lose because of inflation; its effect is not uniform, which does not affect all firms equally, not even the whole economy, and not even those in the same branch of business. Deflation can have unpleasant effects for those who place their bet on high prices.

➤ *Business risk and specific risk*

- *Business risk* - refers to both the degree of development of the technology used by the business and the degree of competition existing in the field in which the firm operates and is one of the fundamental risks that can influence a firm's business.

It also relates to the financial risk of the firm, defined as the firm's dependence on external sources of finance.

- *Specific risk* - occurs based on the securities issued by the firm. If the company issues bonds, it is considered to be much less risky, from the investor's point of view as compared to a company which issues shares. However, from the

point of view of the firm, the situation is exactly the opposite, because the shareholder is both the winner and the loser, while the bond owner must be rewarded regardless of the results obtained by the firm, but does not have the right to veto to control the firm.

➤ *International risk* - refers to the possibility of modifying the exchange ratio between different currencies, as well as to the possibility of occurrence of economic disturbances in different parts of the world. These changes to the international economic context can influence the company both directly - whether the company operates in those areas, or indirectly - by changing the stock exchange rate or even the currency exchange rate.

The tendency of the managers to take risks varies from individual to individual and depends on contexts, individual behavioral variations drawn from experience and business context. Most of the managers avoid the risk rather than accept it, although there are many who believe that the pleasure of success is strengthened by the threat of the risk.

The emotional content of anxiety, fear, joy, and danger is the one that determines the managers' attitudes to risk.

Risk management should include risk-prediction methods, techniques to assess the impact these risks may have on the company business, and strategies to mitigate both the risks and their effects on the company. Attitude to risk is a concept closely related to utility, so the importance of utility in the classical economy derives from the attempt to define the value of a commodity and make the difference between the value of the commodity and its market price. Moreover, the preferences of any individual can be numerically represented by a utility function that can be constructed so that the individual's options between the various alternatives coincide with those choices that maximize the utility expected by the individual.

The utility function is a complete representation of the individual's preferences, and all of their decisions can be fully delegated to another party acting on the principle of maximizing utility.

Depending on the form that utility takes depending on individual characteristics, we can distinguish three types of risk attitudes:

➤ *Pleasure of risk* - for this type of risk attitude, the curve of the total utility is convex to the origin, which suggests an increasing marginal utility. We can say that a person who loves to risk will even accept an unfavorable game. Consequently, if this person has to choose between an investment with a certain (so unriskey) investment and an investment with an uncertain (but risky) gain but of the same value, they will choose the one that has the uncertain outcome, because what they appreciate in an investment is the risk itself.

➤ *Risk neutrality* - in this case, the marginal utility is constant. Thus, the regret that such a person will feel for losing a sum of money is equal to the satisfaction they feel when winning the same sum of money.

➤ *Aversion to risk* - presupposes a decreasing marginal utility law, the utility curve being concave to the origin. In other words, the regret suffered by losing a sum of money by such a person is greater than the satisfaction felt by winning a sum of money of the same value.

3. Risk Analysis and Assessment, a Must-Have of Economic Activity

Any economic activity is aimed at achieving objectives, but most of the times the results obtained from the respective activity are not the same as those predicted. This is due to the uncertainty of the context in which the project or investment is carried out.

The risks that may arise in this context are due to several factors that can be grouped into two categories:

- internal factors - refer to: insufficient delivered quantities, lower product quality, non-compliance with contractual deadlines,

non-competitive pricing, degraded brand image;

- external factors: unfavorable economic context, seasonal decline in sales, lower customer income, increased competition, evolution of customers' wishes, changes in purchasing habits, fashion trends.

Determining these factors, and implicitly of the likelihood of the risks they generate, and the effects these risks have on the company's value can be achieved by various methods.

The emergence of economic contexts with negative or positive results on the value of the enterprise, or other factors that may influence the activity of the economic agent, can be determined by *statistical* (probabilistic) or *mathematical methods*.

In order to assess the effects of these risks on the financial results of the company and the measures to be taken in order to maintain the financial balance, *financial - accounting methods* are used.

The International Credit Agency has drawn up a list of 10 major threats for the survival of an economic operator in "*the event of a non-assessment of risk*" [7], as follows:

➤ *Misplaced business location* - this is related to marketing policy and implies the promotion of inappropriate advertisements and the non-choice of a market for product dissemination;

➤ *Too much capital in fixed assets* - manifested if the efficiency of the use of fixed assets is low;

➤ *Lack of capital* - in cases when too high investments have been made in fixed assets and there is not enough circulating capital to continue the production process;

➤ *Credit problems* - there may be situations where there are no resources to repay debts;

➤ *Poor inventory management* - doubling sales does not imply the need to duplicate inventories. Stocks have to grow only 1.4 times;

➤ *Uncontrolled expansion* - if products are launched on a market that has not been researched beforehand;

➤ *Inappropriate capitalization* - this is determined by the risk of business activity. If the risk is high, the number of dividends required by investors (expected earnings) will be high. The dividends are paid out of the profits and the invested part will be small;

➤ *Lack of experience and qualification* – meaning that there is no interest in raising the professional training of the employees;

➤ *Staff problems* - if the activity goes badly the staff will be tempted to find another job;

➤ *Bureaucracy* - this risk is encountered in activities whose results are no longer satisfactory.

If these threats are analyzed, it is found that one derives from the other as a chain propagation effect.

At the same time, a list of 7 success factors was developed for the assessment of risk.

The specialists have analyzed the factors that determine the success of a business, so they believe that if the following conditions are met, economic performance is ensured by the following:

➤ *Being proactive* - every employee is able to act day by day without waiting for orders from someone. Successful organizational schemes have low and flat pyramid form;

➤ *Approaching the client to understand their needs* - production activity should have a dual purpose: achieving a superior quality product and meeting the needs of a particular segment of consumers;

➤ *Autonomy in decentralization of decision-making* - all activity must be divided into compartments that know exactly what to do and where decisions are actually made;

➤ *Simple and value-based leadership* - Americans call it “KISS” meaning “keep it short and simple”;

➤ *Achieving the proposed goal or the so-called “crocheting the appropriate model”* - the idea is that a new product is launched only on a known market, while on a new market only an already known product is

sold. A new product is never launched on a new market because the risk is very high;

➤ *Well-trained and dedicated staff* - the activity is carried out by a chain of people involved in the production process from the original supplier to the final customer. If each one is interested in the work they perform and does quality work, the risk that breakdowns occur in the production process is very low;

➤ *A shorter control of the activity* - no aspect of control should be neglected in any phase of the activity.

The general state of the national economy influences decisively the evolution of all economic operators in the free market, so they are sensitive to the market fluctuations and the changes that occur in the economic environment, there being a direct link between the economic performances at the national level and the degree of development of the small and medium-sized sectors.

Without ignoring the negative impact of economic agents on the environment, especially during the contemporary scientific and technical revolution, we must admit that the greatest attention should be paid to economic and financial risk factors. If the risks of environmental degradation primarily affect the company's staff and assets, the risks arising from the functioning of the company in a competitive economic environment particularly affect its financial situation.

The traditional approaches to risk management and risk assessment are based on the assumption that “risk analysis actually involves analyzing the variability of past profits, but above all, that of future profits, in relation to the profitability averages of the latest experiences” [8]. Therefore, *traditional methods* of approaching risk in economic activity are specifically based on the indicators included in the financial statements, i.e. activity, liquidity and profitability indicators, and on the analysis of their evolution over time, by comparing the

indicators obtained from a reporting period to another.

4. Final Conclusions

The possibility of quantification of the situations described by the concept of economic risk is related to the use of probabilities or chances of occurrence of events or possible outcomes of an action.

Economic risk is an expression of changes in performance indicators due to the financial structure of the company and it concerns the financial structure of the organization and depends on *how the activity is financed*: if it is exclusively financed from own funds, it then does not involve any financial risk.

The economic and financial balance at the level of the trading companies is achieved through several types of equalities and correlations between the needs and possibilities of the company, respectively between the financial sources and the economic means necessary for exploitation

and commercialization in the long and short run. The general state of equilibrium integrates both the equality of elements and inequalities, each carrying their own economic significance.

From the above, it follows that the risk is exclusively related to negative aspects, so in business the risk needs to be managed effectively. The risks associated with business include, among other things, unfair competition, lack of honesty in the execution of contracts, the use of false payment instruments, deception of business partners and, not least, of associates, internal or external fraud of the company, bad credit management, adverse market conditions, exchange rate imbalances, upstream and downstream market failures, and many other elements of risk, some even institutional or force majeure, affecting the profitability and even the existence of companies.

References

- [1] Horobeț Alexandra, *Managementul riscului în investițiile internaționale*, All Beck Publishing House, București, 2005.
- [2] Blănculescu Ionel, *Riscul și cum poate acesta influența afacerea*, Financial Week, No. 58/2006.
- [3] Negoescu Gheorghe, *Risc și incertitudine în economia contemporană*, Alter-Ego Cristian Publishing House, Galați, 1995.
- [4] Coșea Mircea, *Politici microeconomice de evaluare a riscului*, Lux Libris Publishing House, Brașov, 2000.
- [5] Niculescu Maria, *Diagnostic global strategic*, Economică Publishing House, București, 2005.
- [6] Petrescu Silvia, *Diagnostic economic – financiar*, SedcomLibris Publishing House, Iași, 2004.
- [7] Stoenescu Teodor, *Identificarea riscurilor și managementul acestora*, accessed from www.stcv.ro.
- [8] Spătaru Elena, *Analiza riscului economic și financiar*, Tribuna Economică, Nr 40/2005.