

# The Causes of Financial Risk in Enterprises and Its Precaution

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**Abstract:** With the rapid development of social economy, the increasingly complicated business practice, the increasingly diversified enterprise information users, China's corporate financial risk measurement and management is still lagging behind. Many companies only learn the failure and lessons after crisis. With the impact of the financial turmoil, some well-known enterprises face bankruptcy, and some companies have seized this opportunity to accelerate their transformation and thus took a different path, under this economic context, corporate financial management will be the core issue of business management. The neglect of financial risk and investment decision error is an important reason for the collapse of most companies. Therefore, the research on the understanding, prevention and control of financial risk has become an important subject for enterprises today. Therefore, in the real economic development, enterprises should establish financial risk awareness to effectively prevent financial risks, and actively promote the healthy development of enterprise financial system and economic efficiency. Financial risk is a major problem facing our current enterprises, which is related to the survival and development of enterprises and key to gain profits. Based on the analysis of the actual situation of the current enterprise, this paper starts from the reasons of the formation of financial risk, puts forward the countermeasures to prevent the financial risk, and discusses how to improve the financial risk for the business managers. Through research and building a scientific method of financial risk control, sets precautions to avoid risk, reduce unnecessary losses, so as to bring more benefits for the enterprise.

**Keywords:** Financial Risk; Causes; Precautionary Measures; Control Methods

## 1. Summary of Financial Risks

The financial risk of an enterprise refers to the possibility of loss of business in the process of financial activities due to various unforeseen or controlled factors. The financial risk of the enterprise runs through the whole process of production and operation. This chapter makes a detailed study on the financial risk problem. It starts from the correct understanding of financial risk and makes a concise explanation of its meaning, type and characteristics.

### 1.1 Definition of financial risks

Financial risk can be defined in broad and narrow sense. Broadly speaking, financial risk refers to financial system deviate from the expected objectives, causing economic losses as a result of the opportunity or possibility during financial activities in the enterprise, due to the internal and external environment and a variety of unpredictable or uncontrollable factors. Here the results of the financial activities include two aspects, one is the result of financial activities that is income; Second, financial situation of debt service, business, profitability.

Under normal circumstances, financial risk refers to the financial results reduced the possibility of deterioration of the financial situation. Although every business wants to improve financial results as much as possible and optimize the

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financial situation, financial risk is unavoidable. Business executives and corporate financial officers' responsibility is to fully familiar and able to identify the financial risks arising, take appropriate measures to be prevented and control as far as possible to avoid the loss of financial results and financial deterioration.

## **1.2 Characteristics of financial risk**

### **1.2.1 Objectivity**

Financial risk is does not change not the will of the people, it is an objective existence. In other words, risks exist anytime and anywhere, it can't be avoided, eliminated, only through a variety of technical means to deal with the risk, so as to avoid costs and the loss occurred. There are two possible outcomes in an enterprise's financial activity, namely, achieving the desired goals and failing to achieve the desired objectives, which means that the risk that the expected objectives can't be achieved is objective.

### **1.2.2 Comprehensiveness**

That is, financial risk exists in the whole process of corporate financial management, and reflected in a variety of financial relations. Capital raising, capital use, capital accumulation, distribution and other financial activities, will have financial risk.

### **1.2.3 Incentive**

That is, the objective existence of financial risk will enable enterprises to take measures to prevent financial risks, strengthen financial management, thereby enhancing economic efficiency and maximize the benefits.

### **1.2.4 Coexistence**

That is, risk and income coexist and proportional relationship, in general, the greater the risk of financial activities, the higher the income. Such as venture capital, there is a greater risk, but also because of investment and risk compensation.

### **1.2.5 Uncertainty**

Financial risk has a certain degree of variability, that is, under certain conditions and time it may occur or may not happen. This means that the financial situation of the enterprise is uncertain, so that the enterprise has always suffered the possibility of loss.

## **1.3 The basic types of financial risk**

### **1.3.1 Financing risk**

Funding risk refers to the uncertainties caused by the supply and demand of funding market, the macroeconomic environment, and the financing of the enterprise. Financing risk includes interest rate risk, refinancing risk, financial leverage risk, exchange rate risk, purchasing power risk and so on.

### **1.3.2 Investment risk**

Investment risk refers to the enterprise invested a certain amount of funds, due to changes in market demand and the impact of the final income and expected return risk. There are two types: direct investment and securities investment. In China, according to the provisions of the company law, shareholders have more than 25% of corporate equity should be regarded as direct investment. Securities investment mainly has two forms: stock investment and bond investment. Investment risk mainly includes interest rate risk, reinvestment risk, exchange rate risk, inflation risk, financial derivative risk, moral hazard, default risk and so on.

### **1.3.3 Operational risk**

Business risk, also known as business risk, is the enterprise in the production and operation process for the supply, production and sales of various aspects of the uncertainty caused by the impact of corporate funds operating delays and changes in corporate value. The main risks include purchasing risk, production risk, inventory realization risk, and account receivable risk.

### **1.3.4 Inventory management risk**

Enterprises to maintain a certain amount of inventory for its normal production is essential, but how to determine the optimal inventory is a more difficult problem. Too much inventory will lead to product backlog, taking up corporate funds, making the risk higher. Too little inventory may lead to the untimely supply of raw materials, affecting the

normal production of enterprises, if serious may cause a breach of customer, thus affecting the credibility of enterprises.

### **1.3.5 Liquidity risk**

Liquidity risk refers to the possibility that the enterprise assets cannot normally and definitely transfer cash, and the corporate debt and pay liability cannot be performed normally. In this sense, the liquidity risk of the enterprise can be analyzed and evaluated from the aspects of the enterprise's liquidity and solvency. Due to the inability of enterprises to pay and solvency problems, known as cashout and cashflow risk. As the enterprise assets cannot be quantitatively transferred to cash and the problems occurred are known as the liquidity risk.

## **2. Causes of Corporate Financial Risk**

The development of the global economy, the arrival of the era of integration, the sweeping of the knowledge economy, making our enterprises face increasingly fierce competitions in the economic environment, while the performance of the market economy is more obvious. In this environment, the enterprise's production and operation and financial management is facing this huge risk. Corporate financial risk has a variety of factors. The specific reasons for the formation of different corporate financial risks are not the same. In general, there are several reasons:

### **2.1 Enterprise financial management system cannot adapt to complex and volatile macro environment**

The complicated and changeable environment of enterprise financial management is the external cause of financial risk. As we all know, sustained inflation will continue to shorten the supply of funds, monetary funds continued to depreciate, the relative appreciation of physical funds, capital costs continue to rise. For example, the rise in world crude oil prices leads to higher oil prices causing enterprises increased operating costs, reduced profits and short in achieving the expected benefits. The change in interest rates is bound to result in interest rate risk, including the risk of excessive interest payments, the risk of loss of interest arising from investments and the risk of insolvency obligations. Market risk factors also have a significant impact on financial risk. These factors exist outside the enterprise, but have a significant impact on corporate financial management. Changes in the macro environment for enterprises, it is difficult to predict accurately and cannot be changed. Adverse changes in the macro environment will inevitably bring financial risks to the enterprise. Financial management environment is complex and changeable; changes in the external environment may bring some opportunities for enterprises and may also put enterprises at risk. Financial management system which cannot adapt to the complex and volatile external environment will inevitably make businesses into financial difficulties.

### **2.2 Lack of understanding in corporate financial managers of the objectivity of financial risk**

Financial risk is an objective reality, as long as there are financial activities, there must be financial risk. Many of the financial management lack risk awareness, thinking that as long as the management make good use of funds, it will not have financial risks. Risk awareness is one of the important reasons for financial risk. As China's market has become the buyers' market, enterprises generally endure unsalable product phenomenon. Some enterprises in order to increase sales, expand market share, a large number of sales using credit, corporate receivable accounts increased. At the same time, because the enterprise is in the credit process, the customer's credit rating understanding, lack of control, blind credit, resulting in receivable accounts out of control. A large proportion of accounts receivable cannot be recovered for a long time until it becomes bad debts. Long-term assets owed by the debtors are causing a serious impact on the liquidity and security of corporate assets, brings huge financial risk to the enterprise.

### **2.3 Chaotic internal financial relations**

The chaos of financial affairs within the enterprise is another important cause of the financial risk of Chinese enterprises. Enterprises in capital management and usage, the distribution of benefits and other aspects of ambiguity of authority and responsibility and disorganized management, result in inefficient use of funds and loss of assets. Capital security and integrity cannot be guaranteed. For example, the corporate funds structure is irrational and the proportion of debt funds is too high. In our country, the capital structure mainly refers to all the funds of the enterprise from the

proportion of equity funds and liabilities. Due to funding, decision-making mistakes and other reasons, the phenomenon of unreasonable corporate funds structure is widespread. Specific performance in the proportion of debt in the capital structure is too high, many corporate asset-liability ratio are more than 30%, resulting in a heavy financial burden and insufficient solvency.

China's enterprises generally exist in the phenomenon of slow-moving products, some enterprises in order to increase sales, expand market share, a large number of sales using credit sales products, resulting in a substantial increase in corporate accounts receivable. At the same time, in the process of credit, insufficient customer credit rating and blind credit results in accounts receivable out of control. A considerable proportion of long-term receivable accounts cannot be recovered until a bad debt, long-term debt occupied by the debt, causing a serious impact on corporate assets of the liquidity and security, resulting in financial risk.

## **2.4 Lack of scientific decision-making from financial management**

Financial decision-making is the most direct cause of financial risk. To avoid mistakes in financial decision-making is apply scientific financial decision-making. At present, in the experience decision-making and subjective decision-making is prevalent in the financial decision-making of our enterprises, which leads to frequent mistakes in decision-making, resulting in financial risk.

### **2.4.1 Lack of scientific decision-making investment in fixed assets led to investment mistakes**

In the process of fixed asset investment decision-making, due to the lack of careful analysis of the feasibility of investment projects and research, coupled with the decision-making based on the incomprehensive economic information, unreasonable and decision-makers' decision-making capacity and other reasons, resulting in frequent investment decision-making mistakes occur. Decision-making mistakes lead to investment projects cannot reap the expected benefits, investment cannot be recovered on schedule, bring huge financial risks to the enterprise.

### **2.4.2 Decision-making mistakes in foreign investment, resulting in a large number of investment losses**

Corporate foreign investment includes portfolio investment, joint venture investment. As investors lack of knowledge of investment risk, lack of scientific backup, leading to blind investment and investment decision-making mistakes causing enterprises to have a huge investment losses, resulting in a lot of financial risk.

### **2.4.3 Financing scale and structural decision-making causes improper financial risk**

Some enterprises in China blindly expand the scale of production with insufficient funds. They had to raise a large amount of debt funds, resulting in unreasonable capital structure, debt funds accounted for the proportion of all funds is too high, with many enterprises with asset-liability ratio as high as 30%. Resulting in a heavy financial burden on the enterprise, solvency is insufficient, resulting in financial risk.

## **3. Prevention of Corporate Financial Risk**

In the market conditions, the financial risk is an objective reality to completely eliminate the risk is unrealistic. Therefore, enterprises in determining financial risk control objectives cannot blindly pursue low or even zero risk, but should be based on the principle of cost-effective financial risk control in a reasonable and acceptable range. Therefore, to strengthen the corporate financial risk prevention, preventing and resolving financial risks, in order to achieve financial management objectives, is the focus of corporate financial management. For the reasons for the financial risk of the previous chapter, we focus on how to prevent corporate financial risks at the following points below.

### **3.1 Strengthen the financial management in the ability to adapt macroeconomic changes**

Through careful analysis of the financial management of the macro environment and its changes, so as to more effectively improve the enterprise financial management environment adaptability, and further establish and improve financial management system to adapt to the changing financial management environment, that is, financial management strategy should be developed. In the face of changing financial management environment, enterprises should set up efficient financial management institutions, with high-quality financial management personnel, improve the financial management rules and regulations, strengthen the fundamental work of financial management, so that the

efficiency of the operation of enterprise financial management system improves in order to prevent the financial management system failure to meet the environmental changes, causing financial risk.

At the same time, we must always pay attention to national policy changes. Enterprises running on liabilities on the one hand have to pay attention to the national industrial policy, investment policies, financial policies, fiscal and taxation policies and other changes in the investment projects, business projects, financing, operating costs and other aspects of the possible negative effects. Concerns should be also on about the market structure, market demand, supply and demand changes caused by changes in corporate procurement costs and market investment, resulting in business costs and capital requirements increase, which leads to financial costs rise and operating losses. In addition, in the infrastructure technological improvements, attention have to paid on banks tightening monetary policies, causing lack of funds and delay the duration of the project, affecting the realization of the expected profit. Business operators, if not timely for the emergence of these policy factors and adjust their business strategy and investment direction, will lead to enterprises into the financial crisis.

### **3.2 To improve the awareness of financial personnel risk and strengthen the internal control system**

In order to prevent financial risks, enterprises must strengthen the risk awareness of financial personnel, straighten out the corresponding relationship between internal finance, achieving unity of responsibility, rights and interests. Clarify the status, function and responsibilities of the various departments in the enterprise financial management and give appropriate, truly decent power, and respective responsibilities. In terms of the distribution of benefits, we should take into account the interests of all parties to mobilize the enthusiasm of all departments to participate in the financial management of enterprises, uniting responsibility, rights and interests, so that the internal financial relations are clear. Update the financial staff to adapt to the new environment of knowledge structure, strengthen risk education, so that all employees, especially at all levels of leadership and financial staffs to firmly establish an awareness of risk.

Financial staff at all levels should be soberly aware that financial risks exist in all aspects of financial management. Financial management personnel must incorporate the risk of prevention throughout the financial management work, with timely capture of risk and gauge the ability to prevent risks. In dealing with each specific business, prevent actively, respond properly, and resolve timely of financial risks.

### **3.3 To improve the level of scientific decision-making and the establishment of financial risk prevention mechanism**

Financial decision-making is directly related to the success or failure of financial management, experience decision-making and subjective decision-making will greatly increase the possibility of making mistakes. In order to prevent financial risks, enterprises must adopt scientific decision-making methods. In the decision-making process, we should take full account of the various factors that affect the decision-making, the use of economic models for scientific decision-making, a variety of feasibility programs to carefully analyze, evaluate and choose the optimal decision-making program, and determined to put an end to the financial decision risk, so as to avoid subjective assumptions.

In the process of financing decision-making, the enterprise should first reasonably forecast the capital requirement according to the production and operation situation, and then through the calculation and analysis of the capital cost and the risk analysis of the financing methods to choose the correct financing way to determine the reasonable financial structure, and making the right funding decisions. Liquidity is the life of an enterprise, and firms must accelerate the turnover of inventory and accounts receivable to maintain good asset liquidity. In accordance with method of making decisions above, the possibility of errors caused by greatly reduced, which can avoid the financial decision-making mistakes brought about by the financial risks.

Accurate financial forecasting plays an important role in preventing financial risk. Through financial forecasting and risk warning, enterprises can capture and monitor all kinds of subtle signs before the financial risk actually occurs,

so that enterprises can know their financial needs in advance for making arrangements of financing plan and estimating the funds to be raised. Companies can understand the extent of financing to meet the investment, and then to arrange for production and operation and investment, so that investment and financing linked to avoid the disjoint caused by cash turnover difficulties. Moreover, the forecast also includes understanding and thinking of the future of the various possible prospects, through the forecast enterprise's ability can improve to respond to future uncertain events, thereby reducing the adverse events caused by the loss. At the same time, through the establishment of early warning system, equipping enterprises with risk early warning function, once the signals of financial risk is on, managers can be accurately tasked to prevent the gradual worsening of the situation.

### **3.4 To deal with the appropriate financial risks and avoid blind debt expansion**

Financial risk management is post control of risk, the specific methods are: adhere to the principle of prudence and establishment of risk funds. To establish a fund specifically for the prevention of loss of risk in advance or otherwise before the loss occurs. Such as industrial enterprises follow certain provisions and standards to withdraw bad debt reserves. after the loss occurred, there should have been paid off from the risk funds, or in batches into operating costs, to minimize the financial risk interfering normal financial activities. the establishment of efficient supervision system of enterprise funds. Relevant departments should regularly assess the ratio of asset management, while strengthening the flow of funds and management, to improve the turnover rate of current assets, thereby enhancing the ability of enterprises to improve and increase the short-term solvency of enterprises. In addition, revitalize the stock of assets, to speed up the disposal of idle equipment repaid debt using the funds . focus on investment decision-making. Investment decision-making is one of the main contents of the major business decision-making, which directly affects the enterprise's capital structure. Business decision makers must make a feasibility analysis of investment projects.

The state encourages the advantages of mergers or acquisitions of inferior enterprises, but also to encourage enterprises to develop diversified industries, which is undoubtedly for the enterprise to seek new economic growth point and the effective way of resettling surplus staffs. However, avoid expanding the existing assets, especially the speed of the slow fixed assets (such as land, buildings) as way to assess the appreciation in order to reduce the level of debt and in return carrying out more expansion of debt. From the status quo of China's enterprises, corporate debt expansion after the overall level of assets and liabilities to not more than 70% is appropriate. Enterprises should firmly grasp the debt ratio, will be able to prevent corporate financial risk as a whole.

### **3.5 Technical methods to control corporate financial risk**

#### **3.5.1 Distribution method**

That is, through the joint venture between enterprises, diversification and diversification of foreign investment, such as diversification of financial risk. For more risky investment projects, enterprises can co-invest with other enterprises in order to achieve revenue sharing, risk sharing, and thus diversify the investment risk, avoiding the exclusive risk of investment arising from the financial risks; Due to uncertainty and volatility of market demand, the risk of diversification can be mitigated by varying business methods, that is, operating a variety of products at the same time. In a variety of modes of operation, the loss of certain products due to poor sales may be offset by the benefits of other products, which can avoid the risk of operating a single products and not achieving the expected benefits.

#### **3.5.2 Aversion method**

That is, enterprises in the choice of financial management program, should be conducting a comprehensive evaluation of various programs may have financial risks, opting less risky programs under the premise financial management objectives, to achieve the purpose of avoiding financial risks. For example, if the debt investment can enable the enterprise to achieve the expected investment income, enterprises in the choice of investment, should be venturing into debt investment as much as possible, because the risk of debt investment is much lower than the risk of equity investment. Although equity investment may bring more investment income, from the perspective of risk avoidance, companies should be cautious in equity investment. Of course, the use of avoidance method is not to say that

enterprises cannot carry out risky investment. Enterprises in order to achieve the impact or even control the invested enterprises, in this case, to undertake appropriate investment risk, equity investment is necessary.

### **3.5.3 Transferring method**

That is, the means by which a firm will take part or all of its financial risks. There is a lot of ways to transfer. Companies should be transferring risk based on different risks. They are generally divided into insurance transfer and non-insurance transfer. Insurance transfer: If the enterprise can purchase property insurance, the risk of property damage is transferred to the insurance company. In foreign investment, enterprises can use joint venture investment. Hence, the investment risk is partly transferred to other enterprises involved in investment. Non-insurance transfer refers to the transfer of a particular risk to a specialized agency or department, such as selling the product to the business sector, passing some professional work to a company with extensive experience, expertise and equipment. Transferring financial risk partly or wholly to other parties to bear, can greatly reduce the financial risk of enterprises.

### **3.5.4 Reduction method**

That is, enterprises under the objective existence of financial risk, striving to take measures to reduce the financial risk. For example: enterprises can, under the premise guaranteed need for funds, appropriately reduce the proportion of total debt funds to achieve the purpose of reducing debt risk. In addition, companies can also pay a price to reduce the possibility of risk loss. For example, establish a risk control system to detect and mitigate risks in a timely manner. Enterprises can also establish a risk fund, such as long-term liabilities to establish a special sinking fund, in order to reduce the loss of the normal production and impact of business activities.

## **4. Conclusions**

Financial risk of an enterprise is objective, but it is also predictable and can be controlled to a certain extent. Enterprises only have a certain understanding of financial risk. By taking into account the financial risks in the development of decision-making, regularly conducting financial analysis in various types of enterprises to compare and find out the potential risk factors, subsequently establishing a financial risk prevention system, will allow enterprises to avoid financial risks and to maximize benefits.

Therefore, we should fully analyze and understand the causes of financial risk when we carry out financial management, and take various measures to control the occurrence of risk, enhance the profitability of enterprises and master the ways and means of financial risk control. A variety of different risks are not isolated, they are interrelated to each other in the enterprise. On the one hand, risks bring losses to the enterprise, threatening the development of enterprises and even survival. But on the other hand, in a changing environment of globalizing economy, progress of science and technology and market economy, it gave development of some enterprises to create space and bring opportunity. This is the result of market competition and it is the natural rule of survival of the fittest in the economic sector. In the case of underdeveloped market economy system in China, the financial staff should pay special attention to the prevention of financial risks so as to effectively prevent and resolve financial risks, at the same time ensuring sustainable and healthy development of the enterprise economy.

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