European Journal of Business and Management
ISSN 2222-1905 (Paper) ISSN 2222-2839 (Online)
Vol.6, No.5, 2014

The Impact of Financial Risks on the Firms' Performance

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Abstract
Firms are exposed to a variety of risks including credit risk, liquidity risk, foreign exchange risk, market risk and interest rate risk. An efficient risk management system is needed in time in order to control these risks. Managing risk is one of the basic tasks to be done, once it has been identified and known. The risk and return are directly related to each other, which means that increasing one will subsequently increase the other and vice versa.

Financial risks have a great impact on firm's performance. The study also assessed the current risk management practices of the firms and linked them with the firms' financial performance. The findings confirm whether financial risks can be contained or managed in order for firms to achieve profit maximization for its shareholders.
Keywords: Financial Risk; Firm's Performance; Interest rate parity; Liquidity gap; Liquidity risk; Risk Management.

1.0 Introduction

1.1 Background of study

Risk is defined as anything that can create hindrances in the way of achievement of certain objectives. It can be because of either internal factors or external factors, depending upon the type of risk that exists within a particular situation. Managing risk is one of the basic tasks to be done, once it has been identified and known. The risk and return are directly related to each other, which means that increasing one will subsequently increase the other and vice versa. And, effective risk management leads to more balanced trade-off between risk and reward, to realize a better position in the future (Fatemi and Fooladi, 2006).

Globalization and internationalization has increased the risk of firms in the developing countries. This is due to competition from within and outside the countries by either directly from other or indirectly through access to International trade. Management of financial risks has been a big concern for investors, analysts, managers and shareholders around the world.

The Kenyan economy is becoming more and more open with international trading constantly increasing and as a result the Kenyan firms become more exposed to foreign exchange rate fluctuations. Exchange rate changes can lead to changes in the relative prices of the firm's inputs and outputs. The relative price changes can affect the firms competitive market position, leading to changes in cash flows and, ultimately, in firms value. While it can be observed that firms in developed economies use a variety of instruments to manage financial risks, it is not clear whether the full potential of these instruments is being realized in developing economies notably Kenya since not all firms use derivatives and not all firms use all types and more important, whether they are used appropriately (Njoroge et al., 2013).

Profitability is the most common measure of firm performance. The measures of profitability are used to assess how well management is investing the firms' total capital and raising funds. Profitability is generally the most important to the firm's total shareholders. Profits serve as cushion against adverse conditions such as losses on loans, or losses caused by unexpected changes in interest rates (Gitogo *et al.,* 2013).The primary measure of firm performance is Tobin's Q Which refers to the ratio of the total asset minus market value of common equity plus the book value of equity to the book value of assets. If Q index calculated for company is greater than one , there will be high motivation for investment, namely, a high Q ratio is usually a sign of the company's investment and growth opportunities worth; if Q ratio is less than one the investment should be stopped. Also alternative measures of firm performance such as return on equity (ROE) and return on asset (ROA) will be used. ROE is operating income scaled by the market value of equity and ROA is net income scaled by total assets (Choi *et al.,* 2013).

1.2 Objective of the study

1.2.1 General Objectives

The main objective of this study was to analyze effects of financial risks to firm's performance.

1.2.2 Specific Objectives

i) The find out how credit risk affect firms' performance
ii) To find out how liquidity risk affect firm's performance
iii) Determine the effects of market risk to firm's performance
iv) To analyze the how foreign exchange rate risk affect firm's performance

2.0 Literature Review

2.1 Introduction

The advancements in options pricing research along with improvements in computer technology laid the groundwork for new portfolio management techniques. Balvinder (1995), further said the increasing globalization of commerce is exposing firms to various financial risks, unrelated to their lines of business. Some of these risks are firm or situation specific with no readymade exchange traded instruments to offset such risks. The management of these risks has created a new line of financial derivatives, the over-the-counter (OTC) derivatives.

These derivatives are privately negotiated arrangements between parties that permit either one or all parties to obtain their desired financial flows. Kenya being one of the leading emerging markets and a player in the global market is faced with systemic risk which results from market linkages. Balvinder (2005) imply that shocks arising in one market may be transmitted to other market as well. Kenya still lags behind in development of a well-functioning regulated financial derivatives market.

The commonly used derivatives instruments by Kenyan companies are the forward contracts and swaps. Companies use forward contracts to hedge against their imports and exports while swaps are used when making arrangements to exchange cash flows over time. Howton and Perfect (1998) argues that currency swaps and interest rate swaps are commonly used by financial institutions for an agreement providing exchange payments denominated in one currency for payments in another currency over a period of time.

2.2 Theoretical Review

In risk management, financial economics approach is build on Capital Asset Pricing Model (CAPM) and the classic Modigliani-Miller paradigm (Miller & Modigliani, 1958) which states conditions for irrelevance of financial structure for corporate value (Klimsczk, 2008; Spric, Tekavcic & Sevic, 2007) . The paradigm was later extended to the field of risk management. Rationales for risk management deduced from the irrelevance conditions include: higher debt capacity (Miller & Modigliani, 1963); progressive tax rates; lower expected costs of bankruptcy (Smith & Stulz, 1985). . The conditions underlying MM propositions also imply that decisions to hedge corporate exposures to interest rates, exchange rates and commodity prices are completely irrelevant because stockholders already protect themselves against such risks by holding well-diversified portfolios.

In Capital Asset Pricing Model (CAPM) total risk associated with an asset can be split up in two components: systematic (non-diversifiable) and unsystematic (diversifiable) risk. If the number of assets included in the portfolio is high and these assets are not perfectly correlated, the unsystematic component of the portfolio risk diminishes. The CAPM shows that investors only get compensated for holding systematic risk, since the firm-specific component of risk can be eliminated through diversification (Mondo *et al.,*2013).

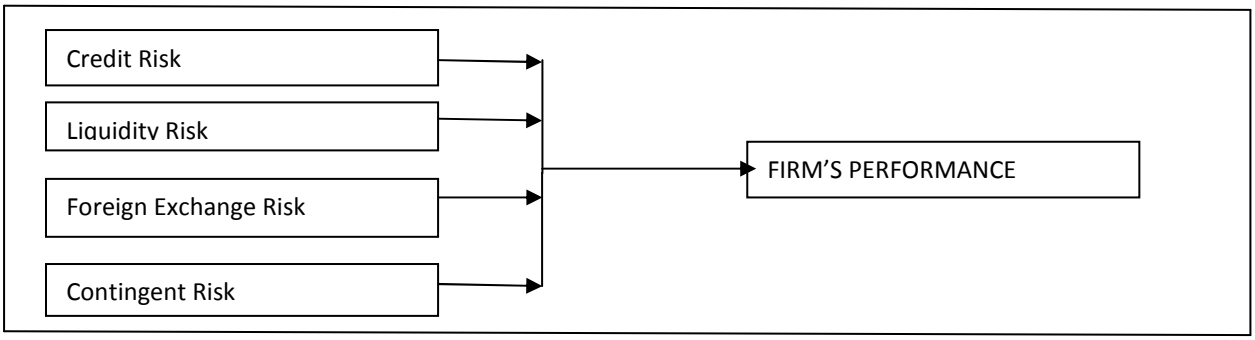
The stakeholder theory was originally detailed by Edward Freeman (1984). Stakeholder theory focuses explicitly on equilibrium of stakeholder interests as the main determinant of corporate policy. The most promising contribution to risk management is the extension of implicit contracts theory (a part of stakeholder theory) from employment to other contracts, including sales and financing (Cornell & Shapiro, 1987). Klimszk (2008) argued that in certain industries, particularly high-tech and services, consumers' trust in a company can substantially contribute to the company's value also the value of implicit claims is highly sensitive to expected costs of financial distress and bankruptcy. Since corporate risk management practices lead to a decrease in these expected costs, company value rises (Klimczak, 2005). The more sensitive a company's value is to financial distress, the higher the motivation for hedging hence reducing financial risk.

2.3 Conceptual Framework

The conceptual framework used in the current study discusses the idea that Financial Risks can either be positive or negative to the firm's performance. This effect may be beneficial to the firm's performance through high risk high return or vise versa.

Given the operations of Global Business, Financial risks play a major role in the firm's performance.

Conceptual framework of effects of financial performance



2.3.1 Relationship between various Risks and Firm Performance (Author, 2014)

2.4 Review of Conceptual Framework

2. 4.1 Credit Risk

Credit risk arises whenever a borrower is expecting to use future cash flows to pay a current debt. Investors are compensated for assuming credit risk by way of interest payments from the borrower or issuer of a debt obligation. It is the risk of loss of principal or loss of a financial reward as a result from a borrower's failure to repay a loan or otherwise meet a contractual obligation.

2.4.2 Consumer Credit Risk/Retail Credit Risk is the risk of loss due to a customer's non re-payment (default) on a consumer credit product, such as a mortgage, unsecured personal loan, credit card, overdraft etc. (the latter two options being forms of unsecured banking credit).

2.4.3 Concentration Risk is a banking term denoting the overall spread of a bank's outstanding accounts over the number or variety of debtors to whom the bank has lent money. This risk is calculated using a concentration ratio which explains what percentage of the outstanding accounts each bank loan represents.

2.4.4 Securitization

This is financial practice of pooling various types of contractual debt, such as residential mortgages, commercial mortgages, or credit card debt obligations, and selling said consolidated debt as pass-through securities, or collateralized mortgage obligation (CMOs) to various investors. The cash collected from the financial instruments underlying the security is paid to the various investors who had advance money for that right. Securities backed by residential mortgage receivables are called residential-mortgage-backed securities (RMBS), while those backed by other types of receivables are asset-backed securities (ABS).

Unlike Knott (2010), Blundell-Wignall, Atkinson, and Lee (2009) argued that the securitization process was not about risk spreading; rather it was a key part of the process to increase revenue, the return on capital, and the share price. The real story, according to Blundell-Wignall et al., was that banks began to mix their traditional credit culture with an equity culture. In order for executives to capture the benefits of this business model, compensation, too, had to evolve.

2.5 Liquidity Risk

Liquidity Risk is the risk stemming from the lack of marketability of an investment that cannot be bought or sold quickly enough to prevent or minimize a loss. It is the risk that a given security or asset cannot be traded quickly enough in the market to prevent a loss (or make the required profit).

2.6 Foreign Exchange Risk (Exchange Rate Risk/Currency Risk)

This is a financial risk posed by an exposure to unanticipated changes in the exchange rate between two currencies. Investors and multinational businesses exporting or importing goods and services or making foreign investments throughout the global economy are faced with an exchange rate risk which can have severe financial consequences if not managed appropriately.

If foreign exchange markets are efficient such that purchasing power parity, interest rate parity, and the international Fisher effect hold true, a firm or investor does not need to protect against foreign exchange risk due to an indifference toward international investment decisions. A deviation from one or more of the three international parity conditions generally needs to occur for an exposure to foreign exchange risk.

Variance represents exchange rate risk by the spread of exchange rates, whereas standard deviation represents exchange rate risk by the amount exchange rates deviate, on average, from the mean exchange rate in a probability distribution. A higher standard deviation would signal a greater currency risk.

Economists have criticized the accuracy of standard deviation as a risk indicator for its uniform treatment of deviations, be they positive or negative, and for automatically squaring deviation values. Alternatives such as average absolute deviation and semi variance have been advanced for measuring financial risk.

Value at risk can be used to examine the tail end of a distribution of returns for changes in exchange rates to highlight the outcomes with the worst returns. Banks in Europe have been authorized by the Bank for International Settlements to employ VAR models of their own design in establishing capital requirements for given levels of market risk. Using the VAR model helps risk managers determine the amount that could be lost on an investment portfolio over a certain period of time with a given probability of changes in exchange rates.

The relaxation of the frictionless and competitive market hypotheses introduces the notion of liquidity risk. Roughly speaking, liquidity risk is the additional risk due to the timing and size of a trade. From a financial engineering perspective, the need is paramount for a simple yet robust method that incorporates liquidity risk into arbitrage pricing theory. The market microstructure literature; Glosten and Milgrom; Grossman and Miller, although conceptually useful, is lacking in this regard. As a first solution to this problem, liquidity risk has recently been incorporated into arbitrage pricing theory as a convenient.

3.0 Firm Performance Measures

Profit is the ultimate goal of all firms. All the strategies designed and activities performed thereof are meant to realize this grand objective. However, this does not mean that firms do not have other goals. Firms could also have additional social and economic goals (Ongore and Kunsa, 2013). However, the intention of this study is

related to the first objective, profitability. To measure the profitability of there are variety of ratios used of which Return on Asset, Return on Equity and Net Interest Margin are the major ones.

4.0 Conclusions

The paper concludes that Financial Risks has great impact on the performance of Firms. This affects the operations in form of Asset acquisitions and maintenance of existing assets as globalization opens up the firm to outside competition, which in the long-run affects its performance.

Financial Risks for instance, Credit Risk affects lending and borrowing by Financial Firms, Foreign exchange risks make firms realize unpredictable losses thus affecting their performance.

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