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The Uncertainty in strategic finance

Anna Paola Micheli
University of Cassino and Southern Lazio, Cassino, Italy

Abstract

This paper, that is dedicated to the analysis of the uncertainty in the complex dynamics of the company, arises from the observation of the importance that uncertainty has acquired in recent years characterized by highly variable framework. This variability of context forces the management to review continuously the decisions taken.More than in the past, today we cannot talk about strategy without referring to the conditions of variability of context. The phenomenon of change is now common to all modern industrialized economies and to all sectors, so it is become a normal condition of life. Hence the idea of this paper that wants to analyze the uncertainty in decisions concerning the financial strategies of the company. The interest of examining the dynamics of uncertainty in business decisions, particularly decision related to financial sphere, is born from the continuous changes of the market and of the environment and from the consequent necessity of the firm to adapt itself to these changes. In this context it is necessary to explore this phenomenon in order to identify paradigms that are able to optimize the long term decisions and therefore the shareholders value.
Keywords: uncertainty, strategic finance, decision making, risk.

Introduction

Uncertainty is a topic that has become increasingly important over time, mainly due to the variability of context. Variability often leads who is at the top of society to review corporate strategic decisions which are taken. The change has become a normal way of life, being common to all types of economies and sectors in which companies operate (Paci, 1968). Thanks to internationalization and institutionalization of markets the different operators are subject to the same rules and exposed to the same risk, according to a logic of domino effect that means that events, which seem to be initially limited to only original context, are extended to other contexts and creating uncertainty among operators, including enterprises. So the valuation of the company cannot be separated from the consideration of uncertainty. Observing a single business, the uncertainty involves the whole enterprise and all decision-making present in it: production planning, procurement of inputs, the location of the new facilities, financial planning and marketing. Thus the uncertainty has a strategic connotation because it becomes an essential variable that the decision maker in company certainly cannot ignore. Several authors have dealt with the theme of uncertainty. According to some authors the uncertainty is connected only to adverse event, while others argue that uncertainty is related to expected results. This latter approach is less restrictive because even in case of negative perception of the event, i.e. in the case of a scenario of lower value than the one taken as reference, it is still possible to achieve a positive result, which does not necessarily give the uncertainty a negative connotation. Gobbi (1974) identifies the lack of information about the realization of an event at a predetermined time interval as an explanatory variable of uncertainty. He says that the phenomenon has different gradations between the two extremes represented by the certainty of necessity and the certainty of the impossibility depending on the amount of information. It assumes different gradations between the two extremes represented by the certainty of necessity and certainty impossibility. He distinguishes uncertainty from risk. In fact, starting from the definition of eventualities, and considering that the same eventuality may appear in the eyes of the observer favorable, indifferent, unfavorable, Gobbi defines the greater or lesser uncertainty as the common characteristic to the three possibilities, depending on the degree with which the same possibilities are known by the subject, and he also limits the concept of risk to the unfavorable scenario. So the author states that there is an uncertainty different from person to person rather than objective uncertainty which is independent from the observation point.

Rowe (1977) claims that the uncertainty is a factor that shapes the characterization of the system. The system has two extreme conditions: known system and not known system. Therefore, the system is expressible in terms of degree of certainty, variable between 0, that represent the condition of certainty, and 1, indicative of the condition of uncertainty. However the uncertainty associated with the lack of information does not always occur in the same way: in some cases, it arises from the unavailability of information able to fully describe the system (uncertainty descriptive); in others, it stems from the absence of information that allow the measurement of the explanatory variables of the system (measurement uncertainty).

Other authors analyze the uncertainty in terms of its relationship with the risk. According to some, as Mowbray, Blanchard and Williams (1969), the concept of uncertainty coincides with concept of risk. For others, however, the two concepts imply distinct conditions. Willet (1901) in his The economic theory of risk and insurance, occurs to the degree of objectification of uncertainty to explain the difference between the two concepts. In fact, according to the American author, uncertainty would reflect mostly the subjective and personal view of the observer; only the part of it called objectified uncertainty, that is about the materialization of an unwanted event, represents the situation of risk. This conception is still more detailed in the Risk, uncertainty and profit of Knight (1977). It occurs several times in the form of measurable uncertainty, other in the form of uncertainty not measurable: the first is associated to events that, being repeatable in time, can be subject to statistical estimation; instead the second is the situation in which it is not objectively estimated the probability of future events, considering the lack of information for statistical purposes. Knight thinks that the conditions of risk subordinated to the possibility of giving to the different results or scenarios of a certain event an objective probability of the event are related to measurable uncertainty, that is typical of the phenomenon unique and unrepeatable, of which may be known the possible outcomes but not the probability with which they can occur.

Part of the doctrine has been moving towards a more subjectivist conception of the binomial risk/uncertainty. De Finetti (1937) and Savage (1954) ascribe the difference between uncertainty and risk to the different knowledge of the events by the parties and not to the possibility to determine the probabilities associated to expected results of any future scenario. According to the authors, only if there are the same degree of knowledge and availability of information in the subjects, we can accept the definition of objective risk given by Knight. Moreover having the same level of knowledge and availability of information in individuals is a rare situation due to information asymmetries. Therefore they recognize the existence of different degrees of subjective probability, that stem from trust attributed by subjects to different outcomes. They do not believe that single level of uncertainty and risk objective exist. From their conception it emerges how difficult is to entrust to objective processes the estimation of a risk. Coase (1937) believes that uncertainty is a variable that can explain the relation enterprise-market and highlight and interpret the decision-making processes that are developed in either. According to this interpretation, the company stands out from the market because of the different way in which it distributes the knowledge: the market knowledge is parceled out among the holders of the property rights and the holders of resources and is coordinated through the communication, prices, the information on action plans of each holder ; in the enterprise, however, knowledge is concentrated in the subject that coordinates, he meets certain limits when he has to decide outside of his specific skills. In this situation he simplifies the choice in order to find the optimal solution. According to Coase the uncertainty is the essential factor in the survival of the enterprise but is unable to explain the phenomena of internalization of certain activities. As Langlois et al (1993) suggests this phenomenon is justified by structural uncertainty because the simple parametric uncertainty, that derived from an insufficient availability of information on some parameters, does not cause any market failure and, therefore, any transfer of assets. Instead there is the structural uncertainty, that affecting the knowledge of the structure of the decision problem, could make it impracticable to determine the contractual relationship and the assignment to the company of a given activity. The uncertainty comes into play even when we talk about business strategies and choices and analysis about the competitive environment that is qualified for its interaction with the company. In the last decade we have seen the gradual decline of the so-called development model financially sustainable in favor of a new development model centered on finance.

Compared to the past, when the main purpose of finance was to find coverage for operational activities, today the same financial area has to hold an assist function to strategies. It finds their place in the top management and it plays a central role in planning. Practically, corporate finance has taken a connotation of a discipline that goes beyond the specific problems related to the exercise of the responsibilities of management of the industrial enterprise, and became a useful instruments for a global management of the enterprise (Paravani 2002)

So the management has to set clear and exact financial strategies, maintaining equilibrium with the relative system, that in this case is represented by the financial system. This is necessary to prevent the different policy actions may conflict and could affect the achievement of the major goals of the enterprise. Moreover, the same dependence on the financial system leads to a bigger uncertainty in the company. Indeed the excessive volatility of financial markets exposes the company to a situation in which there are a lot of emergent phenomena and evolutionary forces that are difficult to anticipate.

From here the opportunity to search, under a strategic profile, appropriate corrective actions, relating in particular to the relational capacity that has a decisive role. In particular, the development of relational skills can go as far as to set up a real power when the company has the ability to influence the decisions of the systems connected to it, because these systems are intersected with its strategic designs. This must be consistent with a particular vision of power, which is defined as the relationship that allows to link two or more subjects, allowing to a share of resources, knowledge, services and anything else is necessary for the realization of their targets.

It's clearly a concept far from ordinary concept, that looking in power the specific condition of the individual firm, independent from the relationships with other companies, but which does not necessarily involve the same ability to influence all stakeholders interested at the relationship. In fact this type of relationship evolve in a relation in which only one of the two parties reaches advantages, considering its greater power. So this relational capacity is to be referred to all external systems. Some systems are directly connected to the business system and others have only a link that derived from the consequences produced by the decisions taken on the dynamics of the company.

In the first group there are: customers, suppliers, lenders, due to their ability to influence directly the dynamics of the enterprise; instead in the second group there are the different fields of the Public Administration. These measures are able to affect the life of the enterprise. In particular the most important measures are: tax law, since its content are very complex and change over time, and it is difficult to interpret them; legislation relating to employment; the measures that want to stimulate technological innovation and exports. Even the relational capacity is important for the determination of uncertainty. The uncertainty increases when intersystem relations become weaker and when the inability to establish lasting and stable relationships between different systems grow. In particular an insufficient ability to relate to the financial system may increase the uncertainty of the company, influencing the possibility of use external resources to feed its financial requirements. If the company is unable to empathize with the objectives of the financial system due of a lack of communication or a real critical conditions that denote a lack of solvency, the company unlikely can procure itself financial resources and, in any case, if it can do, certainly not with the timeliness typical of a company destined to survive over time. This is the reason why the financial performance of the company are part of skills of the management. Both liabilities and assets, which have their own variability and an administrative dynamic rather than a strategic dynamic, have a specific characterization that affect the degree of flexibility of the company. In this sense the overall concept and evolutionary dynamics of the company emerges.

However, from here moves the strong commitment oriented to search financial solutions that allow enterprise to find the resources that arise from its competitive strategies and to minimize its vulnerability to the external environment. (Colombi, 1989)

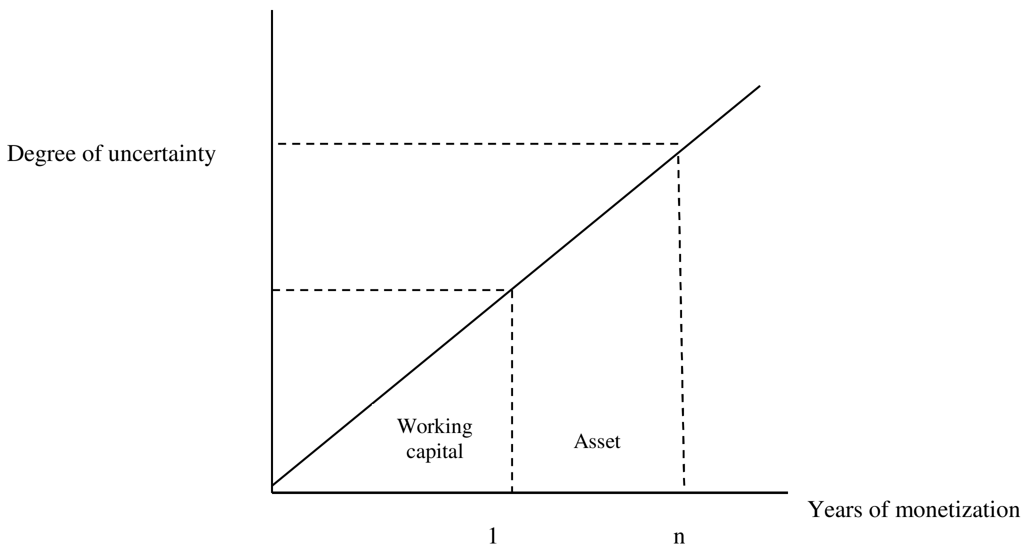
In this perspective, some management decisions affect financial flexibility. With financial flexibility higher levels of certainty business performance are achievable. Thanks to the flexibility the company is able to meet its needs without difficulty and with contained times. So the finance must ensure the ability to liquidate huge resources rapidly to support the needs of operational flexibility, investment in research and development, and corporate finance transactions that have goals like external development, the acquisition of new markets, the achievement of new technologies.

Therefore the financial flexibility is a factor that affect competitiveness. Are not rare the cases, in which the enterprise has to make big investments in its productive structure, investments with short time horizon. Sometimes this is necessary because the framework is very variable. i.e. we can talk about investment in technological innovation, that often require early adoption over competitors to generate real growth of the company in terms of competitiveness and all this is possible if the company is able to procure financial resources in a timely and economical way.

The management have to add to their decisions priority the maximization of funding opportunities that can be taken to cover the company's needs. The management should not only look at the financial structure to reduce the cost of capital, but also with the aim to create the best conditions in order that the company can, also under the financial point of view, set the most appropriate strategic actions, considering the evolution of the competitive environment. If these conditions lack, the financial variable gets to be a constraint for the enterprise system and becomes a factor that aggravates the uncertainty of business results.

In this regard, it is necessary to limit the tendency to accentuate the degree of aggressiveness of the net financial position, increasing the incidence of current liabilities on all the financial resources, in the belief that such position is able to exploit better any opportunities in the short term given by the financial market. Otherwise there is a risk of an inexorable deterioration of global uncertainty, because the cost of short-course is more variable than other sources in the medium and long term, and because increases in short-term accentuates the inability of a business to replace their maturing debts.

Fig.1 Function of uncertainty respect to the time



In the financial dimension, the uncertainty may also have originated from the structure of liabilities. Structure is due to the strategic actions taken by the manager. i.e. there is no doubt that the decisions about the type of production, the form of the process, the type of distribution, determine a specific temporal composition of liabilities that will last over time. In fact, the composition of the working capital and the composition of the fixed capital change due to management decision, while the percentage distribution between them remains stable.

As regards the assets, the uncertainly is characterized by the different times of monetization and any difficulties that may arise in the phase of transformation of investment in flows. With the exception of the immediate liquidity, all assets are subject to the risk of monetization in different times than those previously envisaged. Besides the translation of gross working capital in cash happens in a period of time that does not go beyond one year. But the translation of tied-up capital require medium and long term. In particular the process of monetization of fixed assets, financial, material and immaterial, has a greater uncertainty than the monetization of working capital: the more extensive is the period of time over which you develop a certain process, the greater the possibility that new factors , which are difficult to predict ex ante, can influence the results.

The financial uncertainty may affect the company also indirectly through the effects on the creation of value from financial services that the company intends to offer to its customers.

Credits that are granted in conjunction with the products sold and relieve the buyer from the obligation to find the financial resources. They represent both real levers of differentiation, able to build customer loyalty and, therefore, to reduce the possibility that the customers move to competitor, and an opportunity to make the relationship with customers less vulnerable with the aim of improving the certainty of the performance of the company.

In some companies these services are autonomous areas of operation. For example, factoring and leasing, consumer credit. They are areas that are integrated to the typically industrial areas. So there is stabilization of performance, thanks to the diversification of operations. In this way they have areas that move in an anti cyclical direction compared to the industrial dynamics.

The financial flexibility

In practice it may be that corporate liquidity needs arise in a sudden and unpredictable way that it is not compatible with the time of monetary acquisition provided by financial management.

Sometimes those needs arising from extraordinary and unexpected events, capable to create unplanned needs and unpredictable outflows ex ante, with negative effects on the corporate treasury.

In the majority of cases, these needs are produced by the variations of the incoming flows, which are characterized by a congenital uncertainty, particularly as regards the timing of real realization. Just think of the widespread delays in collects of customers credits and in the grant of funds compared to what had been agreed or planned.

Regardless their origin, when this contingencies come out the company is exposed to financial stress that can affect its short-term solvency or forcing the firm itself to resort to extraordinary measures that may be uneconomic. Some extraordinary measures are: clearance sales of products or stocks, granting of discounts for the collection of bills, prejudicial acceptances of transactions in progress, referrals of new investments. On the contrary the same operations have different nature when they are aimed at economic objectives rather than objectives of extraordinary financial funding. Following some examples of non-detrimental economically appropriate decisions that allow to stem operating losses: the liquidation of part of the warehouse when it is imposed by market requirements, that arise from the changing tastes of customers or affirmation of new competing products in the market; the transaction in onerous conditions of a credit otherwise destined to become payable. If the financial management has prepared a sufficient supply of resources and potential resources, which resources may be used to cover deficits unpredictable ex-ante, the adverse effects of changes in inflows and outflows are avoidable or attenuated.

This is called elasticity reserve that differs from the liquidity reserve defines by Guatri (1990) as the set of availability that allow the management to deal with deficits treasury both expected and unexpected.

In particular, according to the Author, the reserve accomplishes more than one function: it arranges in advance the monetary resources allocated to cover future increases in the investments planned by the finance department; it provides resources necessary to deal with any differences in the dynamics of planned investments and divestitures; finally it absorbs decreases foreseen in financing debt and in merchant credit granted by suppliers, and it also covers unexpected contractions of these forms of borrowing.

The elasticity reserve looks only to unforeseen events that generate implications in corporate treasury and can create serious financial stress in business management.

In elasticity reserve events expected are excluded. The expected events are not considerate because they are already recognized in the cash budget. So it is a programming tool complementary to the treasury budget.

There are not general rules to apply to all companies to determine this reserve because it is necessary to assess the specific problems of each company. First you need to measure the degree of reliability of the estimates expressed in the budget, in fact the risk of unexpected events tends to increase when we predictions unreliable.

In this regard, it may be helpful to look back and analyze the gaps that emerged in previous years.

Second, it must consider all the factors that determine implications on the reliability of forecasts and that therefore affect the level of risk. Among them the following are of particular relevance:

- company's financial structure;
- corporate structure;
- amount of credits;
- trend of the main components of the budget during the previous years.

About the financial structure, the company may proceed with the detection of the degree of existing debts, the possible imbalance in favor of short-term liabilities, and the effects on this factor due to the implementation of the business plan. It is known that when the leverage and impact of short-term liabilities increase, the riskiness of the company grows, and thus also the possibility that the business results can deviate from the values included in the program grows.

Similarly, regarding the corporate structure, it is essential to ascertain the presence of signs of economic crisis in any subsidiaries, since any failure of these could result in the devaluation of their investments included in the balance sheet of the parent company. Even worse a crisis in subsidiaries could transform credit in non-performing loans.

It is necessary to check both the analysis of exposure to the subsidiaries and the average amount of receivables from customers, as well as the health of the customers, since the most of cash inflows derives from the collection of customer credit. The sizing of the elasticity reserve also requires an estimate of the level of change related to plans drawn up by corporate management. More programs will be innovative, the greater the uncertainty of the same. After quantifying the resources needed to minimize the risk of future financial strains, the company must proceed with the determination of the amount of financial resources available.

In the first instance, it can be supposed that these resources coincide with the items of the balance sheet. In fact, usually the items of the assets of the balance sheets are considered as financial resources of the company. However this is a very simplistic representation of the elasticity reserve available and is not able to provide a complete picture. In fact, with this simple definition we include those resources that are not actually liquidated because insufficient to generate cash resources in the way required to cover unexpected cash deficits. Instead we must consider only resources liquidated in compatible time with any monetary needs of management. I.e., the corporate properties that are not used for productive purposes, nevertheless they represent financial resources, they are not always liquidated in times dictated by the sudden monetary needs. Even the assets used in the production cycle are not sure to be sold quickly and at a price in line with the book value of the same. Moreover these transactions may prejudice the productive activity of the enterprise.

In conclusion, the available stock consists of all the available resources which can be liquidated promptly and their divestment will not affect company activity. So we do not consider only the balance sheet, but also include any overdraft usable as already agreed by lenders.

An exact quantification of the elasticity reserve available to the financial management also involves the identification of other resources that although being not currently owned by the company certainly they will become usable at the time when it reveals the necessity. They are the so-called potential liquid resources which are represented by loans that can be granted in the future without difficulty, despite today they have not yet negotiated.

If the company:

- has not exhausted its possibilities of bank debt;
- has still the possibility to resort to capital increases since company has always fully met the expectations of partner remuneration;
- can still count on a particular bargaining power with suppliers having always respected the agreed payment terms.

In this set of potential liquid resources we can include the additional loans by the lenders, the expansion of merchant credit granted by suppliers and possible contributions by the shareholders.

The available elasticity reserve determined by the method just mentioned however, must be compared with the financial need in order to contain unexpected changes in the assets and in liabilities.

From this comparison we can find a surplus of available resources than financial need or a disproportion of the latter than the available resources.

In the first case, the program provided by the company management appears sustainable and with a risk that is not particularly high. So we have only to check if the elasticity reserve is not too big compared to financial need. This last control is necessary to avoid the situation on which there are fruitless financial resources. In this case these resources could be used to reduce debt, to contain the impact of financial charges, to improve business operations.Instead, if the available resources are insufficient, future plans would be too risky and unsustainable. If the management company is not willing to be exposed to a risk as high or it is not objectively possible to acquire adequate financial resources, the program must inevitably be reduced.

The uncertainty and the creation of shareholder value

The company can be defined as an abstract place where different actors (stakeholders) exchange resources by engaging a dense network of contracts. On the one hand this subject contribute to the activity enterprise, on the other hand they are real stakeholders and uncomfortable interlocutors. In fact, rarely all stakeholders have the same goals: customers push to get the services at favorable conditions for them, workers push for better working conditions and higher pay levels, shareholders insist on maximizing the return of capital invested in the enterprise.

So the management has to combine the different objectives, identifying between opposing interests which interest are a priority in order to guarantee firm's survival.

About this it is widely believed that the aims pursued by shareholders take precedence over others. Much of the theory has been oriented in this direction. They believe that the creation of shareholder value is the main goals. More precisely, this theory of shareholder approach spreads firstly among US scholars. Rappaport (1998) and Van Horne (1980) are two strong supporters: the first, with his theory of capitalism of shareholder value and its strong belief to judge the business strategies for the economic benefit that they bring to shareholders in terms of dividend and capital gain share; the second with his interpretation of the process of value creation, understood as objective in function of which financial decision of a firm must be takem, because this is the only rational guide for directing a company and allocate available resources efficiently in a country.

Subsequently, the shareholder value become common even among European scholars sees the property as a prior over-system related to survival of the enterprise, and therefore confirms the need to link the value to expectations of the property.

According to these positions, the management has to process its decisions with the goal of creating value for shareholder. This does not mean that other purposes of different stakeholder are ignored because it is necessary to maintain an adequate balance with the other systems of reference; but rather simply means that the first objective is to maximize shareholder value, while other interests are residual. Secondary stakeholders are: customers, employees, government, suppliers of goods and providers of debt capital. However in reality both the goals of the primary stakeholders and of the secondary are not always achieved in their fullness, often due to

unexpected events that affect the performance of the enterprise, and affect negatively the performance of the equity. In this sense, we can argue that the creation of value is influenced significantly by the uncertainty in business.
First, shareholders are exposed more than other stakeholders because they bring risky capital that is related to changes in the performance of the enterprise. While workers, suppliers and lenders are protected from legal point of view, as regards the remuneration, the deadlines agreed, however the property cannot boast those types of law, considering that both ordinary remuneration and integrative remuneration of risky capital depend on performance of company, dividend policy and the need for self-financing. For example, despite the achievement of a substantial net profit, the company may decide to postpone the payment of dividends, since it intends to accomplish an investment that involve a financial need that cannot be satisfied only with the debt capital.
In short, the return on equity is influenced both from effects of the uncertainty of business performance, both from the constraints imposed by the strategic actions that the corporate governance unit has set to achieve.
Moreover there is the instability that management is able to generate when it subordinates the achievement of corporate objectives to their own interests. In fact often the manager optimizes its own interests and meets only partially the expectations of shareholders. So the manager violates the agency relationship that links it to the property. The agency relationship says that manager work as agent in order to achieve the maximization of shareholder value. This opportunistic behavior is demonstrated by recurrent cases of self-recognition of higher pay levels and/or by special fringe benefits, which marginalize the targets of the property. This discrepancy between the management and ownership is not only a problem of our days, and has implications on the uncertainty and instability of the firm. But today this issue has reached levels unimaginable until a few years ago, mainly because of the increased importance achieved by the markets, which feeds the creation of asymmetric information between managers and shareholders. This is more remarked in listed companies that have scattered capital on the market. The property becomes a hostage of the same manager. Individual shareholders have little chance to influence the designation and especially the decisions of the board. The principal (shareholder) has to check carefully agents in order to prevent this phenomenon, or at least to mitigate the effects on the value and on the survival of the company. Obviously this activity involves costs (agency costs). Some costs are supported primary in order to monitor the work made by managers, certifying budgets and/or making administrative systems more reliable and timely. While others are figurative, as costs related to the restriction of freedom of actions of managers and the costs represented by the" limitation of the power of the manager, with the introduction of limits on the possibility of delegate that managers have. The governing body can use incentives with the aim of limiting the uncertainty generated by the asymmetry of information. In this way agent should work in the interests of property. This mechanism is implemented thanks to the determination of reward systems connected to the results obtained and to the appreciation of the securities of the company. So value culture is infused into the management. The best known example is the stock option, which was born in the Anglo-Saxon company and rapidly has spread in other countries. Stock options give the manager the right to purchase a certain amount of shares of the company with very favorable terms. These are forms of remuneration in the long time and connected to the performance of the company, and so the enable to bring near convenience for the manager and the convenience for shareholder. In this way both managers and shareholders will give much attention to certainty and stability of the business. Clearly, the different incentive plans do not produce all the same results: the incentive mechanisms based on increase of revenue and/or on increase in prices are less popular and therefore they are little used; mechanisms based on parameters such as EVA are more successful . However, such systems are particularly useful in countries like Italy, where the phenomenon seems less diffused than in other contexts. In fact in Italy there are: business holdings articulated on various levels; a modest degree of dispersion of control;a lot of shareholder that have huge percentage of risky capital.

Conclusion

At company level, uncertainty cuts across the whole enterprise, involving all decision-making present in it, from production planning, procurement of inputs, the location of the new plant and the marketing as a whole. As such, it assumes strategic importance and becomes relevant to the governing body, whose activity, therefore, can not disregard it. More precisely, between uncertainty and activity of the summit business, setting up a bi-directional relationship, since large part of the organ of government decisions affecting the uncertain height of the enterprise as well as the same uncertainty affects decisions governing body, directing the choices of some actions strategic rather than on others. The uncertainty is a topic that leaves open questions in doctrine and is subject to further study. Investing the entire business system, the analysis can be extended to the uncertainty in the operational area and in the internationalization processes.

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