

Risks and its types essay sample



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Stand-Alone Risk

This risk assumes the project a company intends to pursue is a single asset that is separate from the company's other assets. It is measured by the variability of the single project alone. Stand-alone risk does not take into account how the risk of a single asset will affect the overall corporate risk.

Corporate Risk

This risk assumes the project a company intends to pursue is not a single asset but incorporated with a company's other assets. As such, the risk of a project could be diversified away by the company's other assets. It is measured by the potential impact a project may have on the company's earnings.

Market Risk

This looks at the risk of a project through the eyes of the stockholder. It looks at the project not only from a company's perspective, but from the stockholder's overall portfolio. It is measured by the effect the project may have on the company's beta. This deals with unfavorable price or volatility that affects the assets contained in a firm's or fund's portfolio. It can be defined as the doubt of a financial institution's earnings which results from changes in market conditions such as the price of an asset, interest rates, market volatility and market liquidity.

Liquidity Risk

The possibility that the cash available to a bank exceed by customer's calls on it, or the income generated by a corporation, along with the funds raised through equity or debt issuance and/or borrowing, are insufficient to cover

operating commitment forcing the corporation to stop operations. It can also be through thin markets sometimes resulting from distractions, which result in the unavailability of hedging instruments at economic prices. Most institutions generally face two types of liquidity risk, the first relates to the depth of markets for definite products and the second to funding the financial-trading activities of the firm. For example, some firms have contract limits for every futures contract based on the volume of turnover and outstanding. Senior managers have to develop methods to identify and monitor the firm's liquidity sources to ensure it can meet the funding demands of its activities. This is achieved by examining the differences in maturities between assets and liabilities and by analyzing future funding requirements based on various assumptions, including the firm's ability to settle down positions quickly in adverse conditions.

Credit Risk (Counterparty Risk)

This risk may occur due to the non-payment by the borrower or counterparty such that loans, bonds or leases will not be repaid on time or in full or the counterparty will fail to perform on an obligation to the institution. The likelihood of this happening is calculated through the repayment record or default rate of the borrowing entity, determination of market conditions, and default rate of a loan portfolio of similar borrowers.

Sovereign Risk

This is the risk that a government action will interfere with repayment of a loan or security. This is measured, by the past performance of the nation and present default rate and situation such as political, social and economic. It is

controlled by severe credit analysis, limiting exposure as a percentage of portfolios, and incorporating covenants into the loan documents.

Settlement Risk

This refers to the risk that an expected settlement payment on a commitment will not be made on time due to bankruptcy, inability or time zone differential and it is related to credit risk but not identical. For example, a bilateral obligation in which one party makes a required settlement payment and the counterparty does not. Settlement risk provides an important inspiration to develop netting arrangements and other safeguards and is also called Delivery Risk.

Interest Rate Risk

The risk due to changes in interest rates results in financial losses related to asset or liability management. It is measured by past and present market instability and the profile of the asset or liabilities of the bank and its possible exposure through gap management.

Foreign Exchange Risk

The risk caused due to the rate change in the foreign exchange that cause foreign exchange denominated assets to fall in value or foreign exchange denominated liabilities to rise in expense. It is measured by marking-to-market the importance of the asset, or raise of the liability, by the actual movement of the exchange rate between the currency of the asset or liability and the currency of the booked or pending asset or liability, or country of earnings return.

Capital Risk

The risk may incur if the institution has insufficient capital for losses, which can result in bankruptcy or regulatory closure. It has a sub-optimal equity-debt capital profile which negatively impacts the market price of its stock. It is controlled by conditions and reserves from past earnings sufficient enough to cover operating losses; and by evaluating the loan, securities and trading operations accurately for any pending losses or deterioration.

Fraud Risk

The risk may occur if the banks own employees or its customers will defraud the bank. This is one of the most complicated situations to measure or control. It is controlled by dividing trading and settlement functions, periodic internal and external audits, and a centralized computer system to track and quickly or accurately resolve the bank's position, portfolio and operations.

Legal Risk

This risk is caused because of claims from dis satisfied employees, clients, improper documentation; criminal or negligent conduct, workplace regulations or environmental defect will severely disrupt the company's operations.

Operations Risk

The risk that human or machine, error or failure will result in financial losses due to documentation scarcity, securities processing, clearing issues, and systems failure. It is difficult to measure errors but the loss can be substantial related to settlement problems or customer liability suits. It is controlled through back-up data processing systems, computerized

accounting or audit system that can flag a problem, and reserves for related losses.

Overhead Risk

The risk that overhead expenses excessively saddle the company's capability. It is measured by the ratio of total expenses or net interest income and total of other income; other expenses tend to rise faster than income in a time of inflation.

Regulatory Risk

The risk that changes in regulations will negatively affect. It is measured by the way a change affect an established operation or restricts entry into a new operation, or affects capital reserve requirements, or operating requirements of the respective national banking regulator.

Economic Conditions Risk

The risk, that an undesirable change in economic conditions can unduly put the bank at risk. It is measured by how the loan portfolio will perform, what interest rates will do, how the securities portfolio may refuse in market value, how liabilities may raise, deposit withdrawals increase resulting in liquidity problems.

Financial Statements

Income Statement Basics

Multi-Step Income Statement

A multi-step income statement is a condensed statement of income as opposed to a single-step format, which is the more detailed format. Both

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single and multi-step formats conform to GAAP standards. Both yield the same net income figure.

The main difference is how they are formatted, not how figures are calculated.

Figure 6. 3: Multi-Step Income Statement

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Sales

These are defined as total sales (revenues) during the accounting period.

Remember these sales are net of returns, allowances and discounts
Cost of goods sold (COGS)

These are all the direct costs related to the product or rendered service sold and recorded during the accounting period. (Reminder: matching principle.)

Operating expenses

These include all other expenses that are not included in COGS but are related to the operation of the business during the specified accounting period. This account is most commonly referred to as "SG&A" (sales general and administrative) and includes expenses such as selling, marketing, administrative salaries, sales salaries, maintenance, administrative office expenses (rent, computers, accounting fees, legal fees), research and development (R&D), depreciation and amortization, etc. Other revenues & expenses

These are all non-operating expenses such as interest earned on cash or interest paid on loans. Income taxes

This account is a provision for income taxes for reporting purposes.

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Balance Sheet

The balance sheet provides information on what the company owns (its assets), what it owes (its liabilities) and the value of the business to its stockholders (the shareholders' equity) as of a specific date.

Total Assets = Total Liabilities + Shareholders' Equity]

Assets are economic resources that are expected to produce economic benefits for their owner. Liabilities are obligations the company has to outside parties. Liabilities represent others' rights to the company's money or services. Examples include bank loans, debts to suppliers and debts to employees. Shareholders' equity is the value of a business to its owners after all of its obligations have been met. This net worth belongs to the owners. Shareholders' equity generally reflects the amount of capital the owners have invested, plus any profits generated that were subsequently reinvested in the company. Balance Sheet Presentation Formats

Although there are no required reporting balance sheet designs there are two customary formats that are used, the account format and the report format. The two formats follow the accounting equation by subtotaling assets and showing that they equal the combination of liabilities and shareholder's equity. However, the report format presents the categories in one vertical column, while the report format places assets in one column on the left hand side and places liabilities and shareholder's equity on the right. Both formats can be collapsed further into a classified balance sheet that subtotals and shows only similar categories such as current assets, noncurrent assets, current liabilities, noncurrent liabilities, etc.

Total Assets

Total assets on the balance sheet are composed of

Current Assets

These are assets that may be converted into cash, sold or consumed within a year or less. These usually include:

Cash

This is what the company has in cash in the bank. Cash is reported at its market value at the reporting date in the respective currency in which the financials are prepared. (Different cash denominations are converted at the market conversion rate. Marketable securities (short-term investments)

These can be both equity and/or debt securities for which a ready market exist. Furthermore, management expects to sell these investments within one year's time. These short-term investments are reported at their market value. Accounts receivable

This represents the money that is owed to the company for the goods and services it has provided to customers on credit. Every business has customers that will not pay for the products or services the company has provided. Management must estimate which customers are unlikely to pay and create an account called allowance for doubtful accounts. Variations in this account will impact the reported sales on the income statement.

Accounts receivable reported on the balance sheet are net of their realizable value (reduced by allowance for doubtful accounts). Notes receivable

This account is similar in nature to accounts receivable but it is supported by more formal agreements such as a “ promissory notes” (usually a short term-loan that carries interest). Furthermore, the maturity of notes receivable is generally longer than accounts receivable but less than a year. Notes receivable is reported at its net realizable value (what will be collected). Inventory

This represents raw materials and items that are available for sale or are in the process of being made ready for sale. These items can be valued individually by several different means - at cost or current market value - and collectively by FIFO (first in, first out), LIFO (last in, first out) or average-cost method. Inventory is valued at the lower of the cost or market price to preclude overstating earnings and assets. Prepaid expenses

These are payments that have been made for services that the company expects to receive in the near future. Typical prepaid expenses include rent, insurance premiums and taxes. These expenses are valued at their original cost (historical cost). Long-term assets

These are assets that may not be converted into cash, sold or consumed within a year or less. The heading “ Long-Term Assets” is usually not displayed on a company’s consolidated balance sheet. However, all items that are not included in current assets are long-term Assets. These are:

Investments

These are investments that management does not expect to sell within the year. These investments can include bonds, common stock, long-term notes,

investments in tangible fixed assets not currently used in operations (such as land held for speculation) and investments set aside in special funds, such as sinking funds, pension funds and plan-expansion funds. These long-term investments are reported at their historical cost or market value on the balance sheet. Fixed assets

These are durable physical properties used in operations that have a useful life longer than one year. This includes: Machinery and equipment

This category represents the total machinery, equipment and furniture used in the company's operations. These assets are reported at their historical cost less accumulated depreciation. Buildings (plants)

These are buildings that the company uses for its operations. These assets are depreciated and are reported at historical cost less accumulated depreciation. Land

The land owned by the company on which the company's buildings or plants are sitting on. Land is valued at historical cost and is not depreciable under U. S. GAAP Other assets

This is a special classification for unusual items that cannot be included in one of the other asset categories. Examples include deferred charges (long-term prepaid expenses), non-current receivables and advances to subsidiaries. Intangible assets

These are assets that lack physical substance but provide economic rights and advantages: patents, franchises, copyrights, goodwill, trademarks and organization costs. These assets have a high degree of uncertainty in regard

to whether future benefits will be realized. They are reported at historical cost net of accumulated depreciation. The value of an identifiable intangible asset is based on the rights or privileges conveyed to its owner over a finite period, and its value is amortized over its useful life. Identifiable intangible assets include patents, trademarks and copyrights. Intangible assets that are purchased are reported on the balance sheet at historical cost less accumulated amortization.

An unidentifiable intangible asset cannot be purchased separately and may have an infinite life. Intangible assets with infinite lives are not amortized, and are tested for impairment annually, at least. Goodwill is an example of an unidentifiable intangible asset. Goodwill is recorded when one company acquires another at an amount that exceeds the fair market value of its net identifiable assets. It represents the premium paid for the target company's reputation, brand names, customers, suppliers, human capital, etc. When computing financial ratios, goodwill and the offsetting impairment charges are usually removed from the balance sheet.

Certain intangible assets that are created internally such as research and development costs are expensed as incurred under U. S. GAAP. Under IFRS, a firm must identify if the R&D cost is in the research and development stage. Costs are expensed in the research stage and capitalized during the development stage.

Total Liabilities

Liabilities have the same classifications as assets: current and long-term.

Current liabilities

These are debts that are due to be paid within one year or the operating cycle, whichever is longer; further, such obligations will typically involve the use of current assets, the creation of another current liability or the providing of some service.

Usually included in this section are:

Bank indebtedness

This amount is owed to the bank in the short term, such as a bank line of credit. Accounts payable

This amount is owed to suppliers for products and services that are delivered but not paid for. Wages payable (salaries), rent, tax and utilities

This amount is payable to employees, landlords, government and others.

Accrued liabilities (accrued expenses)

These liabilities arise because an expense occurs in a period prior to the related cash payment. This accounting term is usually used as an all-encompassing term that includes customer prepayments, dividends payables and wages payables, among others. Notes payable (short-term loans)

This is an amount that the company owes to a creditor, and it usually carries an interest expense. Unearned revenues (customer prepayments)

These are payments received by customers for products and services the company has not delivered or started to incur any cost for its delivery.

Dividends payable

This occurs as a company declares a dividend but has not yet paid it out to its owners.

Current portion of long-term debt

The currently maturing portion of the long-term debt is classified as a current liability. Theoretically, any related premium or discount should also be reclassified as a current liability. Current portion of capital-lease obligation

This is the portion of a long-term capital lease that is due within the next year. Long-term Liabilities

These are obligations that are reasonably expected to be liquidated at some date beyond one year or one operating cycle. Long-term obligations are reported as the present value of all future cash payments. Usually included are Notes payables

This is an amount the company owes to a creditor, which usually carries an interest expense. Long-term debt (bonds payable) - This is long-term debt net of current portion. Deferred income tax liability

GAAP allows management to use different accounting principles and/or methods for reporting purposes than it uses for corporate tax filings (IRS). Deferred tax liabilities are taxes due in the future (future cash outflow for taxes payable) on income that has already been recognized for the books. In effect, although the company has already recognized the income on its books, the IRS lets it pay the taxes later (due to the timing difference). If a company's tax expense is greater than its tax payable, then the company has created a future tax liability (the inverse would be accounted for as a deferred tax asset). Pension fund liability

This is a company's obligation to pay its past and current employees' post-retirement benefits; they are expected to materialize when the employees take their retirement (defined-benefit plan). Valued by actuaries and represents the estimated present value of future pension expense, compared to the current value of the pension fund. The pension fund liability represents the additional amount the company will have to contribute to the current pension fund to meet future obligations. Long-term capital-lease obligation

This is a written agreement under which a property owner allows a tenant to use and rent the property for a specified period of. Long-term capital-lease obligations are net of current portion. Components of Shareholder's Equity

Also known as " equity" and " net worth", the shareholders' equity refers to the shareholders' ownership interest in a company.

Usually included are:

Preferred stock

This is the investment by preferred stockholders, which have priority over common shareholders and receive a dividend that has priority over any distribution made to common shareholders. This is usually recorded at par value. Additional paid-up capital (contributed capital)

This is capital received from investors for stock; it is equal to capital stock plus paid-in capital. It is also called " contributed capital". Common stock

This is the investment by stockholders, and it is valued at par or stated value. Retained earnings

This is the total net income (or loss) less the amount distributed to the shareholders in the form of a dividend since the company's initiation. Other items

This is an all-inclusive account that may include valuation allowance and cumulative translation allowance (CTA), among others. Valuation allowance pertains to noncurrent investments resulting from selective recognition of market value changes. Cumulative translation allowance is used to report the effects of translating foreign currency transactions, and accounts for foreign affiliates.

Stockholders' Equity Statement

Instead of presenting a detailed stockholders' equity section in the balance sheet and a retained earnings statement, many companies prepare a stockholders' equity statement.

This statement shows the changes in each type of stockholders' equity account and the total stockholders' equity during the accounting period. This statement usually includes:

- * Preferred stock
- * Common stock
- * Issue of par value stock
- * Additional paid-in capital
- * Treasury stock repurchase
- * Cumulative Translation Allowance (CTA)
- * Retained earning

Statement of Cash Flow

The statement of cash flow reports the impact of a firm's operating, investing and financial activities on cash flows over an accounting period.

The cash flow statement is designed to convert the accrual basis of accounting used in the income statement and balance sheet back to a cash basis.

The cash flow statement will reveal the following to analysts: 1. How the company obtains and spends cash

2. Why there may be differences between net income and cash flows 3. If the company generates enough cash from operation to sustain the business 4. If the company generates enough cash to pay off existing debts as they mature 5. If the company has enough cash to take advantage of new investment opportunities

Segregation of Cash Flows

The statement of cash flows is segregated into three sections: 1. Operating activities

2. Investing activities

3. Financing activities

1. Cash Flow from Operating Activities (CFO)

CFO is cash flow that arises from normal operations such as revenues and cash operating expenses net of taxes. This includes:

Cash inflow (+)

1. Revenue from sale of goods and services

2. Interest (from debt instruments of other entities)

3. Dividends (from equities of other entities)

Cash outflow (-)

4. Payments to suppliers
5. Payments to employees
6. Payments to government
7. Payments to lenders
8. Payments for other expenses

2. Cash Flow from Investing Activities (CFI)

CFI is cash flow that arises from investment activities such as the acquisition or disposition of current and fixed assets.

This includes:

Cash inflow (+)

1. Sale of property, plant and equipment
2. Sale of debt or equity securities (other entities)
3. Collection of principal on loans to other entities

Cash outflow (-)

4. Purchase of property, plant and equipment
5. Purchase of debt or equity securities (other entities)
6. Lending to other entities

3. Cash flow from financing activities (CFF)

CFF is cash flow that arises from raising (or decreasing) cash through the issuance (or retraction) of additional shares, short-term or long-term debt for the company's operations. This includes: Cash inflow (+)

1. Sale of equity securities
2. Issuance of debt securities

Cash outflow (-)

3. Dividends to shareholders
4. Redemption of long-term debt
5. Redemption of capital stock

Reporting Noncash Investing and Financing Transactions

Information for the preparation of the statement of cash flows is derived from three sources:

1. Comparative balance sheets
2. Current income statements
3. Selected transaction data (footnotes)

Some investing and financing activities do not flow through the statement of cash flow because they do not require the use of cash.

Examples Include:

Conversion of debt to equity

Conversion of preferred equity to common equity

Acquisition of assets through capital leases

Acquisition of long-term assets by issuing notes payable

Acquisition of non-cash assets (patents, licenses) in exchange for shares or debt securities

Though these items are typically not included in the statement of cash flow, they can be found as footnotes to the financial statements.

The Indirect Method

The indirect method is preferred by most firms because it shows a reconciliation from reported net income to cash provided by operations.

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Calculating Cash flow from Operations

Here are the steps for calculating the cash flow from operations using the indirect method: Start with net income.

Add back non-cash expenses. (Such as depreciation and amortization) Adjust for gains and losses on sales on assets.

Add back losses

Subtract out gains

Account for changes in all non-cash current assets.

Account for changes in all current assets and liabilities except notes payable and dividends payable.

In general, candidates should utilize the following rules:

- * Increase in assets = use of cash (-)
- * Decrease in assets = source of cash (+)
- * Increase in liability or capital = source of cash (+)
- * Decrease in liability or capital = use of cash (-)