

# Accounting risk and return



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The paper "Accounting Risk and Return" is a good example of an essay on finance and accounting. Financial decisions of any type contain a relationship between risks taken and returns expected from such decisions. These decisions have a great impact on the profitability of the entity. Accordingly, in this study, an effort has been made to analyze the importance of the relationship between risk and return. Risks

Risk implies chances of occurrence of losses. More risk means assets have more chances of effecting losses in their exploitations and vice versa. To give an example a \$1000 bond with a 5% yearly interest rate has no risk as it is certain that after the year the bond will yield \$50. On the other hand, \$1000 invested in equities have more risk as it may earn nothing and also there are chances of earning say \$100 as dividend after the year. So equity investment is riskier than investments in bonds. It can be said that the "term risk is used interchangeably with uncertainty to refer to the variability of returns with a given asset." (Lawrence J Gitman, page 226)

### Return on investments

Return on investment on assets is the income yielded on the exploitation of assets for business purposes. Simply, "the return is the total gain or loss experienced on an investment over a given period of time." (Lawrence J Gitman, page 226). Assets generate cash flows and therefore returns on investments is measured in terms of the present value of cash flow generated over the useful life of assets, and deducting therefrom the present value of costs incurred and the residual value of such investments is net income from such assets. We can say that "return on assets provides an indication of how effectively an entity utilized its assets in generating net

income.” (K Scott Proctor, page 229)

### Relationship between Risk and Returns

In order to explain the relationship between risk and returns, we are considering financial assets in this write-up. Financial assets are expected to generate cash flows and hence the riskiness of an asset is measured in terms of the riskiness of its cash flows. The riskiness of an asset may be measured on a standalone basis or in a portfolio. An asset may be very risky if it is held by itself but may be much less risky when it is a part of a large portfolio.

In the context of the portfolio, risk can be divided into two parts:

Diversifiable risk and market risks. Diversifiable risks arise from firm-specific factors and hence can be washed away through diversification. Market risk emerges from market conditions and cannot be diversified away. “ The risks that arise from firm-specific effect one or a few investments, while the risk arising from market-wide reasons affect many or all investments. This distinction is critical the way we assess risk in finance” (Aswath Damodarn, page 66) Firm-specific risk is also called unique- risks. Considering from portfolio management unique or firm-specific risks can be eliminated by making suitable changes in the portfolio, but market risks are unavoidable. Generally, investors in financial assets are risk-averse. So they want to be compensated for bearing market risks. In a good order market, there is a linear relationship between market risk and expected returns, and that is explained hereinafter.

Liner relationship of risk and awards

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The risk of an asset can be measured by using measures like standard deviation and coefficient of variation. These methods measure the variability of asset returns. Standard deviation is an indicator of an asset's risk. “

Investment with higher returns have a higher standard of deviation. Because higher standard deviations are associated with greater risks. That relationship reflects risk aversion by market participants, who require higher returns as compensation for greater risks.”(Lawrence J Gitman, page 236)<sup>5</sup>

Coefficient of variation is a measure of relative dispersion useful in comparing risks and returns. “ Coefficient of variation is a measure of relative variation, whereas the standard deviation is a measure of absolute variation.”(Larry J. Stephens, page 53)<sup>6</sup> It is considered and historically established that investments with a higher coefficient of variation are supported by greater risks and thus higher expected returns.

Then there is a role of the concept of correlations in diversifying the risks in a portfolio. Correlation is a measure that provides relationships between two series of results, like investments and actual returns. Through correlation, a relationship between investments and returns can be established. It is always better to diversify by combining positively correlated assets with negatively correlated assets in a portfolio to achieve some kind of balance in portfolio investments to reduce overall variability of returns, that is to say over the range of risks.

Thus there exist a linear relationship between risks and returns in the sense that investments with a higher standard of deviations and a high coefficient of variation tend to provide higher returns. Similarly by establishing correlated relationships between investment and returns, and then mixing assets with positive and negative returns in a portfolio in such a fashion that

provides desired results on acceptable risks by the investor.

### Conclusion

Risk and rewards go hand by hand. Higher the risk results in greater rewards. This can be established by computing the standard deviations and coefficient of variations of investments. These measures are an indicator of risks and have historically established the fact that a higher standard of deviation and coefficient of variation of investments provide greater returns. Similarly, by bringing some equilibrium through a correlation between positive and negative returns of assets, it is possible in a portfolio of investment to establish the desired relationship between risk and returns.