

## Answer on Question #50539, Management, Other

"Every financial decision has an impact on the risk return Profile of a firm." Therefore, the financing decision of Working capital of a firm also determines the risk return Profile of a firm with regard to its working capital.

Explanation:

The purpose of business is to maximize revenue at the lowest cost of capital in a competitive environment. Realization of this goal requires of comparing the size of attachments (advanced) in the production and trading activities of capital with the financial results of this activity.

However, the implementation of any kind of economic activity objectively there is a risk of loss, the volume of which is due to the specifics of a particular business. Risk is the probability of occurrence of losses, damages, shortfalls projected revenues, profits. Loss taking place in the business activities can be divided into material, labor and financial.

For the financial manager risk is the probability of adverse outcome. Various investment projects have varying degrees of risk. Risk it is economic category, so it is an event that may or may not occur. In the case of the aforementioned events there are three possible economic outcomes: negative (loss, damage); zero and positive (gain, profit).

We know that there are two fundamental types of financial decisions that the finance team needs to make in a business: investment and financing. The two decisions boil down to how to spend money and how to borrow money. Recall that the overall goal of financial decisions is to maximize shareholder value, so every decision must be put in that context. An investment decision revolves around spending capital on assets that will yield the highest return for the company over a desired time period. The investment decision also concerns what specific investments to make. Since there is no guarantee of a return for most investments, the finance department must determine an expected return. This return is not guaranteed, but is the average return on an investment if it were to be made many times.

The investments must meet three main criteria:

It must maximize the value of the firm, after considering the amount of risk the company is comfortable with (risk aversion).

It must be financed appropriately (we will talk more about this shortly).

If there is no investment opportunity that fills the first item and second, the cash must be returned to shareholder in order to maximize shareholder value.

All functions of a company need to be paid for one way or another. It is up to the finance department to figure out how to pay for them through the process of financing. There are two ways to finance an investment: using a company's own money or by raising money from external funders. Each has its advantages and disadvantages.

There are two ways to raise money from external funders: by taking on debt or selling equity. Taking on debt is the same as taking on a loan. The loan has to be paid back with interest, which is the cost of borrowing. Selling equity is essentially selling part of the company. When a company goes public, for example, they decide to sell their company to the public instead of to private investors. Going public entails selling stocks which represent owning a small part of the company. The company is selling itself to the public in return for money.

Thus we can conclude that every financial decision has an impact on the risk return Profile of a firm.

Generally firms characterized by high risk have a higher marginal product of relative to firms with low risk. In the market value specification, consistent with real options theory of investment under uncertainty, the impact of risk is positive and significant, and inclusion of the risk term substantially reduces the coefficient on capital.

The purpose of financial risk management is to reduce the losses associated with this risk to a minimum. Losses can be estimated in terms of money, estimated as steps to prevent them. The financial manager must balance these two estimates and plan how best to strike a deal with the sense of minimizing risk.

Economical protection is to forecast the level of additional costs, assessing the severity of possible damage, the use of all of the financial mechanism to eliminate the threat or risk the consequences. In addition, the well-known basic risk management techniques: avoidance, asset and liability management, diversification, insurance, hedging.

Every company seeks the most effective asset and liability management, which in turn represents certain financial decisions, aims careful balancing of cash, investments and liabilities in order to minimize the change in net worth.

Asset and Liability Management aims to avoid excessive risk by dynamically adjusting the basic parameters of the portfolio or project. In other words, this method is aimed at regulating the exposure to risk in the activity itself. Obviously, dynamic asset and liability management implies a rapid and effective feedback between the center of decision-making and management entity. Asset and liability management is most widely used in banking practice to monitor the market, mainly currency and interest rate, risk.

Diversification is a way to reduce the total risk exposure due to the distribution of funds between the various asset prices or yield of which is weakly correlated with each other. Diversification avoids the risk of the equity in the distribution between the various activities. For example, an investor purchasing shares in five different corporations instead of shares of one company increases the likelihood of them average income five times and five times, respectively, reduces the degree of risk. Diversification is one of the most popular mechanisms to reduce market and credit risk in the formation of a portfolio of financial assets and portfolio of bank loans, respectively.

However, diversification can reduce investment risk to zero. This is due to the fact that the business and investment activities of an economic entity is influenced by external factors that are not associated with the selection of specific objects of capital investment, and therefore are not affected by diversification.

Capital Asset Pricing Model (CAPM) is the valuation model yields of financial assets provides a theoretical basis for a number of different financial management technologies yield and risk applicable to the long-term and medium-term investments in shares.

CAPM considers earnings per share, depending on the behavior of the market as a whole. Other initial assumption CAPM is that investors make decisions, taking into account only two factors: the expected return and risk. Many large investment structures are used by this model is a simplified representation of the financial market, in its activities. According to the CAPM allocated systematic and unsystematic risk. Systematic risk is due to general market and economic changes affect all investment instruments and are not unique to a particular asset. Unsystematic risk associated with a particular issuing company. The CAPM is based on the assumption that investors are risk averse, i.e. they ask a larger reward for carrying higher risk.

With the help of the CAPM, we may determine the return of each risky asset being part of the market portfolio in the equilibrium of capital markets. It is a combination of the premium for accepting the systematic risk associated with the risky asset and the return on the risk-free asset. The relationship between systematic risk and return for each risky asset is linear and may be given by the security market line.

$$E(r_i) = r_f + \beta_i(E(r_m) - r_f)$$

Where  $E(r_i)$  is the expected return on investment  $i$ ,  $\beta_i$  denotes the systematic risk of asset  $i$ .  $r_f$  represents the risk-free rate of return, whereas  $E(r_m)$  refers to the expected return on the market portfolio.

Consequently, the NPV of the customer segment would be (under the assumption of time invariant costs of capital) given by the expected cash flows, discounted by the segment-specific risk-adjusted WACC ( $CF_{t,i}^{in}$  denotes the cash inflows of customer segment  $i$  in period  $t$ , whereas  $CF_{t,i}^{out}$ , represents the corresponding cash outflows):

$$CLV_i = \sum_{t=1}^T \frac{CF_{t,i}^{in} - CF_{t,i}^{out}}{(1 + r_f + \beta_i((E(r_m) - r_f)))^t}$$

The higher the risk of a customer segment, the higher the rate of return shareholders will require for investing in that customer segment. To calculate the value of the customer base as a whole, the  $CLV_i$  of the individual customers may be aggregated since the Beta values for all assets are linearly additive. Therefore, the CAPM allows first of all for the determination of the customer value on an individual level, wherein the return and the risk of a customer are taken into account. Furthermore, the value of the customer base and its contribution to shareholder value may be derived.

Management of working capital includes principles, technologies and methods of decision-making related to the optimization level of current assets and current liabilities, as well as their monitoring. Working capital management is an integral part of operational and strategic financial management, is most often made to identify with their own working capital is defined as the difference between current assets and current loan obligations.

Effective policy requires consideration of the working capital of the joint impact of the financial and investment decisions on the risks and profitability of the company as the main characteristics of its strategy. Yield in this case is measured by profitability (operating) total assets (operating profit per unit of assets). Default risk is determined by the size of the working capital. The higher the working capital, the lower the risk, but higher return on assets, and vice versa: a small amount of working capital entails high risks and reduced profitability.

A company should have working capital policies on the management of inventory, trade receivables, cash and short-term investments in order to minimize the possibility of managers making decisions which are not in the best interests of the company. Examples of such suboptimal decisions are giving credit to customers who are unlikely to pay and ordering unnecessary inventories of raw materials. Sensible working capital policies will reflect corporate decisions on: the total investment needed in current assets, i.e. the overall level of investment; the amount of investment needed in each type of current asset, i.e. the mix of current assets; and the way in which current assets are to be financed.

Working capital policies need to consider the nature of the company's business since different businesses will have different working capital requirements. A manufacturing company will need to invest heavily in spare parts and components and might be owed large amounts of money by its customers. Working capital policies will also need to reflect the credit policies of a company's close competitors, since it would be foolish to lose business because of an unfavorable comparison of terms of trade. Any expected fluctuations in the supply of or demand for goods and services, for example due to seasonal variations in business, must also be considered, as must the impact of a company's manufacturing period on its current assets

The trade-off between risk and return which occurs in policy decisions regarding the level of investment in current assets is also significant in the policy decision on the relative amounts of finance of different maturities in the balance sheet, i.e. on the choice between short- and long-term funds to finance working capital.

The cycle of the Working capital begins with the purchase of raw materials which can be found in the inventory Later on, these raw materials are transformed in finished goods. These goods are stocked in the inventory until they are sold to a customer. The sale can be purchased by cash or by trade credit. This trade credit provides a delay until the cash is received. With every step of the cycle there are associated costs, which are direct costs and opportunity costs. The direct costs are the cost of capital invested in each part of the cycle, for example interest on the debt finance to sustain trade creditors. The opportunity costs are represented by the possible returns forgone by investing in working capital instead of some alternative investment opportunity.

Working capital management is vital for a firm, especially for manufacturing, trading and distribution firms, because in these firms WCM directly affect the profitability and liquidity. This is because for these firms it accounts for over half their total assets. It is possible that inefficient WCM can lead to bankruptcy, even if the profitability of a firm is constantly positive. A reason for this could be that excessive levels of current assets can easily lead to a below average return on investment for a firm. An efficient WCM has to manage working capital in such a way that it eliminates risks of default on payment of short-term obligations on one side and minimalizes the change of excessive levels of working capital on the other side.

Efficient working capital management includes planning and controlling of current liabilities and assets in a way it avoids excessive investments in current assets and prevents from working with few current assets insufficient to fulfill the responsibilities. In relevant studies the measure taken as an indicator of efficiency in working capital management is usually cash conversion cycle. Working capital level of a firm indicates that it wants to take a risk. The more working capital amounts, the lower liquidity risk and profitability become.

Statements in finance literature about the importance of working capital for firms are being once more emphasized in these turbulent days of global economies. While firms make efforts to increase return on assets in a way they pay their due obligations as late as possible and keep the cash, decreases in activity volume decreases the cash flow, too and this case increases the liquidity risk. All these raise the importance of working capital.

So we can conclude the following, the value of working capital is insufficient indicator to assess the effectiveness of its use as well as for an unambiguous conclusion about the impact on the risk return Profile of a firm with regard to its working capital. If we talk about the indicators of the Rate of return, then yes, definitely value it will change as the amount of working capital is reflected in the denominator of the formula for determining the Rate of return (Rate of return =  $\frac{\text{Profit}}{\text{Net fixed investment} + \text{Working capital}}$ ), but argued that only the value of working capital determines the risk return Profile of a firm is not a true statement.

Proper management of working capital can be a key domestic source of financing and a reserve of the enterprise. There is does not exists the one correct ideology and methodology of working capital management. We can adopt a more risk policy, give preference to high liquidity, and can maximize the value added in the short term, to see long-term goals. Working capital policy must be conscious, systematic and involved in the strategic priorities of the company.