The inevitability of financial risks in businesses and how to overcome them: Saudi Arabia in focus

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Abstract

Financial risk is made up of potential volatility or changes in earnings that differ from participants' expectations and estimates of these values. This can have both positive and negative impacts depending on the preferences of risk consumers. The investment climate of a nation, especially for developing economies has a great role to play in the level of financial risks that an organization can be exposed to. Even if the best company in the world hires the best managers obtainable in a field to run a company in a country where the stakes are high as regards risk, the company will most likely show signs of financial risks that may just be inevitable. This study carefully analyzed financial risks in businesses with a focus on efficient management in a developing country like Saudi Arabia, using a qualitative research technique. The research provides additional contributions to discuss on financial risks in corporate organizations by not only highlighting the various types of risks applicable but demonstrated how they apply in Saudi Arabia.

Introduction

Business is not without risks. Thus, people who choose to do business must accept the fact that risks are an integral part of their businesses. Obviously, the biggest concern of all businessmen and entrepreneurs when they do business is that their companies are profitable and impresses spectacularly. While some fear that their businesses may not be profitable enough to support its continued operations and growth, there are those who fear that their businesses may not survive a few years. Some companies that have existed for years, even decades, are still constantly confronted with various types of business risks.

The fact that a business has been operating for more than 5 or 10 years does not mean that the business has become immune to risks. It is possible that the organization is using effective risk management strategies that allow businesses to thrive and even grow. From a financial point of view, risk can be considered as the possibility of a deviation in the expected future, which causes the desired results to be differ from the expected, or uncertainty of the future financial products due to a decision made by an economic person in the present based on the results of a study of the behavior of a natural phenomenon in the past.

There can be both positive and negative meanings depending on the preferences of risk consumers. The phenomenon of loss aversion means that the assessment of losses has a greater impact on peoples' behavior than a similar level of profit. However, risk-loving agents may in some cases take on additional risk (Holton,2004). Risk can also be seen as making differences in the yield between the planned, the required and the expected to occur (Khalid, 2003).

The investment climate of a nation, especially for developing economies has a great role to play in the level of financial risks that an organization can be exposed to. Even if the best company in the world hires the best managers obtainable in a field to run a company in a country where the stakes are high as regards risk, the company will most likely show signs of financial risks that may just be inevitable. Corruption, lack of internal control and mismanagement creates enabling environment for risks to thrive. Management issues like lack of control, expertise and transparency can also trigger risk. It is also worth mentioning that governance has emerged as part of a global culture aimed at increasing the participation of various parties in the community with the government in the development and implementation of public policies to express interaction or partnerships between the state, civil society and the private sector to achieve sustainable development (Lavachi, 2019).

Literature Review

Financial risk is made up of potential volatility or changes in earnings that differ from participants' expectations and estimates of these values. This can have both positive and negative impacts depending on the preferences of risk consumers. The phenomenon of loss aversion means that the assessment of losses has a greater impact on people's behavior than a similar level of profit. However, risk-loving agents may in some cases take on additional risk (Holton,2004). Financial risk can occur from sudden changes in exchange rate, commodity prices and interest rates. Business cooperation especially in volatile countries like Saudi Arabia (judging from recent happenings) is susceptible to all these risks especially in the face of increasing global business activities. However, non-financial multinationals can take advantage of financial or operative hedging to shield themselves against these risks.

Management of financial risks should be done by the firm and its shareholders. A number of studies showed that shareholders value can be increased through corporations' risk management in the face of capital market imperfection. Capital. market imperfection can be such as costly external financing, agency conflicts, taxes as well as direct and indirect financing. Proper corporate risk management can make corporations to be more valuable to the benefits of its owners as agency cost could be incurred during the processes. Other benefits could include: Lowering expected cost of bankruptcy, coordination of corporate financing and investment policies, reduction of corporate tax burden and financial distress (Bartram,2002).

Though risk is predictable, but it is always accompanied with other things. That is, the consumption of net risk as a separate product is impossible. As with many products, the consumer's perception and taste for risk may vary depending on experience. Hidden or explicit insurance from government sources can further change consumers' perceptions of risk, thereby making them to favor a more acceptable consumption pattern. These stylized facts allow us to argue that financial risk can be classified as a private product in small products, but when a certain size is reached, the threshold risk is no longer a private product. With increasing thresholds, it becomes a common pool and, as the total financial risk approaches the global system size, it becomes a public good. This "transmutation" of risk into another type of product can cause profound changes in the systemic level of risk, which has manifested itself in the most recent financial crises. Since risk is simply risk, additional products must be added to the original risk unit (s) for this transformation to take place (Congleton, 2012).

The following are various types of financial risks that can occur in a multinational:

Credit risk or default risk arising from the inability of one party to pay or fulfill its obligations to the other, so that they will not be fulfilled. If the company is unable to receive receivables from customers, it will have a poor cash flow and lost revenue.

Market risk arising from a recession in the market, which subsequently leads to a decrease or loss in the value of investments. If business assets decline in value, but everything else remains the same, the company's net worth will also decrease.

Liquidity risk that arises when assets or securities belonging to a business cannot be immediately converted into cash if necessary. This leads to the risk of the enterprise defaulting on its obligations, such as payments on loans to creditors and dividend payments to owners and investors. Owners or board members may ultimately be held personally liable for business debts.

Operational risk that arises from problems or problems in conducting daily business operations, such as equipment breakdowns, failure of business processes, and errors in the workforce. Mistakes made can result in significant financial losses, and this is just one of the many operational risks that enterprises face every day.

Interest rate risk arising from sharp changes in interest rates, in particular, sudden drops that result in financial losses. This is often an offshoot of market risk, since interest rates are directly dependent on changes in the economy.

Foreign exchange risk arising from movements in foreign markets. Currency exchange rates, of course, will affect the profit of a business with foreign operations or conduct foreign transactions. All these risks can be triggered by the following factors:

Instability of the financial market. As a rule, financial markets are unstable and unstable, which can lead to losses for businesses and investors. This instability is often characterized by unstable movements in stock prices and currencies and fluctuations in interest rates.

Economic factors. National economies and various industries can face large-scale problems, a classic example of which is the case of recession. Enterprises can suffer financial losses when a sector-wide economic shift occurs with unstable supply and demand behavior leading to lower prices, lower production and even lower purchasing power of customers.

Actions and decisions of third parties (Counterparty risk). Financial risks can also arise from the actions of external parties such as suppliers, suppliers, competitors and even customers. For example, a business will also suffer if its customers' ability to pay their accounts receivable is impaired. The inability to receive from customers inevitably leads to significant financial losses for the company.

Internal actions (and inaction). Failures in the company's internal processes, systems, and workforce can also increase the organization's exposure to financial risks. If employees refuse to do their job, this can lead to low productivity and, as a result, to a low level of production. This means low inventory levels and fewer goods sold, which ultimately leads to lower incomes.

Legal interventions. Often, governments develop new laws or update existing ones that will affect the financial aspect of the business. This can increase costs or expenses that will reduce profit margins, or it can also affect the decision-making processes for purchasing customers at the expense of the business.

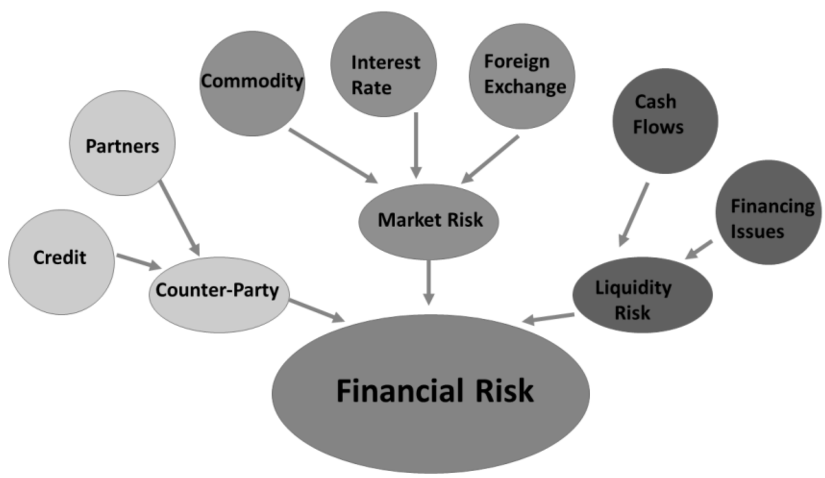

Figure 1: Classification of financial risks
Source: Author

From the foregoing and as illustrated in Figure 1, it is clear that financial risks can emanate from all sides, which makes their prevention or minimization even more urgent. Businesses should be guided by these risks.

An overview of Risk in Saudi Arabia

Saudi Arabia is the largest economy in the Middle East and the richest Arab country in the region. The policy of large-scale public works undertaken by the authorities, as well as foreign direct investment and the reliability of the banking and financial system allowed the country to become the number one and one of the largest regional economy in the world. However, the Saudi economy relies almost entirely on oil. GDP growth has gradually decreased since 2015 to the point where the economy entered into a historical recession in 2017 (-0.7%). Growth was expected to reach 1.9%, and the non-oil economy would grow faster by 2.3% (IMF, 2019).

The IMF reduced its growth forecast for Saudi Arabia in 2019 from 2.4% to 1.9% amid regional and global geopolitical tensions and lower oil prices since late 2018.

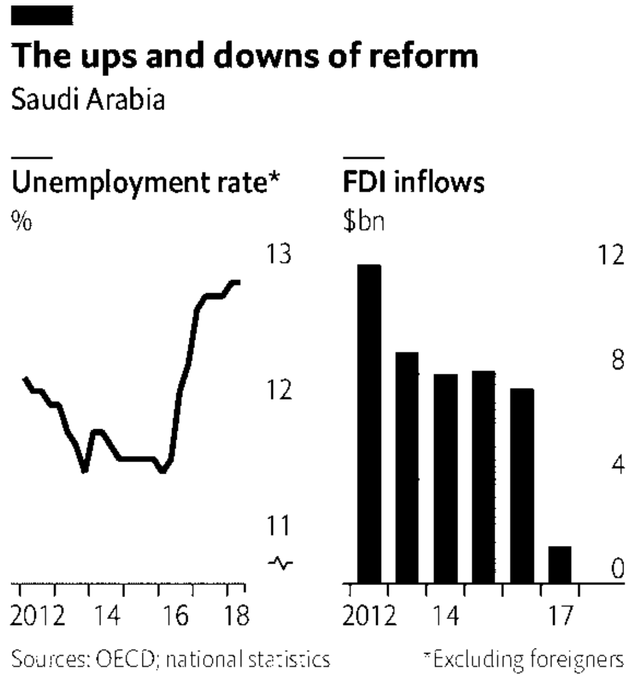

Figure 2: Sequence in the decline of Saudi Arabia economy

Source: OECD national statistics

Figure 2 graphically shows how the economy of Saudi Arabia has declined in the last five years, especially as regards Foreign Direct Investment, this underscore the need to adopt efficient strategies that will minimize financial risks which is a major concern to foreign investors as well as owners of multinational companies. The Saudi Arabian Monetary Policy Authority (SAMA) has introduced a risk management and compliance strategy in its strategy to maintain a culture with a high level of knowledge and awareness on a scientific and technical basis. In order to protect SAMA resources, the Risk and Compliance Department has developed mechanisms and methods for managing potential risks, constantly improving the risk culture and at the same time increasing the level of compliance with international, local, and domestic standards. In addition, the department provides the necessary support to ensure the continuity of critical tasks at SAMA.

A review of a case study (a mining company named Maaden), in Saudi Arabia gives an insight into corporate risk management in the country. The study shows that Maaden's corporate governance concept is based on the three main pillars presented in the corporate system, corporate governance rules and company charter, in addition to the best practices that apply to the management requirements established by Maaden (Obaid, 2003). The government's requirements imposed by Maaden are listed below, such as an authority matrix, conflict of interest guidelines and professional conduct, a guide to punctuality policies and procedures, and a guide to shareholders. In addition, the leadership of the board of directors, the rules of the management committee, the rules of the strategic risk management committee, the regulation on the review committee and the regulation on the executive committee. Finally, the provisions of the Human Resources and Compensation Committee, the Social Responsibility Committee, a disclosure policy and transparency document, and a communications policy document for company management (Hind, 2003).

Maaden has adopted a risk management method in accordance with the ISO 31000 standard, which is based on monitoring, analysis and risk assessment by establishing a situation: (risk identification, risk analysis, risk assessment), and then how to deal with risk by contacting consultants and old experience, and the review committee, coming from the Board of Directors, takes responsibility for monitoring the internal control system, as well as the procedures and rules that govern risk management and access to periodic reporting and monitoring in risk management, through the Tactical Risk Committee and the Operational Risk Committee, and this is followed by financial strategies that determine the numbers of risks by which the company must make a decision; and, therefore, applies to the financial industry of derivative financial instruments and the insurance industry. Since any risk is associated with a financial transaction, it is necessary to identify scenarios that define the risks to eliminate them (Yahia, 2013). An external audit, which is one of the requirements of the Saudi body for legal accountants, represented by the Internal Audit, does assessment of practice, monitoring of risks for the fight and reporting to the company management, as well as making suggestions for improvement (Yahia , 2013).

In another study that investigated 49 companies' German companies operating in Saudi Arabia, the study shows that cultural risk is assessed as more important in the business environment than political, financial, and economic risk. The most critical risk factors are not sufficiently included in the country risk assessment methodology, which is often used as a source of risk information for a particular country. In terms of risk management strategies, participating firms usually use informal approaches rather than structured hedging or insurance products. In addition, the researcher believes that the size of the firm affects the perception of certain risk factors and the level of complexity of risk management (Hain, 2011).

Research Methodology

A qualitative research method that engages the technique of literature review was used in this research. The choice of a qualitative method depends on its ability to give an idea of the problems and draw conclusions on a large scale. This helps identify trends in thinking and opinions, and also provides depth and detail that focuses on how people make meaning from their experiences (Stuckey, 2013). The search process examined a number of peer-reviewed scientific journals relevant to this study. This was done to develop the theoretical framework on which the research foundations were based.

Findings/results

The financial risk management process is not a one-time thing. It should be a continuous process that should not be taken for granted, as financial risks can arise from all sides and at any time. Before starting the financial risk management process, there should be a clear understanding of the goals and objectives of the organization since they will determine the direction of all activities.

The first step is to identify and prioritize financial risks that relate to the business. What follows is determination of the processes that help the company conduct a detailed assessment and analysis of the specific risks it faces: Companies have several ways to identify and evaluate risks. Some of these processes are:

Quantitative risk management. This is the detection, assessment, and monitoring of financial risks in the financial operations of a business using mathematical calculations or estimates. Typically, these calculations relate to income received by the company from sales, investments, and the like. Calculations are also used on historical financial data for forecasting purposes.

Risk assessment and control. This includes considering the company's internal control when it comes to all its financial transactions. As a rule, a weak internal control system will indicate high financial risks. For example, the absence of a reliable system for monitoring and selling sales and collection fees will increase the risk that payments on receivables by customers will not be properly recorded and money will be misappropriated into the hands of employees collecting money.

Audit of financial risks. This is a process that entrepreneurs take to evaluate that a company has proper internal controls and policies, especially in the accounting and reporting system. It will also reveal weaknesses in how transactions are recorded and accounted for.

After identifying the specific financial risks that are applicable in the case of a business, it is necessary to prioritize or rank them according to the severity of the risks and their potential consequences. Typically, the risk that poses a greater threat is the risk that can lead to higher financial losses (and even bankruptcy).

The second step is the determination of the level of risk tolerance in the organization: If managers and employees suffer from financial risks, their every move, every decision and every action will be guarded and permeated by a lack of trust. One of the worst things that can happen is that they will always choose the safest route, "play safe" in their business decisions and miss out on promising opportunities, fearing that using them will pose too much risk for the company. Thus, there must be a predetermined level of risk exposure that the company is willing to accept or tolerate. Setting this level will give them the opportunity to move, so they can focus on creating value, knowing that they are still working within acceptable limits in terms of risk.

Factors to consider when setting a financial risk threshold are:

The period or time horizon during which financial risk is expected. A company may find that the risk is higher if it cannot receive receivables over a three-year period than when customers cannot make payments within one year.

Materiality. A cost-benefit analysis may show that certain costs exceed the benefits derived from it. As a rule, higher costs are considered more substantial and therefore riskier. The company can set a certain ceiling or maximum amount for its materiality level, that is, if losses exceed this level, then it is significant and, of course, represents a high risk.

The volatility of the economic and financial environment. Companies that are in an industry with a volatile nature, such as the banking industry or industries subject to frequent fluctuations in cost and interest, can set lower thresholds for financial risk.

Confidence levels of managers. This is largely personal, on the part of management members. Some managers are “braver” than others, so they are more risk tolerant, while enterprises run mainly by conservative managers should be more careful.

There are several measures of financial risk (or calculation methods) to obtain a risk metric (quantitative result). Examples of risk metrics:

Standard deviation of company investment returns for measuring volatility

Estimated losses due to the default of the debtor on his payments to assess credit risk

Financial liquidity ratios, such as current ratio, quick ratio, cash ratio and asset turnover ratio, to measure company liquidity.

The third step is to formulate risk management strategies. Here, the business will identify risk mitigation strategies that it will adapt to manage the financial risks it faces. The choice of mitigation strategies largely depends on the particular risk that is being managed and the resources available to implement them. In short, let's take a look at some of the most commonly used risk mitigation strategies for financial transactions, especially for various financial risks.

Liquidity risk: The company would like to improve its liquidity by ensuring that it always has enough funds to pay off its debts when they mature, as well as other operating expenses. The following are strategies that can be adopted:

Determining periods of slow and low cash inflows using various forecasting methods and planning cash budgets around them.

Careful monitoring of cash inflows and outflows on a regular basis (for example, daily, weekly, bi-monthly, or monthly).

Regular fulfillment of the maturities of receivables to track payments of debtor customers in order to identify overdue accounts and take the necessary measures to receive them.

Sending messages or collecting reminders to customers about the amounts due; as well as

Maintaining strong relationships with financial institutions, banks, and other lenders, to which the business has obligations.

Credit risk: As much as a business would like to sell exclusively for cash, there are many who cannot do this, and they have no choice but to sell their products or services on credit. Problems can arise when customers are unable to pay, which leads to slow cash inflows and loss of income, when bad amounts should be written off as bad debts. Below are strategies that can be used:

Conducting a thorough verification of data and checking the creditworthiness of customers before selling them on credit.

Establishment and establishment of credit policies and conditions and their clear informing (in writing, signed by both parties) for clients before concluding a purchase and sale transaction.

maintaining strong and positive relationships with debtor customers to ensure that they are constantly informed

The fourth step is the Implementation of the planned strategies.

Risk reduction strategies should be applied or implemented, but in accordance with a policy set in advance. Here plans and strategies are transformed or transformed into actions.

In the fifth step, we can measure and refine: Risk reduction strategies that need to be implemented should be closely monitored to track their progress and determine whether they are effective or not. This allows them to control risks, mainly by making the necessary adjustments in those areas where they are needed. This may be the adjustment of operations or systems or some other corrective action in relation to implemented strategies or methods. As mentioned earlier, financial risk management - and risk management in general - is an ongoing process. Therefore, it can be refined, as necessary. Monitoring should also be a continuous event, with no room for complacency.

In the sixth step, it is essential to report the results of the process. At each stage of the process, communication is especially important. Top management should be aware of the entire risk management process, especially because they would be the one to decide which risk reduction strategies to use and how to implement them. It is also strongly recommended that other members of the organization be informed of the company's risk management initiatives to strengthen their confidence in the company, as well as increase their morale and encourage them to work harder to achieve the organization's goals.

Discussions and conclusion

Financial risks will always be present, in business organizations. Management and owners can "manage" these risks - mitigate or minimize the negative consequences of risks for the company. They can also be avoided, however, but they will always be there, creating varying degrees of threats to the business. Consequently, one of the realities that managers of business must make is to recognize that there are risks and they can never do away with them, the prevailing economic situation either at country level or global level creates environment for certain types of risks to thrive in businesses especially with multinationals. Careful attention should be paid to these types of risks. In the case of Saudi Arabia, counter party risk and market risk are the most susceptible sources of risks for businesses. Risk is a critical variable for understanding entrepreneurial behavior and the cornerstone of any decision to run a business (Mills and Pawson, 2012)

The measures adopted by Ma'adem in their operation to mitigate risk in Saudi Arabia investment climate is good, especially for the use of two standing committees (Tactical Risk Committee and Operational Risk Committee), to monitor risk occurrence and also to fashion out appropriate responses. The report from the investigation of 49 German companies in Saudi Arabia placed high premium on cultural risks and also placed it as a priority over political and economic sources. The case study shows a loophole in risk management in Saudi Arabia as the approach is informal and there is also absence of critical risk factors. This study addressed all the challenges noticed in the case studies. The step by step approach to risk identification and the methodological analysis of how risk management can be approached as discussed in this study provides a valuable guide to risk management in Saud Arabia and in other developing economies. In future research, a quantitative approach can be employed on the research topic so as to make scientific deductions from primary data, the lack of primary data in the study can be considered a limitation.

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