

UNDERSTANDING FINANCIAL RISK: PRACTICES AND TRENDS

MAIN FINDINGS

SOME KEY DATA

Survey Respondents, who are they?

- Financial Director / Chief Financial Officer
- Managing Director
- Treasury Officer
- Other



89% consider that the sensibility of their organization at the **financial risk increased** during the last three years



50% consider that the period 2011-2012 led to the identification of new RISKS

22%

DO NOT UNDERSTAND derivative instruments and complex contracts



1/4 of **MEDIUM SIZED COMPANIES** have no financial risk management policy

47 % heavily exposed to **PRICE RISKS** on **RAW MATERIALS** do NOT HEDGE LIABILITIES instrument of **COVER**



Management of financial risks

60% managed with support and/or external advice

40% internal treated exclusively



66% envisage a **STRENGTHENING OF THEIR PLANS OF RISK MANAGEMENT POLICIES** for coming three years.

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While the ability to manage financial risk enables a company to limit the occurrence and exposure of financial risks on performance, it also presents companies with some major challenges according to a recent study by Mazars.

An effective hedging strategy can contribute to reducing the volatility of a company's financial results, which in turn reduces a company's risk premium. We can already see that the ability to manage foreign exchange, interest rate and commodity price risks increases value and gives companies a level of economic stability, even at times of interest rate and commodity price volatility.

In addition, the globalisation of the economy as well as the increasing number of companies exposed to financial risks are likely to contribute to the development of further strategies that enable companies to actively manage such risks. This means today's Financial Directors are confronted with an increasing number of important choices when it comes to implementing an effective risk management policy.

GENERAL PERCEPTIONS ON THE INCREASE IN FINANCIAL RISKS

One of the main findings of the study by Mazars* is that managing financial risk is now a key concern for companies. Out of those polled, 89% said their exposure to financial risk had increased during the last three years and as a result 66% are looking to strengthen their plans to control and manage financial risks over the next three years.

These figures are not surprising given the current economic environment, which makes Financial Directors increasingly worried about their liquid assets and access to finance in order to manage market volatility.

MAPPING OUT FINANCIAL RISKS

When respondents to the survey were questioned about the primary risks in financing their activities, both large and mid sized companies had in place plans to minimise the effects of interest rate and commodity price volatility on company performance.

The fact that mid sized companies are more concerned about refinancing does highlight the difficulties brought on by the credit squeeze, which limits access to funds from banks and the markets. Whereas large companies are more interested in strategies to optimise the cost of financing.

These concerns were echoed on a global scale and relate closely to the different connections to banking partners, the evolution of prudential banking regulations, as well as the need to manage the cost of financing in a low interest rate environment.

DERIVATIVE STRATEGIES USED TO MANAGE RISK

In general, derivative instruments were understood and used by all companies in the survey, whatever their size. However, responses suggest a paradox in the sophistication of instruments used to hedge foreign exchange risk and the size of company in question. Perhaps surprisingly, simple or 'vanilla' instruments, such as swaps and options, were favoured by large companies. According to the survey, mid sized companies are more frequent users (19%) of more complex derivative instruments than large companies (9%).

A LACK OF FORMALISED RISK MANAGEMENT POLICIES

There was evidence of a variety of instruments in use to manage financial risks. However, strategies and the use of derivative instruments are not always formalised in a management policy by mid sized companies. Indeed, 25% of mid sized companies said they did not have a formal risk management policy, despite exposure to significant financial risks. This compares to 94% of large companies that have centralised financial management policies and dedicated finance and treasury departments in most cases. Despite the fact that smaller companies have to remain constantly aware of the impact of financial risk on performance, the means devoted to managing risk globally is broadly in line with the size of the organisation in question.

Nevertheless, the need to formalise risk management policies is increasingly seen as important in today's economic and business environment. The development and diversity of financial tools used, particularly as indicated by mid sized companies, heralds a greater need to formalise and communicate financial strategies. In particular, the 'disintermediation' of banks offers some interesting alternatives to accessing credit today. The introduction of new investors - both private and institutional - offer companies different return models. However, these diverse sources of funding require risk management strategies to adapt in order to cover the different variety of terms and conditions that apply.

A VARIETY OF PLAYERS AT THE HEART OF RISK MANAGEMENT STRATEGIES?

The involvement of different departments within a company during the various stages of risk management is key to identifying specific operational risks. So, for example, when the risk is connected to the price of raw materials, 52% of those surveyed said they would rely heavily on input by the purchasing department to help formulate risk management decisions.

While the involvement of internal managers is important, independent and expert advice on financial risk management strategies offers much needed additional support, particularly in periods of economic volatility. Indeed, independent advisers with expertise in banking are increasingly called upon to assist with risk management policy strategies through to external management of such policies.

Increasingly, companies are having to approach risk management problems from a range of different angles, whether it's financial, internal audit or information systems. To do so requires both internal and external expertise to fully protect financial strategies put in place.