HOW TO MANAGE FINANCIAL RISKS?

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ABSTRACT: *The paper provides a concise and structured overview of the main aspects of a topic that is highly relevant to the current activities of organizations, namely risk analysis. Given the complexity of this subject, the aim of the paper is to examine key general aspects such as the concept of risk, its typology, and risk management process within the financial sphere. Particular attention is given to the main categories of risk faced by enterprises, including financial risks, and to their key components such as inflation risk, exchange rate risk, liquidity risk, profitability risk, and excessive indebtedness.*

KEY WORDS: *financial risk, risk management process, liquidity risk, risk assessment.*

JEL CLASSIFICATION: *G30, G32, D81.*

1. INTRODUCTION

Financial risk management is a fundamental component of organizational sustainability and effective governance. Uncertainty related to revenues, expenditures, funding sources, and economic conditions exposes organizations to financial risks that may threaten operational continuity and strategic objectives. As a result, managing financial risks has become a priority for both public and private sector entities, requiring systematic identification, assessment, mitigation, and monitoring mechanisms. Financial risk refers to the possibility that an organization's financial outcomes will differ from expected results due to internal or external factors. Common sources of financial risk include budgetary constraints, fluctuations in revenues, cost overruns, liquidity shortages, credit exposure, and changes in economic or regulatory conditions. Effective financial risk management seeks to limit the negative impact of such uncertainties on organizational performance. The activity of any economic entity is inherently conducted under conditions of risk. These risks may vary in terms of predictability and controllability; however, regardless of the type of activity, it is essential to systematically identify and assess potential risks.

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2. CONCEPTUAL FRAMEWORK AND CLASSIFICATION OF RISKS

The risk signifies the variability of the result obtained under the action of internal and external factors of the company, representing the potential prejudice the company's patrimony and activity are exposed to. The total risk results from the synergic action of the economic risk, relative to the operating activity, and the risk relative to the financial activity (Miculeac, et al., 2014).

Effective risk management involves the elimination or mitigation of risks to the greatest extent possible, while accepting only those risks that have a limited impact on organizational performance. Inadequate risk awareness, inaccurate risk assessment, and the absence of appropriate protective measures can directly and negatively affect organizational outcomes. Risk is viewed as a phenomenon arising from circumstances in which the decision-maker is able to identify possible events and even estimate the probability of their occurrence (materialization), without being able to determine with certainty which of these events will actually occur.

Table 1. Conceptual approaches to risk in the academic literature

Author	Conceptualization of risk	Key Emphasis
DEX	The possibility of reaching a state of distress or having suffered a loss or difficulty	Possibility of loss or unfavorable situation
John M. Keynes	Risk is associated with the inclination toward risk, involving consideration of the satisfaction derived from assuming risk; in expectation of higher profit, the entrepreneur may undertake greater risk	Risk propensity and expected profit
Webster	Risk represents the danger of loss or material damage, referring to the possibility of the occurrence of an unfavorable situation	Possibility of loss and unfavorable outcomes
Hedgetts, M.	Risk is the possibility that losses will exceed expectations	Downside deviation
Mihai, I.	Risk signifies variability of outcomes under environmental pressure, representing potential loss affecting assets, interests, and activities	Potential loss and exposure
Băileștean u, Gh.	Risk reflects the variability of profit relative to average profitability and the firm's inability to adapt efficiently to environmental changes	Profit variability and adaptability
Giurgiu, I.	Risk is the probability of the occurrence of an undesirable event	Likelihood of adverse events
Negoescu, Gh.	Risk is the variability of possible outcomes depending on an uncertain event	Outcome variability
Mihalciuc	Risk represents a broad range of uncertainty regarding the future activity of an economic agent	Uncertainty of future activity
Sârbu, I.	Risk represents the danger of failure and complete, unforeseen losses	Threat of failure and unpredictable losses
Toma, M.	All investments involve risk; higher risk requires higher expected remuneration of invested capital	Risk–return trade-off
Niculescu, M.	Risk, inherent to any activity, represents variability of outcomes under environmental pressure	Inherent variability

IFRS	The risks and uncertainties inevitably associated with many events and circumstances must be considered in determining the best estimate of a provision; risk describes the range of possible outcomes	Outcome range and estimation uncertainty
Corporate Finance Institute	The probability that actual results will differ from expected results	Deviation from expected outcomes

The definitions presented illustrate the multidimensional character of risk, whose interpretation varies across disciplines and theoretical approaches. Lexicographic sources emphasize risk as the possibility of loss or unfavorable events, while other authors focus on the probability and severity of adverse outcomes.

A broader perspective conceptualizes risk as uncertainty and variability of results under environmental influence, shifting attention from isolated events to ranges of possible outcomes. Financial and managerial approaches highlight the relationship between risk and return, profit variability, and deviations from expected results, whereas behavioral theory, as reflected in Keynes's view, associates risk with entrepreneurial inclination and the pursuit of higher expected profits. The IFRS framework integrates these perspectives by linking risk to estimation uncertainty in financial reporting. Overall, the literature confirms that risk is a complex construct encompassing uncertainty, variability, potential loss, and decision-making under imperfect information.

In economics and finance, risk generally refers to the possibility that actual outcomes will differ from expected outcomes, including potential losses. In finance, this often focuses on deviations in returns from what was anticipated. Academic sources emphasize that risk arises from uncertainty and lack of predictability of events that could lead to loss or undesirable consequences.

Some economic scholars and researchers define financial risk as a type of business risk that consists in the possibility of adverse financial consequences, such as loss of income or capital, due to internal and external factors affecting financial activity. Practitioner-oriented definitions focus on financial risk as the probability that actual financial outcomes will differ from expected ones, especially in ways that lead to monetary losses. In applied contexts, financial risk is associated with the potential for loss stemming from market volatility, credit defaults, liquidity shortages, and other factors that can undermine a firm's financial stability.

From the perspective of the causes that may generate risk, these are multiple and include: the specific nature of the activity undertaken; competition; managerial imprudence; relationships with clients, suppliers, and financial institutions; inaccurate or insufficient information; force majeure or unforeseen events.

3. FINANCIAL RISK TYPES AND FINANCIAL RISK MANAGEMENT STRATEGIES AND TOOLS

The causes of risk outlined above translate directly into specific categories of financial risk faced by organizations. The nature of the activity and competitive pressures may generate budgetary and revenue risks, while managerial imprudence and inadequate decision-making are closely associated with operational and financial control risks. Weak relationships with clients, suppliers, and financial institutions increase exposure to credit and liquidity risks, whereas inaccurate or incomplete information contributes to forecasting and budgeting risks. Finally, force majeure events and unforeseen circumstances can amplify macroeconomic and systemic financial risks, highlighting the need for robust financial risk management mechanisms.

Depending on their area of manifestation, the principal risks to which an enterprise is exposed include economic risk, financial risk, technical risk, commercial risk, and bankruptcy risk. Economic risk arises from both external macroeconomic conditions and the efficiency of the firm's internal economic processes. It is commonly reflected through *inflation-related risks*, including exposure to interest rate volatility on borrowed funds and exchange rate fluctuations, as well as *operational (economic) risk,* which pertains to the firm's capacity to operate above the break-even point and sustain long-term economic performance.

Financial risk is primarily associated with the firm's financing decisions and capital structure, particularly the use of debt financing. It encompasses *liquidity risk*, defined as the variability of cash flows and financial performance indicators resulting from the firm's financial structure; *profitability risk*, which may arise from declining operating margins, cost inefficiencies, or potential insolvency; and *excessive leverage and ownership dilution risk*, stemming from an unsustainable level of indebtedness that may compromise financial stability and control.

The major categories of risk faced by enterprises, economic and financial risks in particular, require targeted financial risk management strategies and instruments. Economic risks, such as inflation risk, interest rate volatility, and exchange rate fluctuations, are primarily addressed through macroeconomic monitoring, scenario and sensitivity analysis, and financial forecasting, which enable organizations to anticipate adverse developments and adjust pricing, financing, and investment decisions accordingly. Operational economic risk related to the break-even threshold is managed through cost control mechanisms, budgetary planning, and performance indicators that track efficiency and productivity.

Financial risks associated with borrowed capital require more direct financial management tools. Liquidity risk is mitigated through cash flow management, liquidity ratios, and the establishment of financial reserves, ensuring the organization's ability to meet short-term obligations. Profitability risk is addressed by monitoring financial performance indicators, implementing expenditure control, and conducting profitability analyses to maintain sustainable returns. Finally, excessive indebtedness and loss of ownership risk are managed through prudent capital structure policies, debt management strategies, and continuous assessment of leverage ratios.

Overall, the effective management of economic and financial risks depends on the integration of analytical tools, financial controls, and strategic planning instruments, which together support financial stability, resilience, and long-term organizational sustainability.

Table 2. Key financial risk management tools by risk type:

Risk Type	Key Financial Risk Management Tools
Inflation & interest rate risk	Scenario analysis; Financial forecasting; Macroeconomic monitoring
Exchange rate risk	Sensitivity analysis; Hedging policies; Budget adjustments
Operational economic risk	Cost control; Budgeting; Break-even analysis
Liquidity risk	Cash flow management; Liquidity ratios; Financial reserves
Profitability risk	Performance indicators; Cost management; Profit analysis
Excessive indebtedness	Capital structure optimization; Debt ratios; Financial planning

Risk Management Process. The risk management process refers to the systematic approach organizations use to identify, assess, and control financial risks that could adversely affect their objectives and performance. This process enables firms to anticipate potential threats, evaluate their likelihood and impact, and implement appropriate strategies to mitigate losses or exploit opportunities. By embedding risk management into strategic decision-making, organizations ensure that risk considerations are aligned with corporate goals, capital allocation, and long-term sustainability.

Source: Author's own illustration

Figure 1. Steps involved in the risk management process.

The key steps involved in the risk management process include:

- *Risk Identification* – Identifying potential financial risks, such as market risk, credit risk, liquidity risk, and operational risk, that may adversely affect the organization's objectives.

- *Risk assessment and analysis* – Analyzing identified risks to determine their likelihood of occurrence and potential impact, using both qualitative judgment and quantitative techniques.
- *Risk prioritization* – Ranking risks according to their severity and significance in order to allocate resources effectively and address the most critical exposures first.
- *Risk mitigation and control* – Designing and implementing appropriate risk responses, including diversification, hedging, insurance, and internal control mechanisms, to reduce or manage risk exposure.
- *Risk monitoring and review* – Continuously monitoring risk levels and evaluating the effectiveness of mitigation strategies, making adjustments as internal and external conditions evolve.
- *Risk reporting and integration* – Communicating risk information to senior management and integrating risk considerations into strategic planning and organizational decision-making processes.

Financial risk reflects the variability of performance indicators resulting from changes in the firm's financial structure. The use of debt financing typically arises from insufficient internal funds and the existence of profitable investment opportunities. Available capital enables the undertaking of investments that are expected to generate additional returns.

However, firms that rely on borrowed funds must also bear the associated financial expenses, which are charged against operating results. Consequently, both the level and cost of indebtedness directly influence financial outcomes and, therefore, the degree of financial risk. Indebtedness alters the firm's risk profile by increasing the sensitivity of net results to variations in operating performance and financing costs.

An economic entity is considered exposed to financial risk because not all investment decisions lead to financial efficiency. Financial efficiency is achieved when, under conditions of debt financing, the rate of return on assets (economic profitability) exceeds the interest rate on borrowed capital, thereby generating a positive leverage effect. The assessment of financial risk, similarly to operating risk, is carried out using indicators such as the margin of safety, the safety index, and the elasticity coefficient. The analysis of changes in the return on equity resulting from financial policy decisions can be conducted using a model known as the financial leverage effect.

Financial leverage measures the impact of debt financing used to fund investments on the firm's financial return. The financial leverage effect—namely, the variation in the rate of return on equity—depends on the relationship between the rate of return on assets (economic profitability) and the interest rate on borrowed capital, as well as on the level of indebtedness.

Financial risk management involves a structured set of processes, including:

- the identification of risk-exposed areas within the firm's financial activities;
- the estimation of the probability of financial risk occurrence using appropriate analytical and forecasting methods;
- the assessment of interdependencies between financial risk and other material risks, such as operational risk and market risk (including interest rate volatility);

- the definition and continuous monitoring of risk exposures in order to control, mitigate, or minimize their potential impact;
- the identification and analysis of causal risk drivers to evaluate their potential adverse effects on the firm's overall financial performance;
- the quantification of financial risk and the measurement of its associated impact on cash flows, profitability, and financial stability;
- the formulation and implementation of risk management strategies aimed at maintaining the firm's financial activities within acceptable risk tolerance levels and ensuring financial sustainability.

Entities can enhance the effectiveness of their risk management practices by adopting a proactive and systematic approach to risk governance. This includes implementing more robust and data-driven risk assessment models that improve the identification, measurement, and quantification of risk exposures. Risk management strategies should be reviewed and updated on a regular basis to ensure alignment with evolving market conditions, regulatory requirements, and emerging risks. In addition, organizations should invest in continuous employee training to strengthen risk awareness, enhance risk identification capabilities at all operational levels, and promote a strong risk management culture that supports informed decision-making and long-term organizational resilience.

3. CONCLUSIONS

Risk is inherent at all times, and organizations must continuously manage it. The methods used to estimate and predict the likelihood of a company being affected vary depending on the type of risk involved.

Risk in economic literature is a concept linked to uncertainty and the potential for outcomes to diverge from expectations, often resulting in loss or adverse impact. *Financial risk* is a specific category of risk focusing on financial outcomes and the danger of monetary loss due to uncertain financial conditions or decisions.

Effective risk management therefore supports informed decision-making, enhances financial stability, and improves organizational resilience in an uncertain business environment.

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