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A study on financial risk control of group enterprise

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ABSTRACT

Under the conditions of market economy, Group Enterprise has become the main body of the market competition. The risk it faces, especially the financial risk, is a great challenge to the Group Enterprise. Based on the analysis of financial risk characteristics of Group Enterprises, this article builds a control system and puts forward the basic proposal of financial risk control.

Keywords: Group Enterprise; Financial risk control; Comprehensive Risk Management System of Financial Risk Management

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INTRODUCTION

To establish a group enterprise is an important method to optimize enterprise resources and improve the management efficiency. With the development of market economy in our country, and the all-in-one integration of global economy, the scale of enterprise groups becomes more and more huge, and Chinese group enterprises is making a rapid progress. However, with the change of international political and economic environment, the situation which enterprises are facing is becoming more and more complex. While some enterprise groups expanding their scales, others are getting into troubles with financial crisis, even in failure, resulted in the bankruptcy. A lot of group enterprises have serious failure of internal control , then many of them has not achieve their anticipated synergy.

Reasons of the above phenomenons are various, may be the cause of business management, or may be the deterioration of enterprise external environment. After all, the most important reason is the financial risk that companies always face with. Under market economy, Enterprises Group has become the main body of market competition, risks it faces, especially the financial risks, have its characteristic with objectivity, uncertainty, damaging. If the financial risks improper handling, it will affect the healthy of enterprise operation and even lead to a financial crisis.

In China, due to the impact of the transformation of the economic system, industrial restructure adjustment and rapid economic development, group enterprises expands rapidly, but they also faces many problems that need to be solved urgently, especially the problems of financial management, mainly displays in loose money management, budget management difficulties, lack of the group supervision and timeliness, low accuracy of financial information, financial risks occurred frequently. At the same time, due to the complicated property relationships, and the polarization of parent company functions, diversification of financial body , complication of the content in financial management, multiple stratification of financial decisions, diversification of investment fields, related party transactions occurred frequently and other features, makes the content of financial management more complex, and increases the difficulty of financial management. Many problems of financial control were shown in the run, such as the unreasonable allocation of financial controlling power, the unsound method of financial control, and the imperfect financial risk warning and control, etc. All these problems caused the low profitability of group enterprises, loss assets seriously, and make the financial risk management more difficult, and ultimately result in a lack of capacity of continuous operation and development, some group enterprises even went bankrupt.[1]

The process of capital movement between group enterprise′ s parent-subsidiary company is complex, risks may exist in every aspect. Once there is a financial crisis, if the company measures if ineffective, and financial risk is not controlled promptly, it will hinder the smooth implementation of the overall strategy. Also, the company′ s financial risk will flow from the interior to the exterior. So, financial risk will not only damage their own value, but also damage their stakeholders′ value."With the integration of domestic market and the globalization of international economic, a lot of enterprises were ruined by financial risk despite having little operational risk." (Fuchu Guo, 2000) D′ long and San Jiu group enterprise both failed with the same reasons: the business currency flow were fractured. But the fractured currency flow is just the reflection of direct problems, the essential cause is lacking the ability to prevent financial risk and manage cash flow. Therefore, strengthen the management of financial risk has become a very important content in modern group enterprises.

EXPERIMENTAL SECTION

(i) Term Introduction

Definition 1. group enterprise is a collective-enterprise that was constituted by many structured enterprises. These enterprises may be in the upper stream or down stream of the same industrial chain, may share certain resources or using the same industry standard, conduct business activities associated with each other, they generally have a common interest, and were linked together with property bonds. In an Group Enterprise, the core member is the parent company which is the organizer and promoter in the business group. Although there are other independent beneficiaries in business groups, the most important stakeholder is undoubtedly the parent, and profit maximization of the parent company will become the Group′ s operational targets. [2]

Definition 2. Financial Risk is the chance or possibility of losses and failures, which often manifest as the realized financial benefits deviate from the expected financial benefits. That was because in the enterprise financial systems, a variety of difficult and unable to predict and control factors exist objectively, and play a part in enterprise operation. [3]

Under market economy, enterprise financial risk is at the heart of all kinds of risk factors reflected in enterprise finance, and it flows over all aspects of the enterprise financial system. It usually include financing risk, investment risk, customer credit risk(also known as business credit risk),interest rate risk, exchange rate risk etc.

Definition 3. Financial Risk of Group Enterprise is the chance or possibility of losses and failures which runs through enterprise operation process and was faced by financial activities such as fund-raising, fund use, revenue distribution, which comes out because of information blemish existing in the interior of Group Enterprise.

Definition 4. Financial Risk Control is a managerial approach used in certain risk conditions by using prediction, evaluation, decision and management and taking advantage of risks to create more profits for enterprises; at the mean time,taking measures to prevent and remedy the losses caused by financial risk.

Financial control is the core of financial management, what it includes are: risk identification, risk evaluation, risk prevention and risk handling.

Definition 5. Risk Identification is a managerial approach analyzing plenty of reliable qualitative and quantitative information collecting by risk managers to make out all kinds of risk factors enterprises may be faced with, and then determine the potential risks and properties, and understand its developing trend.

(ii)Characteristics of Financial Risk of Group Enterprise

Group Enterprise has a parent-subsidiary system, enterprise units as its members have independent legal personality and organizational system, and have formed multi-stage corporate governance structure in the interior,[4] Financial risk of Group has common characteristics with objectivity, uncertainty, loss, duplicity, besides, other characteristics cited in the following:

A. Integrity. Group′s financial risk has a significant impact on the whole group, that is to say, it makes a great impact on financial strategic objectives, strategic policy and strategic resources so as to make a significant impact on the Group′s overall strategy.

B. Systematization. Group Enterprise has a chain effect of financial crisis, if one part of it goes wrong and has not handled promptly and effectively, it will cause the entire Group′s financial crisis.

C. Diversity. Group Enterprises have characteristics with large scale, scattered layout and different culture, Group's financial risk has shown mixed sources such as inconsistent financial strategy between headquarter and subsidiary corporation, regional factor and different culture of group, all of these factors may result in corporate financial risk.

D. Hierarchy. Structure of Group Enterprise characteristic with hierarchy and networking, subordinate enterprises of different levels such as the core business, holdings, shares layer enterprises and collaboration layers make impacts of different degree on the performance of the enterprise business group.

E. Radioactivity. Parent corporate plays a leading role in the Group Enterprise, through connecting a variety of bonds to decide, influence and guide the operational direction, development strategy, product types and market positioning of enterprises in the group, and also affecting national or regional economic development in macroscopic. Therefore, once the parent company in financial crisis, its impact was greater than others′.It would have serious consequences, not only strike the industrial economy, but also can lead to thousands of job losses, all of these consequences will make a serious impact on society and economy.

RESULTS AND DISCUSSION

(i) Control System of Financial Risk of Group Enterprise

Financial risk management of Group Enterprise in Chinese is based on the structure named "system", which consists of three subsystems, such as identification system of Group Enterprise financial risk, assessment system of Group Enterprise financial risk, and prevention and treatment system of Group Enterprise financial risk.

A. Financial Risk Identification

Group Enterprise financial risk always exists objectively, a controller must first identify the risks that may occur, and predicting the negative impact on the operating because of the risks, so as to take appropriate measures to control risks.

Activities and methods discovering and confirming risks is often to be used identify financial risks. It generally consists of two stages: the first is risk identification, primarily to identify financial risk and areas where it exists, the second is the analysis of financial risk, primarily to analyze the causes of financial accidents, probabilities and consequences of possible loss. This complex process can be illustrated by a identify process describing corporate financial risk management, and can be used by with companies as a specific reference. ［4］See Figure 1.

B. Financial Risk Assessment

Assessment of financial risk is a management method which is on the basis of financial risk identification to estimate and predict the possibility of the occurrence of financial risk and loss severity by analyzing a large number of financial risk information through certain methods. Financial risk assessment is a very complex issue, especially when a number of factors play a role simultaneously.

Financial indicators not only reflect the performance of production and operation of Group Enterprises, but also reflect the scale of the Group Enterprise financial risk. In this paper, Altman multiple linear regression model which has been improved is used to select key indicators among a number of financial indicators that best represents the Group's financial situation of enterprises, such as the ratio of working capital to total assets, and total accumulated surplus assets ratio, the ratio of after-tax interest income to total assets, the ratio of the market value to total liabilities of owners' equity, the ratio of sales revenue to total assets etc. These indicators will be given different weights according to their degree of importance, mathematical processing and regression analyzing will be conducted on the basis of financial data of different Group Enterprises, then mathematical model assessing Group Enterprise financial risk will be acquired as follow: [5] [6]

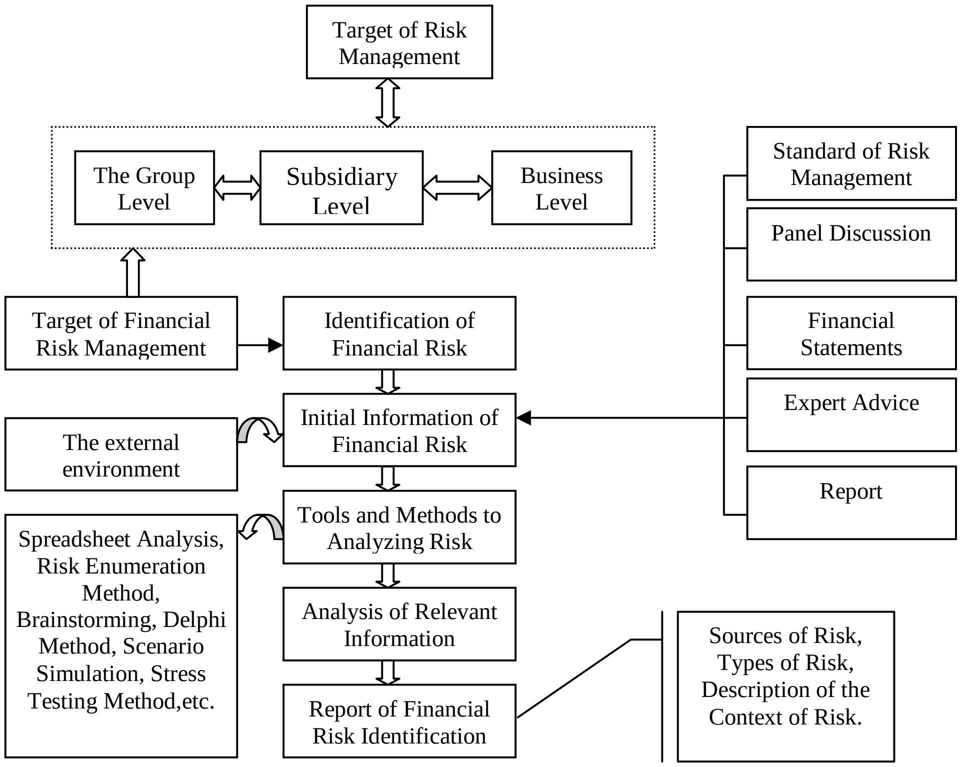

Figure 1.Identification process of Enterprise Group Financial Risk

$$R=1.2Y_1+1.4Y_2+3.3Y_3+0.6Y_4+1.0Y_5 \qquad (1)$$

The parameters related in the model are summarized as below.
R——the extent data of Group Enterprise financial risk

$Y1=\dfrac{\text{circulating capital}}{\text{total assets}}$, discounted capacity and scale characteristics of corporate assets

$Y2=\dfrac{\text{accumulated earnings}}{\text{total assets}}$, cumulative profitability of Group Enterprise

$Y3=\dfrac{\text{earnings after interest and tax}}{\text{total assets}}$, profitability of earnings after interest and tax

$Y4=\dfrac{\text{the market value of shareholder's equity}}{\text{total assets}}$, the degree of fluctuation of shareholder's equity and understanding and evaluation of Public

$Y5=\dfrac{\text{sales revenue}}{\text{total assets}}$, scales, market occupancy and capability of create sales revenue of Group Enterprise

When assessing financial risk based on the above multiple linear regression model, firstly, to amend the corresponding regression coefficient of each financial ratio named Y_1,Y_2 ,Y_3,Y_4 ,Y_5 among the multiple linear regression model, secondly, putting the specific financial ratios Y_1, Y_2, Y_3, Y_4, Y_5 of different enterprises financial statements into the formula (1),thirdly, calculating, then you can find out assessment data named R of financial risk of different Group Enterprise. According to the classification of risk degree in the Altman multiple linear regression model, assessment and judgment of Group Enterprise financial risk can be made.[7]

If $R \geq 3.1$, it means that the operation and finance of Group Enterprises go well, without financial risk.

If $1.79 \leq R < 3.1$, it means that the performance of operation and finance of Group Enterprises is just ok, only at the average level, with some financial risk.

If $R < 1.79$, it means that the operation and finance of Group Enterprises do worse, with a big financial risk.

If the R value is much less than the 1.79, it means that the operations and financial condition of Group Enterprise have been in a deteriorated state, even in the face of financial crisis or near the severity of the bankruptcy.

C. Financial Risk Prevention & Management

Financial risk prevention and treatment of Group Enterprise is a management method which is aiming to reduce the adverse consequences of financial risks to a minimum extent with the most economical way on the basis of fully predictable identify, assess and analyze risks. this process mainly consists of two aspects: On one hand, take various measures to minimize or prevent the risk before financial risk emerge, named the prevention of financial risks. On the other hand, for the financial risk that Group Enterprise can not prevent, take measures to control financial risk, making great effort to minimize losses after financial risk, or compensate the losses by other means, or resume normal production and business activities to reduce the risk of loss, named the treatment of financial risk. The main methods of financial risk prevention and treatment are summarized as the following:

A. Risk aversion. This means that before a certain potential financial risk occurred, by analyzing and judging the conditions and factors of risk to find that financial risk may cause larger losses of production and business activities, so evasive measure will be taken intentionally, for example, refuse or abandon the risks. [8]

B. Risk transfer. For some financial risk that can not be avoided, the Group senior should make insurance investment so that part of the risk can be transferred to the insurance company, financial crisis may be prevented.

C. Risk diversification. This means that enterprise expands scale by joint operation, merger or other multi-dimensional and diversity mode of operation, and using economies of scale to spread the financial risk to make profit from losses and compensate inferior with superior.

D. Risk retention. This mean that for those financial risks can not be avoided or transferred, or because of the demand of operational activities, Group Enterprise should keep this kind of risk. If the risk occurs, the losses will be absorbed and compensated by Group Enterprise itself. This approach should be based on national corporate financial accounting system, in accordance with the principle of conservatism, risk fund such as sinking fund and bad debt reserves should be established to prevent risk losses and enhance the resistance to risk.

(ii)Basic Proposal of Financial Risk Control of Group Enterprise

A. Establishing a Concept of Comprehensive Risk Management of Group Enterprise

There are a lot of restructuring, mergers in the rapid development process of Chinese Group Enterprise, it may face more and more deeper risk especially after the group entered the capital market. It is extremely urgent to establish a risk management philosophy. To Establish a corporate group-wide risk management philosophy can enhance the sensitivity and responsiveness of Group Enterprise to various risk factors, can help enterprises of all types to eliminate hidden dangers in advance, so that financial risk will not occurs in Group Enterprise, generation and conduction of financial risk can be restrained. Effective implementation of a comprehensive risk management requires that Group Enterprises should establish three important business guidance concept on the basis of the scientific outlook on development. The three concepts are summarized as: The first is risk concept, business groups should change the current phenomenon of paying more attention to scale expansion not to asset quality management, and reverse the business situation of a lot of exposure for relatively meager profit, Group Enterprise should make the risk management as the center of the operational management. The second is the concept of capital constraints, strengthen capital adequacy management, make efforts to improve the quality of assets, develop intermediary business, reduce pressure on capital occupancy, to form diversified revenue and profit structure, maintain long-term sustainable development. The third is concept of cost-effective, which includes overcoming the past concept of high cost of pursuing scale indicators that led to high operating costs, poor asset quality, developing correlative management software, implementing a comprehensive cost management.

B. Completing the Financial Governance Structure of Group Enterprise

Corporate Governance determines the goal of enterprise, decision-maker and allocate of risk and benefits which start around risk. Risk affects the achievement of objectives directly, and risk control and management of decision-maker will determine whether the target can be achieved and implemented degree, each part of the governance structure need to take some risks and get the appropriate allocation of income. [9] On July 23, 2002,the Institute of Internal Auditors (IIA) proposed to Congress that: a sound governance structure is based on four main conditions of effective collaborative governance system, which is mainly summarized as: (i)Board of Directors：to ensure control system effectively, to identify and monitor business risk and performance indicators.(ii)Executive management layers: implement risk management and internal control, daily planning and organization.(iii)External Auditor: should maintain independence, auditing and consulting services separately.(ⅳ)Audit Committee(Interior Auditor):the independence of relationship of reporting grow stronger. These four parts are the basis of effective governance under the supervision of the judiciary and regulatory agencies. The illustration of corporate governance Figure 2.

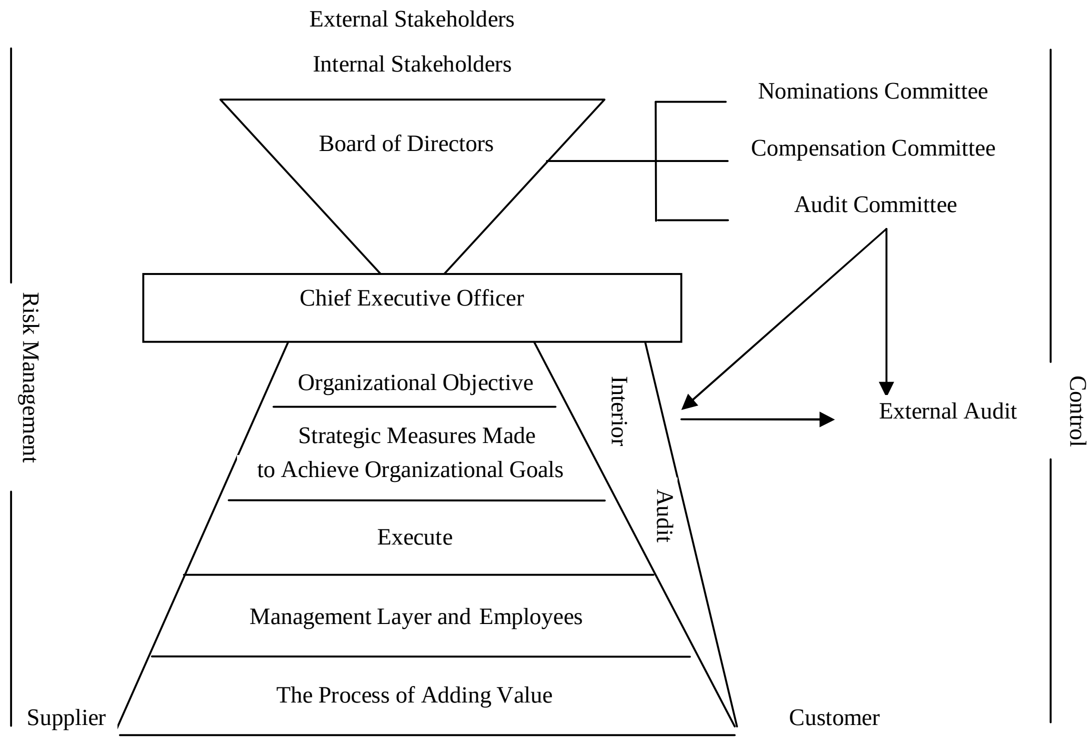

Figure 2.Group Enterprise Corporate Governance structure

(Data Source: The 65th Annual International Conference of Institute of Internal Auditor)

C. Building a Comprehensive Risk Management System of Financial Risk Management As the Core

Group Enterprise should embed the financial risk management into the Group’s value chain to form a more systematic financial risk management system especially form a financial risk early warning mechanism and control mechanisms as value-centered, on this basis, to promote a comprehensive risk management. Comprehensive Risk Management means that an enterprise focus on overall business objectives, through the implementation of the basic processes of risk management in all aspects of business management and business processes, cultivating good risk management culture, establishing and improving the comprehensive risk management system, including risk management strategies, measures to conduct financial transactions,organizational function system for risk management,risk management information system and interior control system,in order to provide reasonable processes and methods achieving overall objective.It is illustrated as Figure 3.[10]

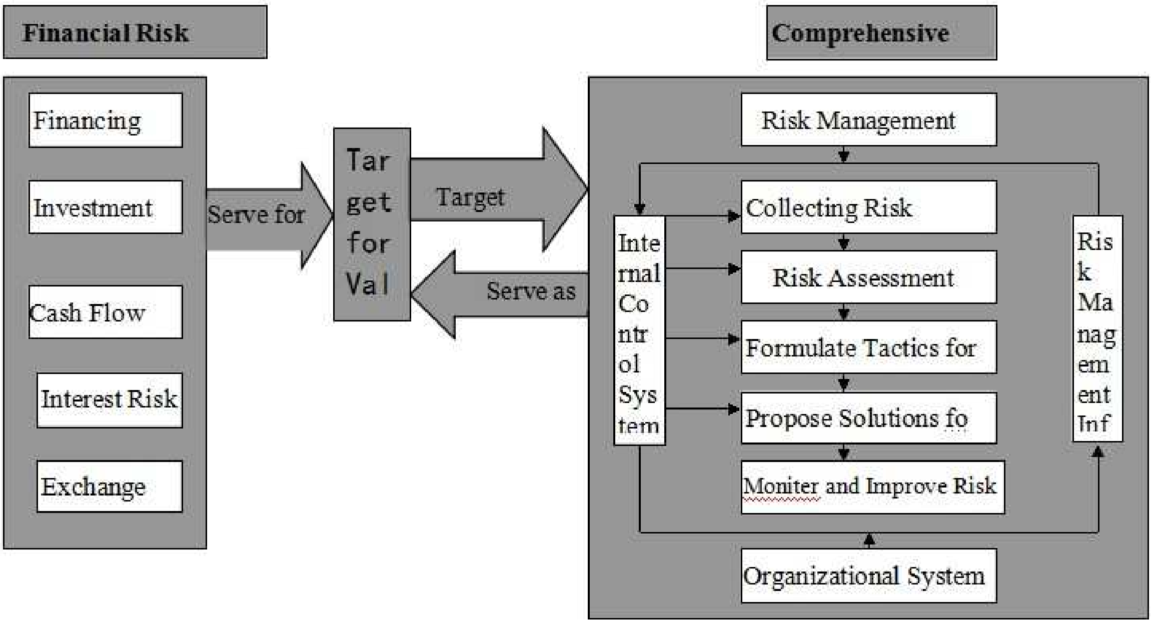

Figure 3.Comprehensive Risk Management System with Financial Risk Management as the Core

D. Building an Internal Control System of Group Enterprise

Internal control system means that around the target of risk management strategy,to aim at corporate strategy,planning,product development,investment, financing,market operations,internal audit, legal affairs, human resources, procurement, manufacturing, sales, logistics, quality, production safety,environmental protection and other business management and their important business processes to formulate and implement Regulations, procedures and practices by carry out the basic risk management processes.Internal control is a process which influenced by the board of directors, managers and other staff provide reasonable insurance in order to achieve effectiveness and efficiency of operations,reliability of financial reporting and compliance with relevant laws and regulations.Internal control system is consists of five elements, namely the control environment, risk assessment, control activities, information and communication, and monitoring. These elements and the way how they constitute determines the content and form of internal control. When designing internal control should,one can make a organic combination of internal control elements in accordance with the characteristics and needs of the enterprise (such as firm size, business structure, management, etc.) to establish three-dimensional, all-round, multi-level framework for internal control and risk prevention. As shown in Figure 4.

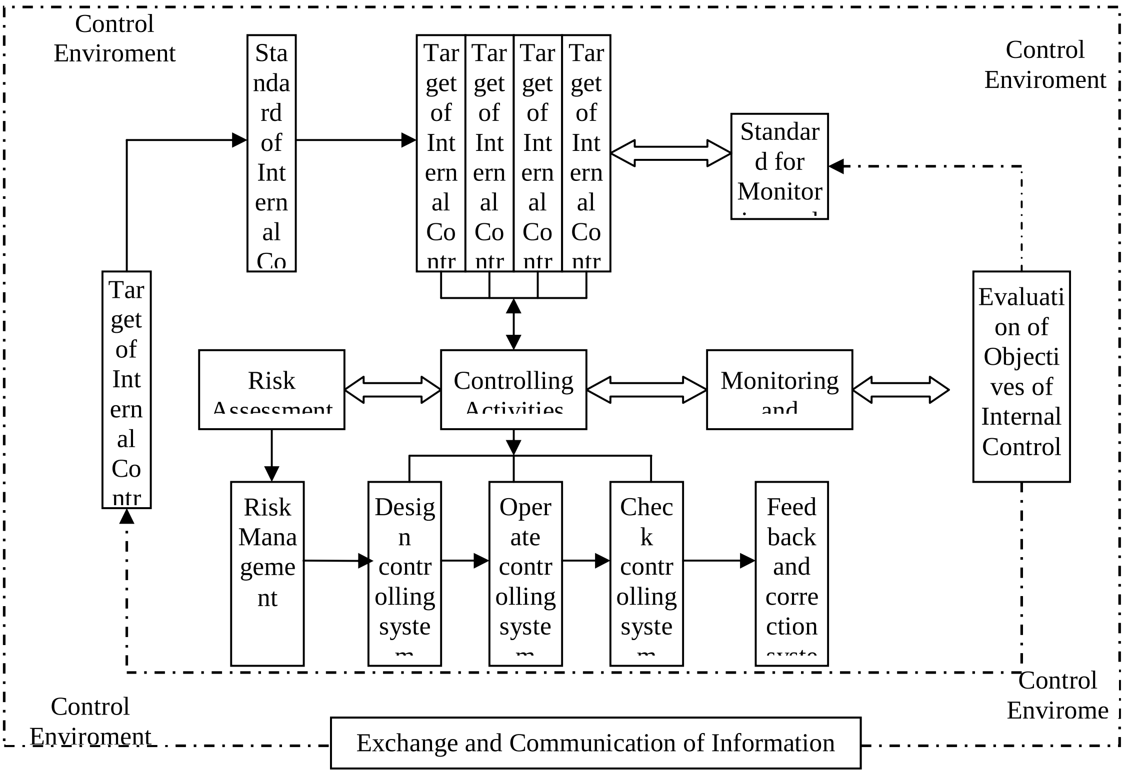

Figure 4. Dynamic Operating Mode for Group Enterprise's Internal Control

CONCLUSION

With globalization of world economy,Chinese Group Enterprises have expanded rapidly.But there are also many constraints existing in the development of Group Enterprises, and the Groups is still very fragile, so that the Group is facing more risks objectively,financial risk is at the core of a variety of risks,to carry out comprehensive risk management with the financial risk control as its core is an inevitable choice to strengthen the Group's risk management.Therefore, to analyze the financial risk control mode from identifying,evaluation,prevention and treatment of the financial risks can promote Group Enterprises to establish a comprehensive risk management awareness and strengthen risk control,thus,sustainable development of the Group will be achieved.

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