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# Navigating Financial Risks: Effective Risk Management Strategies for International Businesses in a Changing Economic Landscape

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**Abstract:**

Based on the forecasts of the four major Australian banks, a cash rate cut is expected by the end of 2024, which could significantly affect international business. This includes potential exchange rate fluctuations and increased exposure to cash and cash equivalents. Generally, lower cash rates weaken the Australian dollar, affecting the import and export costs for companies engaged in international trade. This could disrupt forward contracts used to hedge against currency fluctuations, potentially resulting in financial losses. Additionally, lower cash rates may reduce returns on cash and cash equivalents, increase risk exposure for businesses with large amounts of liquid assets, and affect overall profitability and financial stability. This article explores business risk management in a changing macroeconomic environment from an accounting perspective. It examines the risks associated with currency fluctuations and interest rate changes and highlights how understanding these risks and being adequately prepared can help businesses navigate the challenges of a changing economic landscape.

**Keywords:** accounting, business risk management, Australian cash rate cut prediction, current method of translation

## 1. Background

In November 2023, the Reserve Bank of Australia (RBA) set the official cash rate at 4.35%, significantly influencing the pricing of financial products (Duncan, 2024). Historically, a high RBA cash rate leads to elevated interest rates on home loans, term deposits, and similar products. Conversely, a low cash rate benefits borrowers but disadvantages savers (Beattie, 2024). These fluctuations impact the economy and individual financial decisions.


**Figure 1 Historical cash rate target of RBA (Reserve Bank of Australia, n.d.)**

Based on the RBA's targets, Australia's four major banks—ANZ, Commonwealth Bank, National Australia Bank (NAB), and Westpac—predict future cash rate movements. ANZ forecasts the first rate cuts around November 2024, lowering the rate to 4.10%, with a further reduction to 3.60% by mid-2025. Commonwealth Bank expects the first reduction around September 2024 to 4.10%, and a further drop to 2.85% by mid-2025. NAB predicts an initial cut in the December quarter of 2024 to 4.10%, with a decrease to 3.10% by the end of 2025. Westpac anticipates a cut to 4.10% around September 2024, followed by a reduction to 3.10% by September 2025(Duncan, 2024).

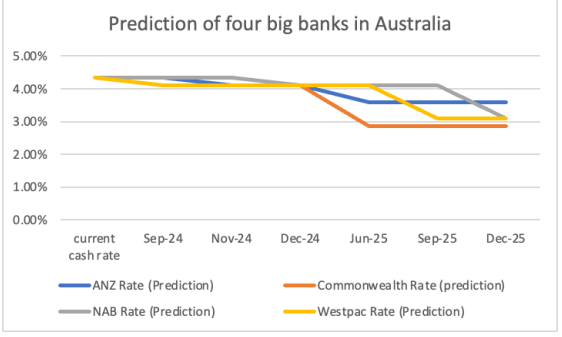


**Figure 2 Predictions of four big banks in Australia**

All four major banks expect initial interest rate cuts followed by further reductions in 2025. This consensus indicates a widely expected monetary easing over the next two years, due to anticipated economic changes. These cash rate changes will significantly impact international businesses operating in Australia. A lower cash rate generally weakens the Australian dollar, affecting exchange rates for forward contracts and increasing risk exposure for cash and cash equivalents. This complicates financial planning for international trade, as currency fluctuations alter the cost structure of imports and exports and may change accounting methods. Additionally, a lower cash rate will reduce returns on cash and cash equivalents, potentially decreasing investment income and affecting overall profitability and financial stability (Lioudis, 2024). This article explores enterprise risk management in a dynamic macro environment from an accounting perspective. Understanding and preparing for these risks is essential for companies to effectively respond to the challenges posed by changing economic conditions.

## 2. Methodology in Accounting

In international transactions, three types of currencies are commonly used: local/foreign, functional, and presentation currencies. This discussion focuses on the current methods of conversion between functional and presentation currencies. Under the International Financial Reporting Standards (IFRS), the income statement should use the average exchange rate prevailing between the order date and the payment date. In contrast, most accounts on the balance sheet should apply the current or spot exchange rate at the end of the financial year. This difference in the application of exchange rates can significantly impact the financial statements. (International Financial Reporting Standards Foundation, n.d.)

Specifically, the use of different exchange rates for the income statement and the balance sheet can result in fluctuations in reported net income or losses, which in turn affects the retained earnings account on the balance sheet. This relationship is often expressed as follows:

Opening balance of retained earnings + net income/loss – dividends paid = Closing balance of retained earnings.

When the net income or loss calculated using the average rate for the income statement differs from that calculated using the spot rate for balance sheet accounts, it leads to variances in the retained earnings. This variance can create complexities in financial reporting and analysis, particularly in understanding the true financial performance and position of a company. Consider a parent company in Australia (AUD) with a subsidiary overseas using USD. For the income statement, assume the average exchange rate (AUD/USD) is 1.2. The subsidiary's figures would then be translated as follows:

| | Parent (AUD) | Subsidiary (AUD) | Subsidiary (USD) |
|---|---|---|---|
| Revenue | 1,000 | 120 | 100 |
| Expense | (300) | (24) | (20) |
| Earnings before interest and tax | 700 | 96 | 80 |
| Interest and tax expense | (200) | (24) | (20) |
| Net income | 500 | 72 | 60 |

**Figure 3 Translation of Income Statement**

However, in the balance sheet, using the spot rate of 1.3 causes differences between retained earnings and net income:

| | Parent (AUD) | Subsidiary (AUD) | Subsidiary (USD) |
|---|---|---|---|
| Asset | 10,000 | 1,200 | 1,000 |
| Liability | 6,000 | 910 | 700 |
| Equity | 4,000 | 390 | 300 |
| Capital | 3,000 | 260 | 200 |
| Retained Earnings | 3,000 | 130 | 100 |

**Figure 4 Translation of Balance Sheet**

Note that capital is typically calculated using the historical exchange rate; however, in this example, it is assumed to be 1.3. The subsidiary's retained earnings in AUD should include the net income of 72 AUD, corresponding to 60 USD as reported in the income statement. Yet, when converted at the balance sheet's spot rate of 1.3, these retained earnings become 78 AUD, resulting in a 6 AUD discrepancy. This difference should be reflected in the Foreign Currency Reserve (FCR), which accounts for translation gains or losses not realized in net income. This translation process can lead to potential financial reporting manipulation and complicate risk management. Accurate conversion between functional and presentation currencies is critical to effective business risk management. Companies must implement sound financial planning and analysis practices to manage these risks effectively. Such risk management ensures that companies can navigate the complexities of currency conversion and maintain their financial stability in a dynamic global market.

## 3. Methodology in Business Risk Management

The diagram provided outlines a comprehensive risk management process that begins by defining the scope, context, and criteria. This initial stage involves understanding internal and external factors, identifying stakeholders, and establishing evaluation criteria. The core approach includes risk assessment, which involves identifying, analysing, and evaluating potential risks. This stage requires documenting risks, assessing their likelihood and impact, and prioritizing them according to their importance. Next, the process moves to risk treatment, which involves strategies such as avoiding, mitigating, transferring, or accepting risks. Effective communication and consultation

with stakeholders ensure transparency and support, while ongoing monitoring and review track the effectiveness of risk treatments. Systematically recording and reporting all stages provides accountability and promotes continuous improvement, enabling organizations to cope with uncertainty and achieve their goals.

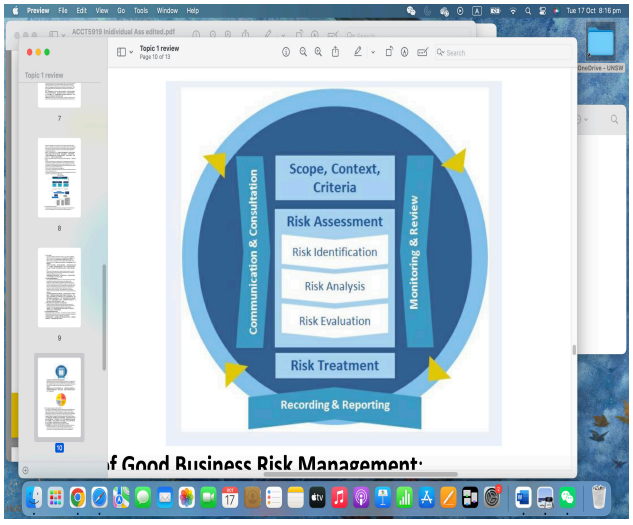


**Figure 5 Risk Management Framework**

The figure illustrates a well-structured and robust risk management framework that systematically addresses all aspects of risk. This integrated approach embeds risk management into the overall management system, ensuring cohesion. Customization of the framework adapts it to the specific needs and context of the organization, ensuring its relevance. Inclusiveness engages all relevant stakeholders, promoting collaboration and a shared understanding. The framework is dynamic, adapting to changing conditions and emerging risks, and it emphasizes making informed decisions based on the best available information. Continuous improvement is a key focus, aimed at enhancing the efficacy of risk management practices. Additionally, the framework considers human and cultural factors, recognizing their significant impact on risk management outcomes. Together, these elements create a comprehensive, adaptive framework that supports effective decision-making and enhances organizational resilience.

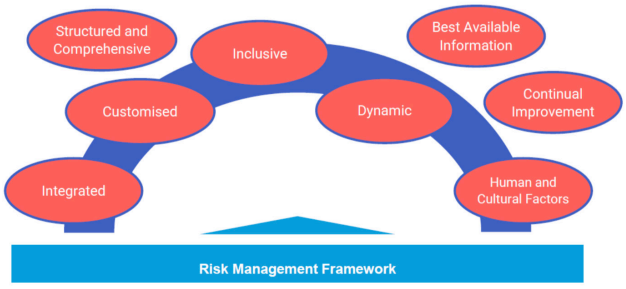


**Figure 6 Risk Management Framework**

To address risk management issues, we employ a 'what-if' approach to identify the most influential factors. This involves assuming the absence of certain elements and assessing the severity of potential consequences. The risk matrix categorizes activities based on their tolerance for disruption. Critical operations that cannot tolerate any disruption are marked in red. Activities that can endure a short-term major or partial disruption are marked in orange. Yellow indicates activities that can be scaled back in the short to medium term, and green denotes activities that can be suspended for a longer period, if necessary. These criteria help determine which operations require the most urgent protection and thus prioritize our risk management efforts.

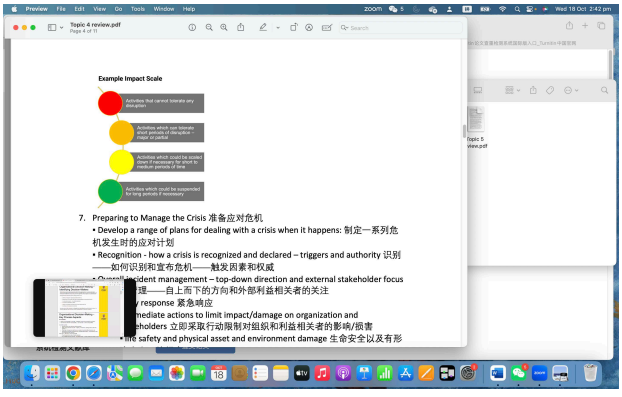


**Figure 7 Impact Scale for Principles-Based Framework**

## 4. Analysis of an example – Commonwealth Bank in North America

The Commonwealth Bank, one of Australia's four major banks, also has a branch in North America. As a financial institution, it is significantly impacted by exchange rates, especially with predictions of lower interest rates (Reserve Bank of Australia, 2017). In its US disclosure document, the bank explains that exchange differences from the translation of its foreign operations are accumulated in the foreign currency translation reserve. Specifically, assets and liabilities are translated at the exchange rate on the balance sheet date, while revenues and expenses are translated at the exchange rates on the transaction dates. All resulting exchange differences are recognized in the foreign currency translation reserve (Commonwealth Bank of Australia, n.d.). However, this accounting method introduces some risks, especially in the case of expected interest rate cuts. The expected decline in interest rates may lead to an expansion of liabilities and an increase in financing costs. In addition, these conversion practices may also raise liquidity and solvency issues. Large fluctuations

in exchange rates may lead to a mismatch in the value of assets and liabilities, thereby exacerbating financial risks. These risks will be further analyzed using a risk matrix to quantify their impact and likelihood. The risk matrix will illustrate how exchange rate fluctuations can lead to increased liabilities, higher financing costs, and potential liquidity constraints. By evaluating these factors, a better understanding of the company's financial stability can be achieved as well as anticipating potential challenges.
Here is a risk matrix:

| likelihood | Consequences | | | | |
|---|---|---|---|---|---|
| | 1 Notable | 2 Minor | 3 Moderate | 4 Major | 5 Extreme |
| A Almost certain | | | | | |
| B Likely | | | | Funding cost risk | Liability expansion risk |
| C Moderate | | | | | |
| D Unlikely | | | | | Liquidity and solvency risk |
| E Rare | | | | | |

**Figure 8 Risk Matrix**

## 4.1 *Liability expansion risk*

In financial analysis, examining the balance sheet reveals a significant relationship between liabilities and equity, particularly in the context of the presentation currency. When liabilities increase while assets remain constant, equity decreases. Furthermore, any translation losses recognized in the income statement also reduce equity. This interaction affects the Hoening's ratio, which is the quotient of equity divided by total assets and indicates a company's ability to withstand asset devaluation without compromising its equity. A lower Hoening's ratio signals higher vulnerability, while a higher ratio suggests a stronger financial position.
With impending interest rate cuts, the expansion of liabilities becomes a concern. This trend could lead to adverse consequences, such as increased interest expenses, exacerbating financial strain. The combined effect of higher liabilities and lower interest rates amplifies this risk, potentially compromising the company's ability to service debts to local banks, particularly in the US.
Moreover, analyzing consolidated financial statements reveals substantial fluctuations in the foreign currency translation reserve, net of tax, between December 2022 and December 2023. This volatility raises concerns about financial reporting integrity and potential manipulation, undermining the transparency and reliability of the financial statements. Such irregularity increases the risk of liability expansion, creating uncertainty about the company's financial stability (Commonwealth Bank of Australia, 2024).

Consolidated Statement of Comprehensive Income
For the half year ended 31 December 2023

| | Half Year Ended [1] | | |
|---|---|---|---|
| | 31 Dec 23 $M | 30 Jun 23 $M | 31 Dec 22 $M |
| **Net profit after income tax for the period from continuing operations** | **4,837** | 4,853 | 5,243 |
| **Other comprehensive income/(expense):** | | | |
| **Items that may be reclassified subsequently to profit/(loss):** | | | |
| Foreign currency translation reserve net of tax | **(15)** | (85) | 314 |
| Gains/(losses) on cash flow hedging instruments net of tax | **884** | (584) | (377) |
| (Losses)/gains on debt investment securities at fair value through Other Comprehensive Income net of tax | **(202)** | 20 | (249) |
| **Total of items that may be reclassified** | **667** | (649) | (312) |

**Figure 9 Consolidated Statement of Comprehensive Income of Commonwealth Bank in North America 2024**

## 4.2 *Funding cost risk*

The emergence of funding cost risk, stemming from escalating debt interest expenses due to liability expansion, highlights the interconnected nature of accounting methodologies and financial risk management. Financial reporting plays a crucial role in focusing the company's attention on this risk and in the development of solutions and strategies, indirectly affecting internal operating efficiency. With an increased likelihood of liability expansion, there is a corresponding rise in funding cost risk. This risk is rooted in the vulnerability posed by expanding liabilities and exposure to financing challenges. The measurement of likelihood is intricately tied to the underlying factors contributing to liability expansion, including the historical trend of liabilities and the potential for manipulation of financial reports. These considerations substantiate the assessment of a higher likelihood, signaling heightened vulnerability of the company to funding cost risk.
However, determining the severity of consequences requires careful consideration. While the escalation of funding costs imposes an additional financial burden, its impact on the daily operations of the Commonwealth Bank's international finance department is deemed moderate. Despite the incremental costs incurred, the core functionality and operational efficacy of the department remain largely intact. Consequently, while the consequences of funding cost risk are tangible in terms of increased expenses, they are deemed to be of moderate severity, as they do not significantly impede the department's core functions or strategic objectives.

## 4.3 *Liquidity and solvency risk*

Both risks can be viewed as consequences of the risks discussed previously. Within the framework of an accounting approach, the risk assessment of a banking institution is multifaceted, requiring an analysis of organizational resilience and branch-specific dynamics. The bank's extensive presence in Australia and its strong financial position mitigate the immediate impact of localized setbacks, such as those at the North American branch, thereby reducing the

risk of imminent cash flow challenges leading to bankruptcy in the short term.

However, a closer examination of the North American branch reveals a more complex scenario. The branch's ability to resolve the problem solely through its own profits is questionable. While the likelihood of this risk occurring is very low, the potential consequences are significant. As a result, this risk is placed in the orange section of the risk matrix due to the severity of the potential consequences.

From an accounting perspective, responding to extreme situations often requires strategic financial maneuvers, such as adjusting financial statements to improve perceived performance. This may involve removing recurring charges or classifying increased funding costs as one-off expenses to present a more favorable financial picture. However, such manipulations undermine the integrity of financial reporting, erode stakeholder trust, and exacerbate liquidity risk. This creates a vicious cycle: reduced credibility leads to increased risk exposure, highlighting the intricate interaction between accounting practices, risk management, and organizational resilience in the banking industry.

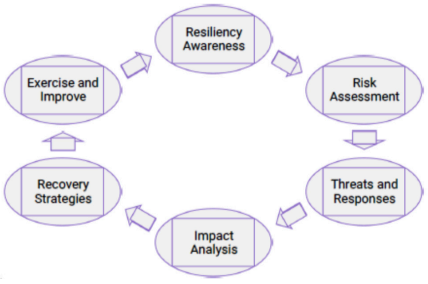


**Figure 10 Resilience Cycle**

## 5. Learnings

The integrated risk management framework reflects the interdependence of four key areas: strategy, people and culture, technology and information, and processes and operating models. Together, these components enhance an institution's ability to manage financial risk. An effective strategy aligns objectives with risk management practices to address issues such as rising debt interest payments. A strong culture fosters ethical standards and transparency in financial reporting, thereby reducing the risk of financial manipulation. Advanced technology and reliable information systems enable real-time data analysis and risk assessment, supporting accurate accounting practices. Streamlined processes and rigorous accounting methods reduce the likelihood of financial reporting manipulation. Collectively, these interrelated areas form a robust framework for managing complex interest rate fluctuations and accounting challenges, ensuring continued financial stability.

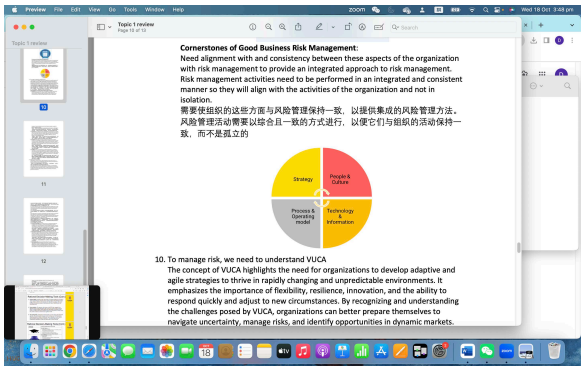


**Figure 11 Cornerstones of Good Business Risk Management**

The three-line model is essential for enterprises, with internal audit serving as the third line of defense. It provides independent assurance and advice to help achieve organizational goals, maintain the integrity of financial reporting, and ensure compliance with accounting standards. The role of internal audit is crucial in managing financial risks, such as those arising from the expected decline in interest rates which can lead to increased liabilities and rising financing costs. Internal audit ensures accurate and transparent financial reporting, reviews the accuracy of financial statements, and prevents financial misstatements that may damage the institution's reputation. In situations where financial manipulation may occur, internal audit provides the necessary oversight to accurately reflect the institution's financial position. This helps prevent a cycle of declining reputation and increased liquidity risk.

In summary, internal audit is indispensable in the three-line model for managing financial risks. Its role in monitoring, ensuring transparency, and upholding financial reporting integrity is critical to addressing interest rate fluctuations and accounting challenges, thereby supporting financial stability and operational efficiency.

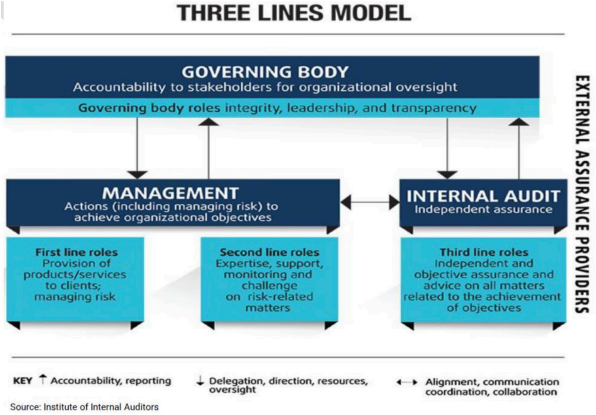


**Figure 12 Three Lines Model**

## 6. Conclusion

With all major Australian banks predicting rate cuts, organizations must employ a multifaceted risk management strategy grounded in robust accounting principles. This strategy should integrate key elements such as strategy, people and culture, technology, and processes. Together, these components form a framework that enables multinational financial institutions to effectively identify, assess, and mitigate financial risks associated with debt expansion and rising financing costs.

Strategic alignment ensures that organizational goals are synchronized with risk management practices, facilitating proactive responses to issues like rising debt interest. Cultivating an ethical culture is crucial as it reduces the risk of financial manipulation and enhances the transparency and integrity of financial reporting. Additionally, leveraging advanced technology and reliable information systems supports real-time data analysis and accurate accounting, reflecting the true financial situation.

Streamlined processes and strict controls are vital to prevent financial reporting manipulation and to manage liquidity risks effectively. The internal audit function provides independent assurance that helps maintain the integrity and compliance of financial reporting. It is particularly critical in identifying and mitigating the risks posed by potential debt expansion and increased financing costs due to rate cuts.

By focusing on these strategic areas and enhancing internal audit oversight, financial institutions can bolster their resilience against financial risks, ensuring long-term financial health and operational efficiency amid fluctuating interest rates and a dynamic economic environment.

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