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Managing Business Risk

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Managing Business Risk

⇨ *Avoiding problems and maximising profitability*

Overview

The acceptance of risk has always been an integral part of business activity. Crucially, value is created in a domain of scarcity, and one of the main factors delivering scarcity is *risk*. There is a close relationship between the level of risk taken and the likely reward, with the greater risk requiring the higher return.

The acceptance of risk is therefore an integral part of business, as is the principle that the higher the risk the higher the rate of return needs to be. The willingness to take risks of both a personal and financial nature is one of the defining characteristics of the entrepreneurial decision-maker. Interestingly, a 1999 study commissioned by PricewaterhouseCoopers concluded that while in continental Europe strategies tend to be oriented towards avoiding and hedging risk, Anglo-American companies view risk as an opportunity, consciously accepting the responsibility of risk management as necessary to achieving their goals. Successful leaders and organisations understand this, taking steps to ensure that the risks resulting from their decisions are measured ones, with the likely consequences well understood. Avoidable risks are identified and eliminated while others are reduced.

Accepting that risks exist provides a starting point for the other actions that are needed – and foremost among these is the need to create the right climate for risk management. People need to understand why control systems are needed, and this requires communication and leadership so that standards and expectations are set and clearly understood.

Benefits of managing risk

Successful business leaders take a holistic view of risk, going beyond the direct financial perspective and actively embracing and managing risk.

Managing risk requires an awareness of what the dangers are and recognition of the signals that potential problems are becoming reality.

- Greater flexibility, preparedness and continuity in the event of potentially dislocating events.
- Increased efficiency, awareness and control in all operations.
- Greater likelihood of success, as risks are better understood, monitored and managed.
- Less personal stress on individuals and teams, resulting from a feeling of openness, mutual support and security.

- Less complacency, more entrepreneurialism and a driving desire to compete and succeed.

Action checklist: managing risk

Reducing the risk inherent in business decisions is rarely a linear process. Instead, it is best achieved by applying principles and techniques appropriate to the specific situation and risk.

Consider the amount of risk that is acceptable

An early step when managing risk is to determine the appetite and risk-bearing capacity of the organisation. In other words, articulate the nature and extent of the risks that are acceptable. This must be done in the context of the environment in which the business operates, assessing the likelihood of risks becoming reality and the effect that these would have. Only when this is understood can appropriate measures be taken to minimise the incidence and impact of risk.

Identify and prioritise risks

It is sensible to be aware of and take into account the human dimension. People behave differently and inconsistently when making decisions involving risk. They may be exuberant or diffident, overconfident or overly concerned. Or, they may simply overlook the issue of risk.

One important priority is to identify significant risks within and outside the organisation, and allow these to inform decisions. In that way, unnecessary surprises are more likely to be avoided. Examples of significant risks might be the loss of a major customer, the failure of a key supplier or the appearance of a significant competitor.

Understand the catalysts that cause risks to be realised

Once risks are identified they can be prioritised according to their potential impact, as well as the likelihood of them occurring. This helps highlight not only where things might go wrong and what their impact would be, but how, why and where these catalysts might be triggered. There are many potential risk catalysts, five of the most significant types include:

Technology. New hardware, software or system configuration can trigger risks, as well as new demands placed on existing information systems and technology. When in 2003 London’s first directly elected Mayor implemented a policy of congestion charging for traffic using the centre of the city, the greatest threat to the success of the scheme, and his tenure as Mayor, was posed by the use of new technology. Fortunately for London and the Mayor the technology worked, and the scheme was generally seen as a success.

Organisational change. Risks are triggered by issues such as new management structures or reporting lines, new strategies and commercial agreements (including mergers, agency or distribution agreements).

Processes. New products, markets and acquisitions all cause process change and this, in turn, can trigger risks to occur.

People. New personnel, a loss of key people, poor succession planning or poor people management can all lead to dislocation. However, the main cause of dislocation within this category is behaviour: everything from laziness to fraud, exhaustion to simple human error can all be catalysts resulting in risk being realised.

External environmental factors. Changes such as regulation, political, economic or social developments all severely affect strategic decisions, bringing to the surface risks that may have lain hidden. The sudden and tragic arrival of the SARs epidemic, centred in Asia in 2003, highlights this risk, with economic confidence and performance throughout the region significantly affected.

Use a simple risk management process

The stages of managing the risk inherent in decisions are simple.

1. Assess and analyse the risks resulting from the decision through a systematic process of risk identification and quantification.
2. Consider how best to avoid or mitigate risks.
3. In parallel with the second stage, manage, control and monitor the risks.

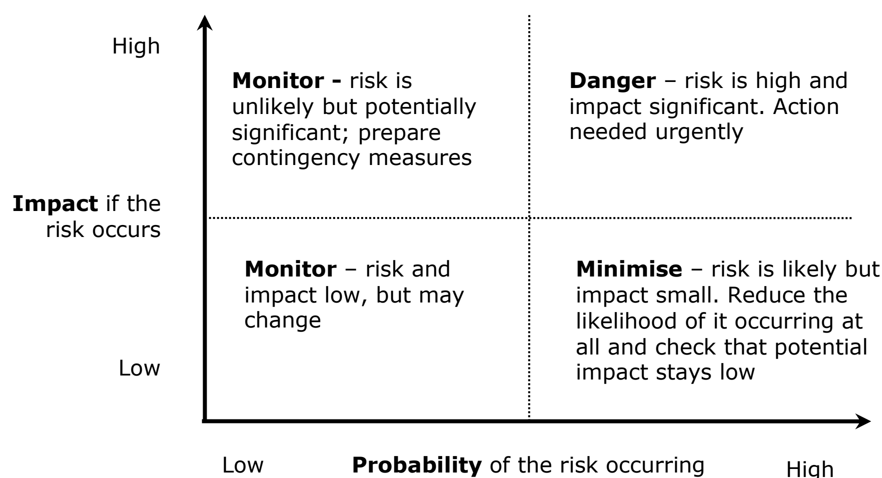
Risk assessment and analysis. It is harder to assess the risks inherent in a business decision than to identify them. Risks that lead to frequent losses, such as an increasing incidence of employee-related problems or difficulties with suppliers, can often be overcome using past experience. Unusual or infrequent losses are harder to quantify. Risks with little likelihood of occurring in the next five years do not hold much meaning for a company trying to meet shareholders' expectations in the next quarter, half-year or year. It is valuable to quantify the potential consequences of identified risks and then to define courses of action to remove or mitigate such risks.

Risk management and control. Experience shows that risk has to be actively managed and accorded a high priority – not only within the decision-making process but permanently and across the organisation as a whole. This might mean that risk management procedures and techniques are well documented, clearly communicated, regularly reviewed and monitored. In order to manage risks, you have to know what they are, what factors affect them and their potential impact.

Once the inherent risks in a decision have been understood, the priority is to exercise control. This essential part of the risk management process builds on the need to ensure that every employee is aware that unnecessary risk-taking is unacceptable. They should understand what the risks are, where they lie and understand their role in controlling them. In order to exercise control over identified risks, it is sensible to do the following: share information, prepare and communicate guidelines, and establish control procedures and risk measurement systems.

Avoiding and mitigating risks. When mitigating risks, start by reducing or eliminating those that result only in cost: essentially non-trading risks. These might include property damage risks, legal and contractual liabilities and business interruption risks, and can be thought of as the 'fixed costs' of risk. Reducing these risks can be achieved with techniques such as quality assurance programmes, environmental control processes, enforcement of employee health and safety regulations, installation of accident prevention and emergency equipment, training and security to prevent crime, sabotage, espionage, threats to people and systems. And, of course, if you reduce the risk, the cost of insuring against it (in cases where you are able to) should go down.

Managing the impact of risk



Other ways that risk can be reduced or mitigated are to share them with a partner and to monitor or subject them to contingency plans. For example, acceptable service level agreements from vendors are essential to reduce risk. Joint ventures, licensing and agency agreements are also different ways of mitigating risk.

In order to minimise the chances of things going wrong, it is important to focus on the quality of what people do – doing the right things right reduces risks and costs.

Actively managing and using information is also crucial. Risk management relies on accurate, timely information. Management information systems should provide details of the likely areas of risk and of the information that is needed to control the risks. This information in turn must reach the right people at the right time, so that they can investigate and take corrective action.

Create a positive climate for managing risk

Simply recognising the need to manage risk is not enough. The ethos of an organisation should recognise and reward behaviour that manages risk. This requires a commitment by senior managers and the resources (which includes training) to match. Too often, control systems are seen only as an additional overhead and not as something that can add value by ensuring the effective use of assets, the avoidance of waste and the success of key decisions. A survey by PricewaterhouseCoopers of 100 American companies with revenues between $250 million and $30 billion revealed that more than half of their managers believed controls got in the way of getting work done. Rather than seeing risk management as an integral part of business which could assist firms in achieving their corporate objectives, they were viewed as a bureaucratic burden and policing process. In short, it seems that control systems are often seen as getting in the way of people doing their jobs, rather than things that help make sure they don't do their jobs badly.

Overcome the fear of risk

Risk aversion still predominates in business. Everyone accepts that risks need to be taken if you are to keep ahead of the competition. The answer seems to be a better understanding of what the real risks are; for people to genuinely share responsibility

for the risks being taken, and for people to change their own mindset, embracing risk as an opportunity, not a threat. Organisations need to stop taking the fun out of risk, emphasising the need to control it in a way that is often perceived as bureaucratic and stifling. As any entrepreneur will tell you, risk is both desirable, providing new opportunities to learn, develop and move forward, and necessary, compelling people to improve and effectively meet the current of challenge and change.

Avoiding problems

Quantify potential risks. Because each risk may have a different level of impact, quantifying their effects is essential. Risks can be mapped both in terms of likely frequency and potential impact, with the emphasis on materiality. Also, the potential consequences of risk may be ranked on a scale ranging from inconvenient to catastrophic.

Assessing and mapping risk

Ability to control risk	Minor	Significant	Major	Critical
No control				
Weak control				
Significant control				
Total control				

Potential impact

If the ability to control the risk is plotted against its potential impact, as shown in the diagram above, you can decide on actions either to exercise greater control, or to mitigate the potential impact. Risks falling into the top right quadrant are the priorities for action, although the bottom right quadrant (total/significant control, major/critical impact) should not be ignored as management complacency, mistakes and a lack of control can lead to the risk being realised.

Identify potential business risks. Risk surrounds us all of the time. Some of the most common areas of risk affecting business are summarised in the table below. This is not a comprehensive listing but rather a stimulus to help consider the major areas where risks might lie. It also allows for a structured analysis and reduces the chances of risks being overlooked.

Areas of organisational risk

Financial	Commercial	Strategic	Technical	Operational
Accounting decisions and practices	Loss of key personnel and tacit knowledge	Marketing, pricing and market entry decisions	Failure of plant or equipment	Product or design failure, including failure to maintain supply

Treasury risks	Failure of commercial partners (such as licensees, agents, JV partners)	Acquisitions decisions	Infrastructure failure	Failure to develop new products
Financial viability of debtors and strategic suppliers	Failure to comply with legal regulations or codes of practice	Market changes affecting commercial decisions	Accidental or negligent actions	Client failure
Fraud	Contract conditions	Political or regulatory developments		Breakdown in labour relations
Robustness of information management systems	Poor brand management or handling of a crisis	Resource-building and resource allocation decisions		Corporate malpractice (such as sex discrimination)
Inefficient cash management	Market changes			Political change
Inadequate insurance				

To this list should be added another, intangible category: the opportunity cost associated with risk. In other words, avoiding a risk may mean avoiding a potentially huge opportunity. There is a tendency for people to be too cautious and risk averse, even though they are often at their best when facing the pressure of risk or deciding to take a more audacious approach. It is also worth considering that sometimes the greatest risk of all is to do nothing.

Dos and don'ts

Do:

- Understood the causes of risks by asking:
- What has caused similar problems?
- What might be causing the problem to occur here and not elsewhere?
- What precipitated the problem?
- What combination of factors might have caused the problem?
- If X is the cause, how does it explain all the facts?
- Look for relationships and trends in the data, investigating conflicting data and determining its relevance.
- Avoid decisions based on feelings alone and think critically, asking "Why?" "What else?" and "What if?" questions to probe thinking.

Do not:

- Limit the sources of information analysed, confuse the issues or fail to work out what is essential.
- Adopt too narrow a perspective, fail to consult or be subjective or irrational.
- Ignore the mistakes (and lessons) of the past.
- Prefer existing thinking and orthodoxy.
- Rush to a decision or solution that appears obvious.

Key questions

- For the most important areas of activity: What are the greatest risks to the most important areas of activity? What are the potentially dislocating events that could inflict the greatest damage on your organisation?
- What level of risk is acceptable for the company to bear?
- What is the overall level of exposure to risk? Has this been assessed and is it being actively monitored?
- What are the risks inherent in the organisation's strategic decisions and what is the organisation's ability to reduce the incidence and impact on the business?
- What are the costs and benefits of operating effective risk management controls?
- Are the risks inherent in strategic decisions (such as acquiring a new business, developing a new product or entering a new market) adequately understood?
- At what level in the organisation are the risks understood and actively managed? Do people fully realise the potential consequences of their actions and are they equipped to understand, avoid, control or mitigate risk?
- What review procedures are in place to monitor risks?
- To what extent would the company be exposed if key staff left?
- If there have been major new developments in the organisation (such as a new management structure or reporting arrangements), are the new responsibilities understood and accepted?
- Are management information systems keeping pace with demands? In particular, are there persistent 'black spots' – priority areas where the system needs to be improved or overhauled?
- Do people in the organisation resent risk or are they encouraged to view certain risks as opportunities?

Things you can do

The activities you can undertake yourself to manage business risk include:

Analysing financial and other data to inform decisions. List the techniques of greatest value to you. These may include: balance sheet analysis, ratio analysis, cash flow forecasting, discounted cash flow, investment appraisal and customer data.

Establishing clear performance targets. This means: possessing a clear view of the desired outcome, being challenging, prepared to stretch the bounds of the possible and ensuring that targets are specific, measurable, attainable, relevant and time-constrained. You should also understand what resources and other actions may be needed for you or your colleagues to achieve these targets – consider how to incentivise individuals to achieve their performance targets and provide additional help and support to team members, following through with any commitments.

Reviewing a successful business case. How was it presented? Why did it succeed? What were the potential problems and how were these overcome? Focus on the presentations and discussions that were involved as well as the written material.

Learning from other business initiatives and projects. Find ways to share expertise and experience and to encourage your team to develop ideas from other businesses, both internally and externally.

Creating a positive climate for managing risk. By itself, simply recognising the need to manage risk is inadequate. The ethos of the entire organisation should recognise and reward behaviour that manages risk, grows revenue and controls costs. This requires a commitment by senior managers and the resources (which includes training) to match. Too often, control systems are seen only as an additional overhead and not as something that can add value by ensuring the effective use of assets, the avoidance of waste and the success of key decisions.

Undertaking a SWOT (Strengths, Weaknesses, Opportunities and Threats) analysis. This is a method of understanding where opportunities lie as well as areas where weaknesses need to be addressed. Strengths and weaknesses are typically found within an organisation, whereas opportunities and threats are most often external to it. Typical sources of strength or weakness include:

Financial issues	Personnel issues	Operational issues	Product and market issues
Cash-flow and cash management	Quality (meaning the ability, experience and attitude) of managers and employees	Current product portfolio	Warehousing, transport and logistical factors
Financial structure	Concentration of skills and expertise (to what extent is the fate of the business in the hands of a talented few?)	Research and technical expertise, and the ability to develop popular new products	Distribution channels, including discount structures and dealership or franchise operations
Financial reporting systems	Levels of motivation	Market research systems	Pricing
Financial issues	**Personnel issues**	**Operational issues**	**Product and market issues**
Ability to raise capital	Rates of pay	Information management systems	Brand perception
Credit control activities	Ability to attract and retain the best personnel	Supply chains	Customer service
Risk management systems	Scope and effectiveness of training methods	Production lead times and efficiency	Overall market potential for the product
	Flexibility of people and their ability to adapt to changing situations	New processes that reduce costs and increase efficiency	Experience of the marketing mix (knowing which sales activities are most effective)
	Organisational culture: whether it promotes efficiency or frustrates it	Stock control	
	Organisational structure: whether it remains relevant and effective		
	Levels of delegation and empowerment, and productivity in terms of quality and quantity of work completed		

	The degree of initiative that is both allowed and taken		
	Effectiveness of communication channels		

These factors can be either strengths or weaknesses, and they often change from one to the other surprisingly quickly. Typical sources of opportunity or threat tend to be more difficult to assess than internal factors, and include:

Sources of opportunity

- New markets (including export markets)
- New technologies
- New products and product enhancements
- Mergers, acquisitions and divestments
- New investment
- Factors affecting competitors' fortunes
- Commercial agreements and strategic partnerships
- Political, economic, regulatory and trade developments

Sources of threats

- Industrial action
- Political and regulatory developments
- Economic issues
- Trade factors
- Mergers and other developments among competitors
- New market entrants
- Pricing actions by competitors
- Market innovations by competitors
- Environmental factors
- Natural disasters
- Crises, notably including health and safety issues, product quality issues, product liability problems
- Key staff attracted away from the business
- Security issues, including industrial espionage and the security of IT systems
- Supply chain problems
- Distribution and delivery problems
- Bad debts (resulting from the fortunes of others)
- Demographic factors and social changes affecting customers' tastes or habits

Using scenario thinking. Decisions should focus on the reality of how situations are developing. This requires managers to develop foresight, considering how situations and markets might develop. The great advantage of scenario thinking is not in predicting the detail of what the future will be, it is in understanding what forces are driving us towards that future.

Activities that can be done with members of your business or team include:

Creating awareness of the need for sound commercial thinking. When managing risk, one of the most important factors is attitude. Fostering a view of the organisation that understands financial issues and is entrepreneurial – looking to

increase revenues, remove waste, serve customers and manage risk – is invaluable. Above all, people need to feel ownership and responsibility for their business's financial performance and their role in achieving success.

Assessing financial and reputational risks. Encourage your team to assess the risks in their business decisions by asking:

- What is the probability of this occurring?
- What will be the impact if it does occur? How could the decision affect the way the organisation is viewed in the community?
- What could cause this risk to occur?
- What preventive actions will reduce the probability of these causes occurring?

Because each risk may have a different level of impact and consequence, quantifying their effects, even in the most general of terms, is essential. Once you have assessed and acted to reduce the probability and impact of risks, you are still faced with the question: How much risk is acceptable? The answer is situational. Some of the factors you need to consider include customer benefits, legal restrictions, ethical considerations, your personal risk tolerance – and that of your manager – and business benefits. Talk with colleagues about situations where too much risk was taken. Which of the above considerations applied? What can you learn from these situations?

Further action

Use the following table to identify areas for further development.

Issue	Response	Further Action
Is there a positive climate in your organisation for managing risk?		
Have you identified and quantified potential business risks?		
Issue	**Response**	**Further Action**
Would scenario planning help you and your colleagues understand how and why your business situation is changing?		
Do you have a clear understanding of potential opportunities – and how these can be realised?		

For Further Information or to Arrange a Consultation

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