Fāilte Ireland Business Tools

Risk Management

A guide to help you manage events or circumstances that have a negative effect on your business

This guide describes the risk management process, defines a risk, identifies some common risks to small business, explores the various ways you can protect your business, and discusses the tools you can use to identify and assess risk to your business.

Fāilte Ireland

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Risk Management

This guide looks at dealing with events or circumstances that have a negative effect on your business and covers the following content:

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1. What is a Risk?

Whether you're aware of it or not, risks are all around you. From the moment you get up in the morning until the moment you go to bed, you're constantly being exposed to risks of varying degrees. Some examples of risks you may face in your everyday life include:

- Slipping in the shower and seriously injuring yourself
- Getting burnt while cooking breakfast
- Hitting a car while driving to work

Trying to define the exact nature of a risk is not always straight forward; in fact, the term risk may have slightly different definitions depending on the discipline in context. For example, in some disciplines, the definitions of risk place a great deal of emphasis on the probability of an event occurring, while a more comprehensive definition might incorporate both the probability of the event occurring and the consequences of the event.

For the purposes of a small business, a risk can be simply defined as an event or circumstance that has a negative effect on your business, for example, the risk of losing money due to bad business decisions.

It is also useful to understand the components that make up a risk. Research shows that an existence of a risk requires two elements:

- There has to be uncertainty about the potential outcomes; and
- The outcomes have to matter.

To illustrate this definition, consider playing a fun game of cards with your friends. There is no risk involved in this activity. However, if you and your friends decide to put bets onto that game of cards i.e. gambling, there are now risks involved. This risk for you would be losing your money.

“Risk management is a culture, not a cult. It only works if everyone lives it, not if it's practiced by a few high priests” *Tom Wilson, Allianz Chief Risk Officer*

Risk and reward

There is also a direct and undebatable relationship between risk and reward. It has always been known that to gain large rewards, you must be willing to expose yourself to considerable amounts of risks. Past leaders and entrepreneurs have proven this. Particularly in a business context, deciding on how much risk to take and what types of risks to take are critical to the success of a business. For example, if you decide to play it safe and not expose yourself to any potential risk, it is unlikely that you will be earning your maximum potential. However, exposing your business to all the wrong types of risk can be just as bad for your business, if not worse.

Damodaran, A 2008, *Strategic risk taking: a framework for risk management*, Wharton School Publishing, Upper Saddle River, N.J.

2. Common Small Business Risks

Being aware of the most common risks small businesses are faced with enables you to be better prepared and hence deal with them appropriately.

Business risks can be broken up into the following:[1]

- Strategic risks - risks that are associated with operating in a particular industry
- Compliance risks - risks that are associated with the need to comply with laws and regulations.
- Financial risks - risks that are associated with the financial structure of your business, the transactions your business makes and the financial systems you already have in place
- Operational risks - risks that are associated with your business' operational and administrative procedures.
- Market/Environmental risks - external risks that a company has little control over such as major storms or natural disasters, global financial crisis, changes in government legislation or policies

Keep in mind that not all risks will fit perfectly into one of the above categories. There may be incidents where a risk overlaps into two or more categories such as the protection of confidential information. In this example, there are laws that have to be considered, making it a compliance risk. However, the management of confidential information can also be an operational risk as it may be part of a business' daily activities.

Some of the more common risks that apply to small businesses include:

- Breakdown of machinery and equipment
- High staff turnover or loss of a key staff member with unique skills
- Security of data and intellectual property
- Theft
- Increased competition
- Failure to comply with legislation, regulation and/or standards
- Bad debts created customers
- Negative cash flow
- Natural disasters such as fires and storms
- Issues relating to internet connectivity
- Internet fraud and scams
- Insurance coverage
- Consequences arising from lack of innovation

[1] Business Link, *Managing Risk*, 2010.

3. What is Risk Management?

"Risk comes from not knowing what you're doing" *Warren Buffett, American business magnate, investor, and philan-thropist*

Risk management is the process whereby organisations identify, assess and treat risks that could potentially affect their business operations.[1] It should be a central part to any organisation's strategic management and its objective is to add maximum sustainable value to all the activities of the organisation.

Risk management is not something that you just do once and forget about. Rather, it should be a continuous and developing process. Risk management should also be integrated into the culture of your business and you should put in effort to convey this to all your staff, at all levels. This approach to risk management will create an environment of accountability, performance measurement and reward, thus promote operational efficiency throughout your business.

The following are some ways in which risk management can protect and add value to your business:[2]

- ✓ Provide a framework for your business that enables future activity to take place in a consistent and controlled manner
- ✓ Improve decision making, planning and prioritisation by comprehensive and structured understanding of business activity, volatility and project opportunity/threat
- ✓ Contribute to more efficient use/allocation of capital and resources
- ✓ Reduce volatility in the non essential areas
- ✓ Protect and enhance assets and the image of your business
- ✓ Optimise operational efficiency

[1] AIRMIC, *Risk Management Standard*, 2002.
[2] Ibid.

4. Identifying Risks

One of the more recognised and structured approach to identifying risks is to consider the key processes and assets that are responsible for your business' success. You can use techniques such as brainstorming and the SWOT analysis. Keep in mind that this activity should be done by someone that understands the business inside out.

If you wish to use the services of an external consultant, it is best that you spend time with them to ensure that they understand how the business operates in practice. Any 'standard solution' should be approached with caution as each business is unique, thus often requiring a customised approach.

When identifying risks, you should not only focus on the strategic or corporate level (i.e. top-down approach), but also at the level where the risk arises or has its most direct impact (bottom-up)[1].The latter is often neglected but you should be aware that almost every person within your business plays some role in the management of risks. It is therefore always important to involve all staff in order to capture information about risks and allow better decision making.

> "*overcome challenges*"

You should also factor in all the potential risks that are applicable to your industry. However, industry-wide risks are not always a negative thing. With the correct approach and resources in place, these risks are usually opportunities for individual businesses that can successfully overcome the challenges.

[1] Sadgrove, K, *The Complete Guide To Business Risk Management,* 2005.

5. Assessing Risk

The process of assessing risk involves four steps:

1) Risk awareness

Before risk management can occur, you need to recognise that risks exist within your business and that they can and should be managed. Further, it is good practice if you embed risk within the culture of your business.

2) Assess the risks

Every type of risk should be approached differently and should have its own assessment format. For example, environmental risks such as fire involve physical audits, while strategic risks are more likely to involve research and analysis. It is recommended that you develop a standard methodology for assessing each type of risk.

A thorough risk assessment usually includes measurement. This allows you to analyse trends, and to make decisions based on fact, not opinion.

The next part of the process is to determine the priorities of each risk. This will allow you to allocate appropriate resources depending on the rankings of the risks. For example, if your business has had a history of high staff turnover, you may rank the risk of staff leaving unexpectedly high as opposed to the risk of a forest fire, which would be relatively low (depending on your location).

> *"higher risk exposure"*

A common practice for many businesses is to limit their risk assessment to those risks which they know they can resolve or ones that they can afford to resolve. This is a dangerous strategy and almost defeats the purpose of risk management. When undertaking this task, you should not have any preconceptions about risk. No risks should be excluded simply because of a lack of resources or because you may feel that they cannot be solved. If you are unable to acknowledge that a risk exists when you clearly know it's there, you won't be doing yourself and your business any favours. In fact, you will be holding your business back from finding solutions to overcome the risk which consequently will result in higher risk exposure for your business.

3) Treat the risks

Once all the risks have been identified and assessed, you should develop strategies to prevent them from occurring. Strategies include:

- ✓ Avoid: choosing not to accept the risk.
- ✓ Minimise, reduce or control: through means such as improved monitoring, or changing the process.
- ✓ Spread (also known as transferring or sharing risk): by diversifying, sub-contracting, outsourcing, joint venture, hedging, or insurance.
- ✓ Accept: deciding that the risk is within agreed risk tolerances.

4) Monitor

The final stage is to monitor risks. This includes regularly measuring the risk (to ensure that it remains within stated tolerances), and auditing (to ensure that the procedure is being followed).

As part of the monitoring process, you should be looking at things such as:

- ✓ Trends that indicate a growing danger
- ✓ Data that shows variances from the norm, or is outside pre-set limits
- ✓ Key performance indicators
- ✓ One-off reports on new areas of risk
- ✓ Information from a range of sources
- ✓ Key findings from audits

6. The Risk Matrix

A comprehend-sive Risk Analysis Matrix can be downloaded from the Government of Western Australia's website

Probability and severity are two important factors in measuring risk (these are also known as 'likelihood' and 'impact'). For example, businesses often suffer small problems frequently, and major problems rarely. As a general rule, the more severe the event, the less likely it is.

Below is a diagram illustrating a typical 3x3 risk matrix.

High severity			
Medium severity			
Low severity			
	Low probability	**Medium probability**	**High probability**

Utilising such a grid can assist you in prioritising your risk management programme. Risks should be prioritised in order from the top right of the grid to the bottom left. For example, if you have a highly probable risk that may potentially also have a high impact, it should be urgently addressed.

If your business has only a few risks that lay in the bottom right-hand corner of the matrix, it may be more beneficial to spend resources on other things. However, if you have many of these bottom right-hand corner risks (low severity/high probability) it may all add up to a rather serious problem.

"impact of a risk"

Putting numbers to the matrix

It is also useful to quantify the impact of a risk. By multiplying the probability by the severity, you can quantify the importance of the risk. To do this you need to make the analysis more sensitive, by using a 4 x 4 or a 10 x 10 grid. For example, in a 10x10 grid, a terrorist bombing might rate as 10 (probability 1 x severity 10), whereas the risk of flooding could be 54 (probability 6 x severity 9). When trying to quantify the impact of a risk, many people opt for the 10x10 matrix as it automatically produces a percentage, which many people are familiar with.

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