Business Advocacy Network

Managing business risk

Introduction

This note has been written to assist business associations to think about how they manage and mitigate risk though the principles set out here are just as applicable to individual businesses.

Most associations – which are businesses in a different form – originated from a handful of businesses finding some resource, taking a risk, and creating a new entity. Similarly, most businesses are started by one or more entrepreneurs to who take a risk with their – and maybe other people's – money to start a business.

Many entrepreneurs and managers either assume that the risks to their survival are small or possibly do not think about them at all. Certainly, few businesses ever undertake any sort of risk assessment or put in place mitigation plans, unless they are pressed by a customer or funder. But the recent health crisis has reminded businesses of the importance of looking at risk. Moreover, businesses cannot begin to mitigate the risks until they have identified them.

Thinking about risk

It is important to think about the risks and then important either to undertake actions immediately intended to mitigate the risk (for example, adopting a policy to deter staff from working at a computer screen for too long, or ensuring that there is a first aid box available on site) or, in some cases, to prepare contingency plans (for example, so that people can work from home if it becomes impossible to work from the office). It is important to remember, however, that not all risks can be addressed through creating lots of rules which are unlikely either to reduce the likelihood of a risk occurring or reduce the impact should it occur. In other words, managing risk is not just about managing compliance. Whilst some risks can indeed be managed through a rules-based approach, some risks require a different approach. Specifically, they require that everyone in a business is alive to the possible risks and takes personal responsibility for mitigation. An obvious example these days is the phishing e-mail.

Risks can be divided into three categories: 'firm risk', 'market risk' and 'environment risk'. Kaplan & Mikes (2012) call them preventable risk (which they define as risks arising within the business), strategy risk (risks taken to improve returns) and external (uncontrollable) risk, though firm risks are not always preventable and market risk may be about more than strategy risk.

Whilst this can be a useful way of categorising risk, they still need to be identified and then managed by assessing the likelihood of them occurring and the potential impact if they do occur.

Firm risk

Firm specific or internal risks tend to be specific, are usually controllable and thus can be minimised or avoided. Examples include unauthorised or inappropriate or unethical actions by staff; employees performing poorly because they have been inappropriately or inadequately managed; failure of operational procedures or processes; faulty or insufficient infrastructure. It would, to be fair, be too costly for most businesses to eliminate all risks, so they will want to allow some tolerance but, as far as possible, businesses will want to

eliminate these risks. Firm risks can be mitigated through active prevention: putting in place procedures designed to minimise the risk from occurring (for example, screening incoming email and blocking email from unknown sources) and then encouraging appropriate decisions and behaviour by staff (for example, still questioning the veracity of any e-mail that looks suspicious).

However, businesses will find that they are unable to anticipate every possible risk or circumstance. A first line of defence is to be clear about the company's values and goals and encourage staff to take responsibility for their own decisions.

One area, in my experience, where many firms could do more is in relation to their financial control and, in particular, understanding what the accounts are telling them. Whilst it is never possible to eliminate financial risk, it can nevertheless be controlled to a large extent.

Market risk

Businesses work in markets and there is inevitably a degree of risk that comes from so doing. Examples include the threat of new competitors or the threat of a completely new technology or the risk that fickle customers will take their custom elsewhere. Businesses accept some risk, however, because otherwise they will not be able to compete. A bank takes a risk every time it makes a loan; an investor takes a risk that the investment may not generate a given return or indeed that the whole investment may be lost. All money spent on research and development is at risk.

Risks such as these are inherent in being in business and, whilst businesses would prefer not to face them, recognise that they have to live with them. Indeed, a strategy intended to generate a high return may mean living with a higher risk. That is why most large firms have a policy that new development or projects must be expected to generate a pre-defined return – they do not actually expect them all to generate such a return but aim to set the threshold so that the successful projects generate enough of a return to cover the failures.

Market risks are harder to mitigate than firm risk and generally cannot be managed through a rules-based approach. Instead, they largely have to be managed through a system that considers the likelihood of a risk coming to pass and adopting plans designed to mitigate the impact if they do.

Business environment risk

Businesses do not work in isolation: they operate in a world in which they have no control over a wide range of factors that include economic trends, legislation and regulation, infrastructure, corruption, security, revolutions, natural disasters such as earthquakes or typhoons or pandemics, trade wars, the sudden imposition of tariffs, power cuts etc. Since, like market risk, firms cannot prevent any of these from occurring, they need to focus on identifying the possible risks and then taking actions to mitigate the likely impact. In some cases, the business may consider the risk so low that they ignore it: this was the view taken by most businesses in relation to pandemics, though Wimbledon Law Tennis Club perceived the risk differently and had pandemic insurance which covered all its losses resulting from the cancellation of the tennis in 2020. Some risks creep up on. Like changes in weather arising from global warning, yet businesses could be taking steps now to mitigate the potential impacts. In some countries, power cuts are seen as so unusual that most businesses do not have generators; in other countries, the risk is perceived as so high that most businesses have a generator.

Some businesses make use of scenario planning, a technique originally developed by Shell in the 1960s, looking at external opportunities and threats and preparing narratives of what the world might look like is say five years time. The scenarios can then be used by the

business to determine how it would respond if the scenario came to pass – and put in place now actions to mitigate the possible risks.

Assessing risk

Risk assessment is the process of identifying, understanding and evaluating risks with the potential to affect, possibly existentially, a business. Any assessment has to include

- Identification of the possible hazards – what could harm your employees or customers or suppliers or what harm could any of them bring about?
- Identification of who or what might be harmed – which employees are most at risk from the potential hazards?
- Evaluation the likelihood of a risk occurring and the potential impact

Involve your staff in your risk assessment – they are likely to have a much better idea of what is risky. Think about long term risk as much as short-term risk – noisy machinery might bring about deafness for people exposed to it for a long time.

Managing risk

The way that risks are managed depends on the category but all risks should prompt thinking about mitigation. A compliance-based approach may be appropriate to manage preventable risks, but will be inappropriate to manage market or environment risk. Firm risks can be managed through taking actions designed to minimise the risk – such as reducing noise or separating people and noisy machines with acoustic baffles or ensuring that there is a staff succession plan – or taking actions to mitigate the impact of the risk occurring – such as having fire extinguishers or first aid kits easily available or maintaining a roster of consultants who can provide cover in an emergency. Many firms attempt to address hazards by putting up signs warning people about the risk, but people tend not to take too much notice so focus on encouraging behaviours that reduce risk.

Once you have a list of risks, it is worth summarising them all on a spreadsheet together with an assessment of impact (typically scored 1-5, covering insignificant, mi nor, moderate, major, severe) and an assessment of likelihood (typically scored 1-5, covering rare, unlikely, possible, likely, almost certain). These can be combined into an overall risk factor (typically describing the risk as minor, moderate, major or severe). In the next column, for each risk, set out the action that has been undertaken to mitigate the risk or the contingency plan that has been put in place. For each risk, you should also consider appointing a 'risk manager', a member of staff who has responsibility for worrying about the particular risk and ensuring, for example, that contingency plans are kept up to date.

Having considered the risks and the mitigating steps, build these into your business plan. Many firms have a 'risk plan' but this is no use if it conflicts with or is ignored by the business plan.

Further reading and further information

- Kaplan, R.S. & Mikes, A (2012) Managing risks: a new framework, Harvard Business Review 90(6) available at https://iga.fyi/risk.

Copyright © 2020 Irwin Grayson Associates

The Business Advocacy Network is an initiative of Irwin Grayson Associates and intended to support business member organisations (BMOs) to engage in public private dialogue and to advocate improvements to the business environment. This factsheet has been written by David Irwin. You are free to use the factsheets and other materials provided that the source is acknowledged. The Business Advocacy Network can be found at businessadvocacy.net. IGA can be found at irwingrayson.com and contacted at david@irwin.org. You can follow David Irwin on twitter at @drdavidirwin.