LAP

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Strategic Management LAP 75 Performance Indicator: SM:075 **Student Guide**

Prepare for the Worst; Expect the Best

Nature of Risk Management

Objectives

A Explain categories of business risk.

B Describe risk-management processes and strategies.

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So What?

Cage, Aiden, and Tyler are planning a camping trip. First, they identify equipment and supplies that they'll take—a tent, sleeping bags, food, etc.—and determine who will bring each item. Then, they brainstorm problems that they might run into on their trip: rain, extreme hot or cold temperatures, poison ivy, mosquitos, poisonous snakes, and even raccoons.

After making a list of these risks, the friends talk about how they can prepare themselves for each one. The three decide that if rain is forecasted for their camping weekend, they will postpone their trip. They will take several layers of clothing to prepare for extreme temperatures—hot or cold. They'll do their best to avoid poison ivy while camping, but they'll take some calamine lotion just in case. Bug spray will keep the mosquitos away. They'll take their chances with the snakes. And, they'll make sure that they put their food in sealed containers so raccoons can't get to it. Now, rather than worrying about what could go wrong on their camping trip, the friends can have fun.

Businesses, too, devote time to anticipating future events. They identify potential problems and opportunities, determine the importance of each, and develop a plan to respond to each problem or opportunity. In the business world, this process has a special name—risk management.

Risky Business

Few things in business are certain. Consumer preferences, weather conditions, employee productivity, and many other factors that **impact** business can change almost overnight. To survive in this environment of unknowns, businesses must identify and face these possibilities and problems—these risks—head on. By doing so, a business can lessen risks' harmful effects and better achieve organizational goals.

What is risk? **Risk** is the possibility of loss (failure) or gain (success) inherent in conducting business. All business risks are either pure or speculative. A **pure risk**, such as a tornado, brings the possibility of loss or no loss, but no gain. Either a tornado hits your business, or it doesn't. A **speculative risk**, on the other hand, brings the possibility of loss, no change, or gain. An example would be investing in stocks. The value of your stocks could go down, stay the same, or go up, depending on the market.

▲ *Beachfront hotels are exposed to the speculative risk of travel and tourism and the pure risk of hurricanes.*

In the business world, organizations look to risk management to lessen or eliminate the impact of pure risks and to reduce the losses and increase the gains resulting from speculative risks. As a business activity, **risk management** involves the planning, controlling, preventing, and limiting of business losses, as well as enhancing possibilities for gain. Keep in mind that risk management doesn't involve avoiding all risk; instead, it involves taking calculated risks that have the lowest possibility of loss and the highest possibility of gain. Risk management helps a business to be **proactive**, not **reactive**, in facing risk, and it reduces uncertainty about the future. By reducing business losses, risk management also helps to control costs, protect the business's assets, and encourage the long-term survival and success of the firm.

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▲ *By identifying and reducing risks, a company can help avoid costly domino effects.*

Will You Risk It?

Business risk comes in many shapes and sizes. Some risks are merely "bumps in the road," but other risks have the potential to ruin even the most profitable businesses. Risks are often categorized as hazard, financial, operational, or strategic risks.

Hazard risks. Hazard risks are potential events or situations that can cause injury or harm to people, property, or the environment. Most pure risks fall into this category, since hazard risks have the potential to cause business losses, but no gains. Tornados, earthquakes, floods, hurricanes, and other natural phenomena are considered to be hazard risks, as are fires and other property damage. Other hazard risks include crime (e.g., theft, data breaches), product recalls, and liability claims. Cybercrime is a real risk that can be very costly to companies. CNN's video "Cyber Security: It's Not Just About Yahoo" explains the far-reaching consequences of a data breach: www.cnn.com/2016/09/30/opinions/yahoo-data-breach-vishwanath/.

Hazard risks that can personally impact employees and customers include illness, injury, disability, harassment, and discrimination. Inadequate safety equipment or hazardous working conditions, for instance, could result in employee injury. Customers could slip and hurt themselves on a business's icy walkways, a heavy box could fall from a high shelf and hit customers on the head, or an employee might make inappropriate comments to customers. All are hazard risks.

Construction workers are trained in the use of safe work techniques and equipment to prevent injury. ▶

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Lastly, depending on the severity of a hazard risk, a firm might have to cease operation for a length of time. Consider retailers located in the path of a hurricane: Many close in anticipation of the storm, while others are forced to shut their doors after the storm to do repairs. Any business interruption (and the resulting loss of revenue) is a hazard risk, as well.

The Gray Zone

The Visionary Company, a cloud-based subscription TV and video service, is developing virtual reality (VR) devices capable of offering a 4D experience including images, touch, sound, and smell. Sandy, Visionary's VR manager, is responsible for the VR800, the company's latest VR device. Because a rival subscription service company already offers a similar device, Sandy wants Visionary to release the VR800 as soon as possible.

However, Sandy just learned that many customers have encountered problems with the competitor's VR device. Although she feels certain the VR800 will not encounter similar issues, Sandy is unsure what to do. She's afraid that if she tells her superiors about the competitor's difficulties, they will halt development of the VR800, which is Sandy's pet project—one that she believes will make a lot of money for the company. Should Sandy tell her supervisors about the competitor's problems? Or should she keep quiet so her favorite product concept will be approved for production? Why?

Financial risks. Financial risks are possible events or situations that directly impact a company's cash flow. Many risks prevent a company from having sufficient funds to meet its financial obligations. External financial risks that can have such an impact include inflation, interest rate increases, and **credit downgrades**, while inaccurate financial data, improper budgeting practices, and inadequate accounting processes are internal risks that could hurt the business's bottom line.

There are instances, though, when financial risks can be used to a company's advantage. Investment risk, as we mentioned earlier, brings with it the potential for gain as well as loss. Also, fluctuations in foreign exchange rates have the potential to benefit a company. When the value of the U.S. dollar increases, businesses that typically acquire their resources and raw materials overseas enjoy a reduction in expenses; the items that they purchase from foreign suppliers cost less. Unfortunately, changes in foreign **exchange rates**—specifically, a drop in the dollar's value—can also hurt a business. When the dollar loses value, the cost for imported resources and supplies goes up.

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◄ *Changes in currency valuations can have a huge impact on business locally and on an international scale.*

◄ *If employees strike, it can cause major financial difficulties and a negative company image.*

Operational risks. Operational risks make up a broad category of risks that are the result of employee actions, core processes, and daily business activities. Some of these risks involve disagreements and/or problems with human resources, labor relations, suppliers, channel members, and company management. Regardless of the amount of time that company executives devote to succession planning, for example, there is always some operational risk involved. A chosen successor may leave the company prior to assuming a leadership role. Or, after assuming one of the top posts with the company, the successor could prove to be an ineffective leader.

Other operational risks include poor product development, unreliable manufacturing equipment, and product shortages. (What would a business do if it couldn't produce enough goods and/or services to meet its market's demands?) Another common operational risk, insufficient information management, can result in poor quality data and information which, in turn, can lead to poor decision-making and a failure to achieve company goals.

Some risks fall into multiple categories. If a delivery truck's brakes fail, for instance, the employee driving the truck may be injured (a hazard risk), and the business may have difficulty getting their products to consumers until the brakes are fixed (an operational risk).

Strategic risks. Strategic risks are the most consequential of the four categories of risk. They typically have significant impact on the firm and have the potential to affect the execution of an organization's long-term plans. Many strategic risks involve damage to the company's reputation as a result of **brand erosion**, fraud, negative publicity, etc.; threats posed by new competitors and/or new competing products; and technological innovations that make certain products obsolete. For an example of a business strategy that attracted criticism, view the ABC video "Critics Say Uber Incentive Encourages Risky Driver Behavior" at www.abc7chicago.com/news/critics-say-uber-incentive-encourages-risky-driver-behavior/1764377/.

Regulatory and political issues such as compliance requirements, employee protection laws, and environmental concerns can also result in strategic risks for the firm. If experts determine that a manufacturer's entire product line is potentially toxic, the company would need to quickly modify and/or replace its products or go out of business. For example, in 2016, the FDA banned 19 antibacterial ingredients from soap products giving companies a year to comply with the new regulations.

Finally, strategic risk arises from product demand increasing or decreasing due to changing customer wants. Increasing product demand may result in a possible gain for the company, but declining interest in the company's products may result in company defeat.

◄ *Whether gamers prefer consoles or Internet connectivity creates a strategic risk for game developers.*

The Riskiness of Risk Management

Risk management is quite common in today's business environment. In fact, most businesses utilize risk-management processes and strategies. Nevertheless, risk-management critics have voiced a number of concerns about it over the years. First of all, these individuals claim that it is often difficult to determine who within a company is responsible for risk-management efforts, and as a result, many risks are overlooked. Also, because risk is constantly in flux, critics complain that any risk-management plan that a business might create is potentially out of date as soon as it is developed. These individuals also point out that risk management seems to focus on what could go wrong in every situation, rather than concentrating on how to make things go right. Finally, risk management costs money that these critics believe could be better spent elsewhere on more profitable activities.


endopack/iStock/Thinkstock

▲ *Many companies try to minimize the health risks of poor posture and work habits by providing adjustable furniture and computer monitors.*

Proponents of risk management, however, work hard to dispel these criticisms and misbeliefs. As an example, risk-management supporters explain that many larger businesses have a **chief risk officer** (CRO) and risk-management staff, although everyone is ultimately responsible for managing risks. Production employees, for example, may be required to wear certain personal protective equipment (e.g., safety goggles, boots, gloves, hard hats, etc.) to protect themselves from workplace injury. And, a credit manager might determine that it is too risky to extend credit to a customer who has several delinquent accounts with other businesses.

Secondly, these individuals point out that risk management involves monitoring risks and revising risk-management strategies on a continuous basis, rather than just once. Also, they explain that risk management helps to create a risk-aware culture, not a risk-averse one. Lastly, these supporters propose that risk management is well worth the money because it helps to better align strategy and performance—maximizing profits and minimizing losses.

Summary

All organizations face risk, which is the possibility of loss (failure) or gain (success) inherent in conducting business. Many firms rely on risk management to make the most of these risks. Risk management is a business activity that involves the planning, controlling, preventing, and limiting of business losses, as well as enhancing possibilities for gain. Risks can be categorized as hazard, financial, operational, or strategic risks.

TOTAL RECALL

1. What is risk?
2. Distinguish between pure and speculative risks.
3. What is risk management?
4. Explain the four risk categories and provide three examples of each.
5. How do risk-management supporters respond to criticism about the business activity?

Managing Risks Right

Because every business faces unique risks, risk-management activities conducted at different firms are never exactly the same. However, most risk managers and their staffs agree that there are four basic risk-management processes that every business should implement: **risk identification**, **risk measurement**, **risk response**, and **risk monitoring and control**.

Risk Identification

The first general risk-management process that businesses commonly implement involves identifying and listing every risk that could impact business objectives and activities. Risk management focuses on **retroactive risks**, which have occurred in the past, as well as prospective risks, which have not happened before but could occur in the future.

Retroactive risks are fairly easy to identify, and they are more common than prospective risks. Let's say that thieves broke into Hope's jewelry store and stole $25,000 worth of merchandise last year. As a result of the crime, Hope is likely to identify burglary as a hazard risk that her store must manage. She might also review her business's **incident logs**, **audit reports**, customer complaints, staff surveys, and professional journals to determine other retroactive risks.

ronstik/iStock/Thinkstock

▲ *Identifying the prospective risks associated with data management and storage is complex because new threats frequently arise.*

Prospective risks are a bit more difficult for businesses to identify because these risks have not happened yet. If a business has not experienced a particular risk in the past, how will it know what new risks it may face in the future? The organization might conduct staff brainstorming sessions, an **environmental scan**, or interviews with customers and employees to identify potential problems and issues. While planning a new business, for example, a first-time entrepreneur would be forced to identify many prospective risks, since s/he has never started a business before. See how many examples of prospective risk you can identify in the CBS video "Benefits and Concerns of Drones" at www.youtube.com/watch?v=_3tduc4kZoQ.

When identifying risks, risk management focuses on the causes, sources, or triggers of different risks, rather than on the impact that each risk might have on a business. All of these potential risks are recorded in an established **risk register**. To make risk identification easier, risk management may also use a previously developed **risk checklist** that contains common, standard risks that the business faces on a regular basis.

For instance, a business located near a fault line is likely to always identify earth-quakes as a risk. If that same business has frequent run-ins with a local labor union, labor relations might be another standard risk for the company. As a result, the business would probably include earthquakes and labor relations, along with many other common risks, on its risk checklist. Then, whenever existing risks are reviewed and new risks are identified for the company, risk management already has a list of standard risks to work with.

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Measuring Risk

Risk has two dimensions: impact and probability. **Probability** is the likelihood that an event will occur. The probability of a risk occurring is always somewhere between zero and 100%. Impact, on the other hand, is the effect or influence of an event and can vary in terms of time, cost, and effects on health, human life, etc. It is the combination of impact and probability that creates a risk's severity.

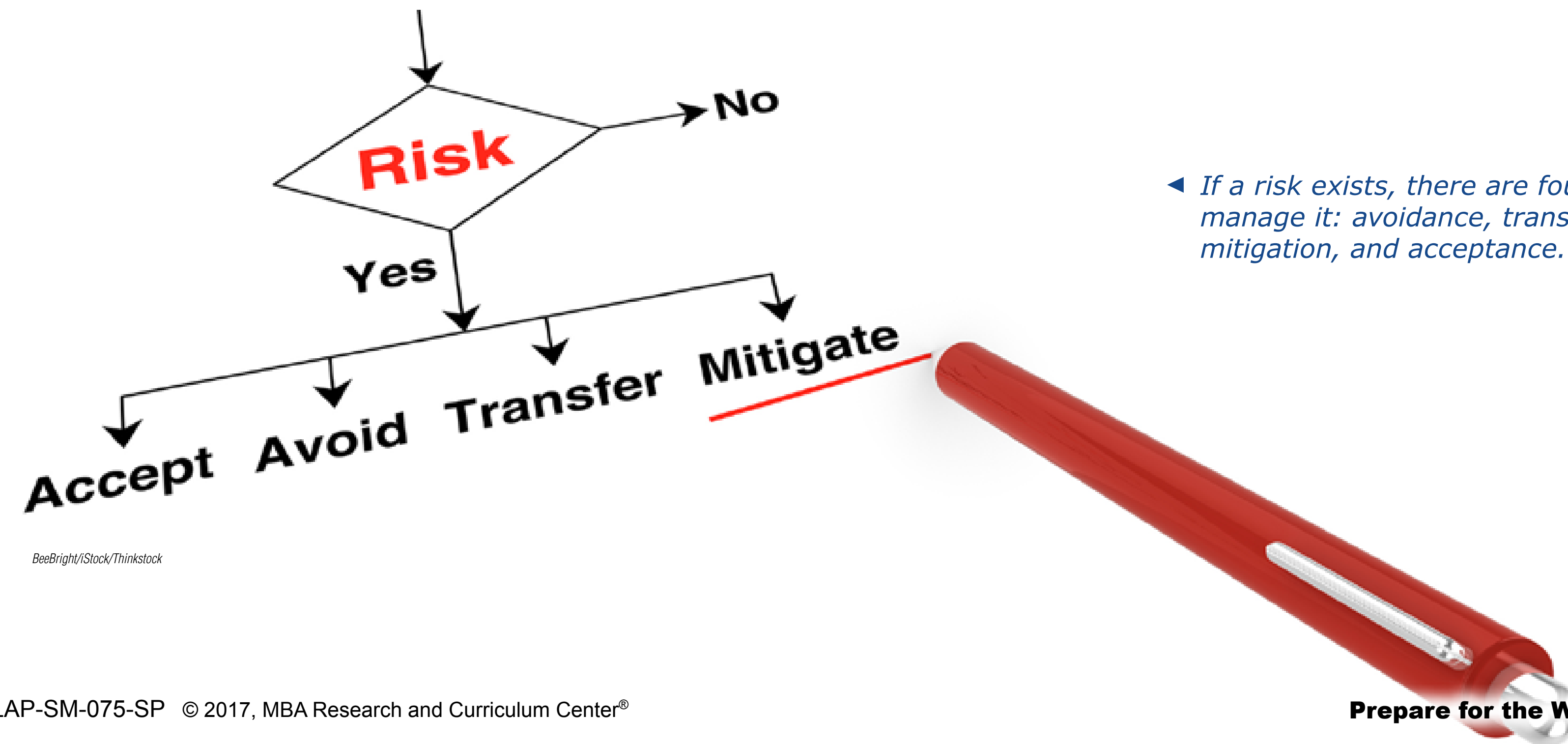
A **risk impact/probability chart** can be used to rate potential risks. The probability that a risk will occur is represented on one axis of the chart, and the potential impact of the risk is represented on the other. Based on research and past experience, risk management determines the potential impact and probability of each risk. Then, the different risks are plotted on the chart accordingly. After the chart is complete, the low-level risks, medium-level risks, and critical risks (which should take priority in the risk-response process) can be quickly determined. View MindTools' example "Risk Impact/Probability Chart" at www.mindtools.com/pages/article/newPPM_78.htm.

Charting the probability and the severity of potential risks helps an organization to determine which risks are most important to focus on. ►

Another method that is often used to determine which risks to focus on involves quantifying (scoring) risks based on their impact and probability. First, a risk's probability is determined on a scale of one to five. A score of one means that the risk is unlikely to occur, and a score of five means that the risk is very likely to take place. Then, the same would be done for the risk's impact. An event with a score of one would have very little impact on the business, while a score of five means that the event could paralyze the business if the risk occurs. Finally, the probability score would be multiplied by the impact score to determine the level or severity of risk. If a risk's overall score is low, little attention will be devoted to it, but if the overall score is high, the risk would become a top priority.

Responding to Risk

After determining the size of each risk, the most effective course of action to take for each risk is selected. Risk management must determine what to do in response to a risk, who will be responsible for implementing the response to it, and when to respond to it. Common **risk responses** include avoidance, transference, mitigation, and acceptance. View the TED Talk "Risk Management: Chris Davenport" as a mountain climber explains these four risk-management methods: www.youtube.com/watch?v=zyet9fPS24k.



BeeBright/iStock/Thinkstock

◄ *If a risk exists, there are four ways to manage it: avoidance, transference, mitigation, and acceptance.*

Avoidance. By avoiding or eliminating a risk, a business chooses not to do something that is considered risky. For example, by looking both ways before crossing the street, you avoid the risk of being hit by a car. And, by eliminating potential hazards, like slippery floors and dangerous materials, a business can avoid the risk of employee injury. Keep in mind, though, that while avoiding risk certainly can prevent losses, doing so can also sometimes mean losing out on a potential gain. A transport company, for example, may refuse to deliver dangerous materials and may lose many business opportunities.

Transference. Transference involves moving the impact of a risk to someone or something else and is often used when the impact is measurable in dollars and cents. Common transference devices include insurance, contracts, warranties, and guarantees. By purchasing auto insurance, for instance, you can transfer the risk of damaging someone else's car in an accident to the insurance company. However, there is a clear disadvantage to transference: You are still ultimately responsible for the outcome. In other words, you will still be responsible for paying the fine for causing the accident, not your insurance company. Similarly, doctors purchase malpractice insurance to avoid paying for costly mistakes, but they are still ultimately responsible for any errors that they make.

moodboard/moodboard/Thinkstock

◄ *Reporting an accident to your insurance company can help with the costs of towing and repair, but you might have to pay fines if it's determined you caused the accident.*

▼ *In addition to helping manage the risks of transportation, GPS tracking can also mitigate the risk of theft by locating stolen assets.*

Madmaxer/iStock/Thinkstock

Mitigation. Many risks are simply too difficult and expensive for a business to eliminate completely. In those instances, risk management is likely to recommend that the firm mitigate the risks. Mitigating a risk means reducing or controlling its impact if it occurs. Anyone who wears a seatbelt is mitigating the risk of being seriously injured in an automobile accident, and any business that installs fire sprinklers, fire extinguishers, and smoke alarms mitigates or reduces the damage that a fire could cause to its facilities. View the Weather Channel video "Engineers Test Storm Resistant Homes" to see how the insurance industry conducts research to develop construction methods to mitigate or reduce future loss: www.youtube.com/watch?v=oF_zBqY9aGU.

Acceptance. Acceptance is also known as the retention or assumption of risks. It involves accepting a risk's consequences because the potential payoff is higher than the losses. A business that accepts a risk might consider it a cost of doing business.

Although risks that are accepted are usually rare and/or have little impact, businesses need to develop contingency and fallback plans in the event that these risks do occur. A **contingency plan** includes specific guidelines to use in response to undesirable circumstances. These guidelines include activities that should be implemented if a certain risk occurs. These activities usually focus on lessening the risk's impact. In addition, in case these activities fail to address the risk sufficiently, each contingency plan should be backed up by a fallback plan, which explains what to do and how to recover if the contingency plan fails.

▲ *Lifeboats and flotation devices are standard equipment that help cruise lines reduce the loss of life if a ship is damaged.*

An organization's response to risk is often based on whether it is risk-averse, risk-seeking, or risk-tolerant. **Risk-averse** organizations attempt to avoid risk as much as possible. Organizations that fall into this category are typically ones that deal with dangerous situations quite often—hospitals, fire and rescue services, and police departments. The IDG TV video "Hollywood Effects for Medical Simulators" shows how surgery simulation helps hospitals minimize risks: www.idg.tv/video/59343/hollywood-effects-for-medical-simulators.

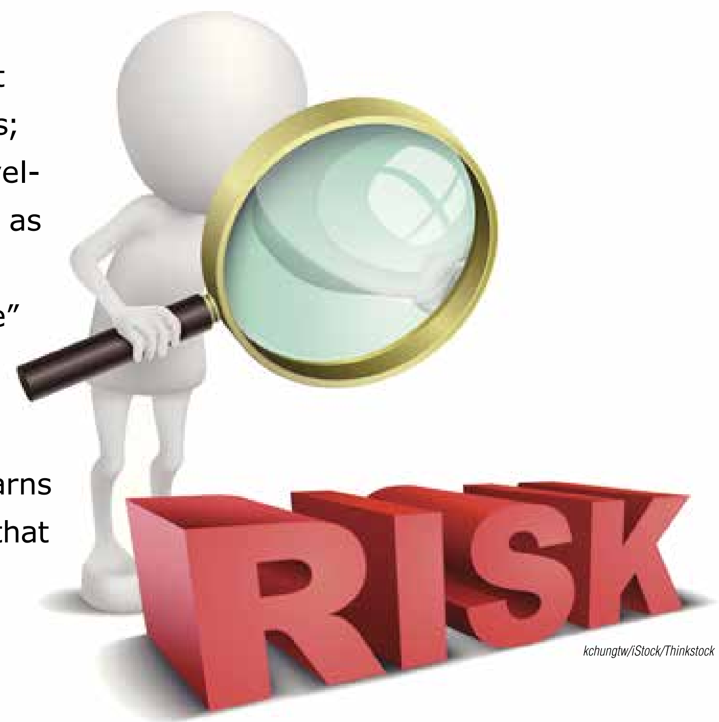
Risk-seeking organizations, on the other hand, look for ways to turn risk into a strategic advantage and/or capital. Companies involved in space exploration are great examples of risk-seeking ventures. Whether delivering supplies to the International Space Station or releasing satellites for Google, private space companies like SpaceX stand to benefit from the development of new technology and gained knowledge. However, these companies have to accept the risk of failed missions, or even lost lives. Watch *National Geographic's* video "SpaceX Makes History" to see the tension and excitement of risking not only the launch, but the landing of a reusable rocket: www.channel.nationalgeographic.com/mars/videos/spacex-makes-history/.

Not all risk-seeking organizations risk lives, but even the development of a new candy can be a risk-seeking opportunity. Suppose a candy company develops a fat-free chocolate recipe and skips extensive product testing so it can be the first candy company to offer a fat-free chocolate treat. The company gains a significant advantage over its competitors. However, if the new chocolate causes many customers to get sick (something that could have been prevented via more rigorous product testing), the company runs the risk of losing its existing client base.

The third type of organization is the risk-tolerant organization. Firms that are **risk-tolerant** accept risk when necessary, but they do not seek risk. Such companies are content with the status quo—they manage existing risks as appropriate, but they choose not to take risks on new products, new markets, new equipment, etc.

Monitoring and Controlling Risk

The last of the four basic risk-management processes is the risk-control process. It involves determining the effectiveness of current risk-response strategies and tools; tracking risks to determine if they are growing, in decline, or unchanged; and developing responses and workarounds for previously unidentified risks. For example, as cyber criminals become more sophisticated, companies have to monitor and adapt to new potential threats. The Investopedia video "A Conversation with John McAfee" explains the need for better security products: www.investopedia.com/video/play/john-mcafee-hiring-hackers-and-mgt-capital-investments/.



kchungtw/iStock/Thinkstock

Monitoring new and existing risks is especially important because as a business learns more about a particular situation, its view of a risk may change. This might mean that more (or less) attention needs to be paid to the risk. Also, when a business's risk-tolerance level changes, risk management must determine if a risk that was once important continues to be significant.

Summary

There are four basic risk-management processes. First, risks are identified. Next, the risks are measured. After that, risk management responds to the risks. Finally, risk management monitors and controls these risks and risk-response strategies.

TOTAL RECALL

1. What processes, tools, and resources are used to identify risks?
2. Explain the role of probability and impact in the risk-measurement process.
3. Describe four common risk responses.
4. What activities occur during the risk-control process?

Make It Pay!

Identify five risks that your employer or school faces. Categorize each one as a hazard, financial, operational, or strategic risk. What strategies does the business or school use to respond to these risks—avoidance, transference, mitigation, and/or acceptance? In your opinion, is each of these risks being managed properly? Why or why not?

