Risk Management: An essential tool for Sustainable Business Growth

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Quote

"Risk is like fire: If controlled, it will help you; if uncontrolled, it will rise up and destroy you." - ***Theodore Roosevelt***

Introduction

Most industries and organizations are going through a period of rapid change. New competitors with disruptive business models are emerging. Customer demographics and dynamics are changing. Technological advancements are bringing about paradigm shifts in business fundamentals. The regulatory landscape, which is an exponent of many of the above factors, is also changing to remain relevant. And recently, Covid-19 pandemic. Thus, organizations are finding themselves charting unknown waters more and more often.

Given these changes and uncertainties, it is becoming imperative for companies to be forward-looking in terms of identifying and preparing for emerging and evolving risks. Rather than merely reacting to risks when they occur, businesses must focus on being proactive with an ability to look at what the risks of the near future are.

Risk Management is a tool that can help drive competitive advantages as well as sustainability and business growth.

Meaning of Risk

According to ISO 31000, risk is defined as the effect of uncertainty on objectives. Risk is also the combination of probability of an event occurring and the impact of its consequences. On the other hand, realization of opportunities is a situation whereby an entity is strategically positioned to capitalize on the state of the environment. This is known as **positive risk.**

Every organizations has several objectives such as maximization of profit, among others. The objective of profit maximization can be impacted by adverse events. Let's take a company that manufacture drugs as an example. Drug contamination or adverse drug reactions might trigger product recall and cause large liability claim including heavy regulatory sanctions. Consequently, the bottom line will be adversely affected.

However, effective risk management will ensure adequate controls are put in place to mitigate risk of product failure or adverse drug reactions as highlighted above.

Company's Executives must be aware of those events that may occur and make it impossible for their organizations to create value or seriously reduce their capacity to create value thereby unable to achieve their strategic objectives.

Types of Risk

Basically, there are three types of risk which are;

- Pure risk;
- Speculative risk; and
- Upside risk.

Pure risk - This is where there is the chance of loss but no chance of a gain. It is also known as 'downside risk'. Often when risk is mentioned, this is the type of risk we mean, but remember that, strictly 'risk' is the spread of all results, good and bad.

Examples of pure risk include; fire destroying a factory, an IT system being hacked, an employee being injured at work and fraudulent transactions by an employee. All these events will have negative impact on company's operations.

Speculative risk - This is where there can be both good and bad outcomes. It might occasionally be called 'two-way risk'.

Examples include; developing a new product, entering a new market, buying a more advanced machine and developing a new website. Each of these could go well or badly.

Upside risk – This is a possibility of making a gain. We often refer to Government Bonds as upside risk because they are inherently risk free.

Categories of Risk

There are a number of categories of risk. We shall examine a few of them here:

Strategic Risk

Everyone knows that a successful business needs a comprehensive, well-thought-out business plan. But it is also a fact of life that things change, and your best-laid plans can sometimes come to look very outdated, very quickly.

Strategic risk is the risk that your entity's strategy becomes less effective and your company struggles to reach its goals as a result. This arise from long term effects such as those relating to the nature and type of business, changes in competitive and legal environment, poor long-term decisions being made.

Examples include; Reduction in business vitality due to change in business strategy, loss of intellectual property and trade secrets.

The consequences of this risk will include; sharp decline in revenue, reduction in market share, among others.

History is littered with examples of companies that faced strategic risk. Some managed to adapt successfully; others did not.

A classic example is Kodak, which had such a dominant position in the film photography market that when one of its own engineers invented a digital camera in 1975, it saw the innovation as a threat to its core business model, and failed to develop it.

It is easy to say with hindsight, of course, but if Kodak had analyzed the strategic risk more carefully, it would have concluded that someone else would start producing digital cameras eventually, so it was better for Kodak to cannibalize its own business than for another company to do it.

Failure to adapt to a strategic risk led to bankruptcy for Kodak. It has now emerged from bankruptcy as a much smaller company focusing on corporate imaging solutions, but if it had made that shift sooner, it could have preserved its dominance.

Operational Risk

Operational risk is defined as the capital charge for the risk of loss arising from inadequate or failed internal processes, people, systems or external events.

Operational risk also refers to as unexpected failure in your company's day-to-day operations. It could be technical failure such as server outage. Operational risk is usually caused by people, processes, systems and external events.

Some of the examples of operational risk events include; machine breaking down, a key employee leaving, fire breaking out in the warehouse, fraud occurrence, etc.

The consequences of these risks will include; inability to produce, system continues to struggle, job loss, going concern problems, amongst others.

In some cases, operational risk has more than one cause. For example, consider the risk that one of your employees writes the wrong amount on a cheque, paying out ₦100,000 instead of ₦10,000 from your bank account. That's a people failure, but also a process failure. It could have been prevented by having a more secured payment process, for example, having a second member of staff to authorize every major payments, or using an electronic system that would flag unusual amounts for review.

In some cases, operational risk can also stem from events outside your control, such as a natural disaster, or a power cut, or a problem with your website host. Anything that interrupts your company's core operations comes under the category of operational risk.

While the events themselves can seem quite small compared with the large strategic risks we talked about earlier, operational risks can still have a big impact on your company. Not only is there the cost of fixing the problem, but operational issues can also prevent customers' order from being delivered or make it impossible to contact you, resulting in a loss of revenue and damage to your reputation.

Financial Risk

Most categories of risk have a financial impact, in terms of extra costs or lost revenue. But the category of financial risk refers specifically to the money flowing in and out of your business, and the possibility of a sudden financial loss.

For example, let's say that a large proportion of your revenue comes from a single large client, and you extend 60 days credit to that client.

In that case, you have a significant financial risk which could also be tagged credit risk. If that customer is unable to pay, or delays payment for whatever reason, then your business is in big trouble.

Having a lot of debt also increases your financial risk, particularly if a lot of it is short-term debt that is due in the near future. And what if interest rates suddenly go up, and instead of paying 8% on the loan, you are now paying 15%? That's a big extra cost for your business, and so it is counted as a financial risk.

Compliance Risk

Compliance risk is exposure to legal penalties, financial forfeiture and material loss an organization faces when it fails to act in accordance with industry laws and regulations, internal policies or prescribed best practices.

This is the risk arising for not complying with rules and regulations. For example, failure to comply with local tax and statutory laws, poor employee health & safety, product quality/safety issues (violations of regulations).

In extreme cases, a compliance risk can also affect your businesses future, becoming a strategic risk too. Think of tobacco companies facing new advertising restrictions, for example, or the late-1990s online music-sharing services that were sued for copyright infringement and were unable to stay in business.

Compliance failure may result in penalties, reputational damage, shut down of operations, removal of operating licenses, etcetera.

Reputational Risk

There are many different kinds of business, but they all have one thing in common: no matter which industry you are in, your reputation is everything.

Reputational risk, often called reputation risk, is a risk of loss resulting from damages to a firm's reputation, in lost revenue; increased operating, capital or regulatory costs; or destruction of shareholders value, consequent to an adverse or potentially criminal event even if the company is not found guilty.

If your reputation is damaged, you'll see an immediate loss of revenue, as customers become wary of doing business with you. But there are other effects, too. Your employees may get demoralized and even decide to leave. You may find it hard to hire good replacements, as potential candidates have heard about your bad reputation and do not want to join your firm. Suppliers may start to offer you less favourable terms. Advertisers, sponsors or other partners may decide that they no longer want to be associated with you.

Reputational risk can take the form of a major lawsuit, an embarrassing product recall, negative publicity about you or your staff, or high-profile criticism of your products or services. *And these days, it does not even take a major event to cause reputational damage; it could be a slow death by a thousand negative tweets and online product reviews.*

Meaning of Risk Management

Risk management is the identification, evaluation, and prioritization of risks followed by coordinated and economical application of resources to **minimize**, **monitor**, and **control** the probability or impact of unfortunate events or to maximize the realization of opportunities.

Objectives of Risk Management

- To enable entities prepare for potential losses in the most economical way.
- To reduce anxiety.
- To meet any legal obligations.
- To ensure survival of the firm.
- To ensure stability of earnings.
- To minimize the effects that a loss will have on other persons and the society.

Benefits of Risk Management

- Sees risk that are not apparent.
- Provide insights and support to the Board of Directors.
- A risk management program can reduce business liability.
- Well-run systems (e.g. greater efficiency because routine maintenance is used to prevent the risk of machine breakdown).
- Creates awareness on possible threats.
- Society benefits because both direct and indirect losses are reduced.

- Limits the impact of disaster (e.g. stand-by arrangements are in place to take over Information Technology).
- Greater confidence amongst investors, employees, customers, suppliers and partners.
- Better matching to risk appetite of shareholders.

Conclusion

Every organisation is faced with risk, called business risk. Risk abound everywhere and cannot be eliminated but can be reduced. Risk also present both threats and opportunities.

Gradually, risks are no longer regarded as hazards to be avoided but in most cases, as *opportunities* to be embraced and *expropriated*. This is driven by the concept that risk creates *opportunities* and opportunities create *value*, and value ultimately creates the desired *stakeholders' wealth*.

The key to managing risk is not to make risk zero, but to control its effects towards the positive direction.

The main essence of risk management is to enable entities to proactively manage adverse events that can impact on their existence. This will enable a sustainable business growth.