Risk

Risk is a common occurrence in all aspects of life, including business.

Definition

Risk

The potential that a chosen action will lead to an undesirable outcome.

Upside vs downside risk

Downside risk is typically the focus for risk management.

Definition

Upside risk

The risk that something positive happens.

Downside risk

The risk that something negative happens.

When do you take on risk?

A business might take on a risk when the outcome would be beneficial to them, e.g. through greater financial returns.

Businesses have to balance managing risks against the costs of risk management. Risks may be accepted if the costs of managing them are simply too high.

Threats, assets and vulnerabilities

Risks result from the combination of three factors: **assets**, **threats** and **vulnerabilities**. For a risk to exist, all three factors must be present.

Definition
Asset Any resource owned by an organisation. **Threat** Something which may damage, steal, destroy, or otherwise adversely affect the organisation's ability to use or retain an asset, and what the asset needs protecting against. **Vulnerability** Any gaps in the organisation's efforts to safeguard its assets against threats.

A risk exists when there is an asset under threat, e.g. due to a fire, and there are vulnerabilities not countered by the organisation's risk management measures, e.g. lack of fire alarms or fire procedures.

Types of risk

Risks can be categorised into different types: **strategic**, **operational**, **financial** and **legal**.

Types of risk	
Strategic (business risk)	Relating to the business and its strategic position.
Compliance	With laws and regulations, e.g. the risk of not abiding by health and safety legislation.

Financial	Risks relating to financing the business and undertaking financial transactions.
Operational	Risk in undertaking day to day business, e.g. the breakdown or theft of key equipment.

There's also **business risk** - the strategic/operational risks that the business's financial objectives won't be met or that it will fail.

Risk categorisation can help manage risks effectively:

- To help identify risks, which can be done in more detail in smaller categories than when looking at the organisation as a whole
- To analyse the risks better, as specialists in a particular area might be best qualified to examine risks related to that area
- To decide who is best to take responsibility for managing those risks

Strategic risk

Strategic risks are typically managed by the board of directors as part of their remit to set and manage the strategy of the business.

PESTEL

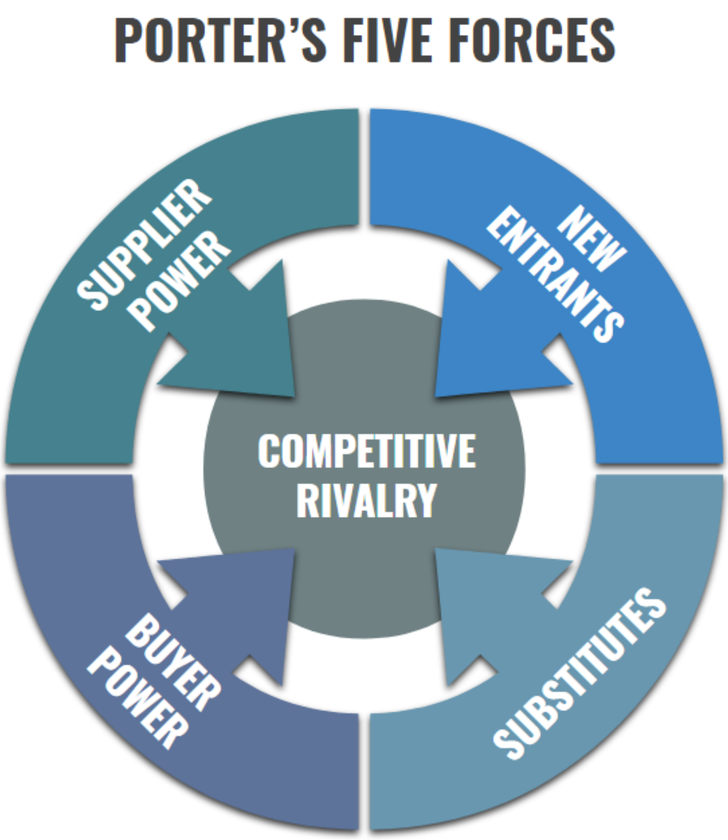
A good starting point is to consider risks arising under the PESTEL factors (Political, Economic, Social, Technological, Environmental and Legal) :

PESTEL	
Political risk	How and to what degree a government intervenes in the workings of organisations, e.g. tax policy or employment legislation.
Economic risk	Arising from factors like economic growth and inflation which have a major impact on how businesses operate and make decisions.

Social risk	Cultural and demographic trends in the population like attitudes to health, which can impact how a company operates and the demand for its products.
Technological risk	Arising from factors like computer security and the rate of technological change which organisations must remain aware of, adapt to and manage any associated risks.
Environmental risk	Arising from weather and climate, either directly impacting a company or creating/diminishing markets.
Legal risk	Remaining aware of legal changes avoids the risk that companies may not abide by the law, which could result in a range of issues.

Porter's 5 forces

Some risks can be considered in relation to Porter's 5 forces, a business strategy model examining key issues at an industry level.



Porter's 5 forces	
Competitive risks	Risks relating to changes caused by competitors in the market, e.g. new or changing products.
Risk of new entrants	Are new competitors likely to be entering the industry and what impact would this have?
Supplier risk	Factors include changing prices and availability which may lead to increased costs and create a risk of poor customer service.
Buyer power	Customers may move on, exert power to reduce prices or enter liquidation and cease to exist. Over dependence on key customers is a major risk. Reputational risk is another related area.
Risk of substitute products	A substitute is a different product fulfilling the same need as a company's product. If substitutes become popular, this will reduce demand for the company's product.

Reputational risk

For many businesses, their **brand** dictates their success and position in the market. Brand can also be affected by reputation and, hence both should be continually monitored and managed, and considered as part of the business strategy development process.

Definition

Brand

What customers think about the organisation's activities and products and what these can offer them.

Reputation

What people think and say about the company, i.e. how a brand is perceived.

Reputational risk

The risk of a negative impact on the reputation or brand of a company detrimentally affecting the success of the organisation.

Business probity

A strong set of moral principles and values can ensure an organisation protects its reputation. This is called **business probity**.

Definition

Business probity risk

The risk of not acting with good ethics and moral principles.

Responding to reputational issues

Managing reputational risk can be through:

- Preventing reputational issues, e.g. through ensuring business probity
- Responding to reputational issues when they arise, e.g. through establishing a crisis management team to coordinate the response

Industry variation of risk

Risks vary significantly from industry to industry.

Operational business risks

Businesses must also consider **operational risks**. These may include fraud, theft, health and safety issues and the breakdown of IT systems.

Definition

Operational Risk

Internal risks relating to the day to day functioning of the business.

Risk and large projects

Large projects have sizeable scope for problems, making them very risky. They need a detailed feasibility analysis at their inception, and strong project management throughout to combat this.

Fraud risk

Some companies are more susceptible to fraud, e.g. banks.

Definition

Fraud risk

The potential of an organisation to commit fraud.

Employee malfeasance risk

For example false advertising or breaking legal or statutory codes of conduct.

Definition

Employee malfeasance risk

The risk an organisation's employees may pose of committing an offence that would reflect badly on the organisation.

Financial risk

Businesses face a range of different financial risks.

Types of financial risk:

- **Financing the business** – E.g. changing interest rates or lack of cash flow
- **Undertaking financial transactions** - E.g. exchange rate risk or non-payment by a customer
- **The possibility that the actual return on an investment is different to expected** – E.g. the possibility of losing some or all of the original investment

Risk and return

One key element in financial risk is the linking of the risk taken to the return gained. A greater potential return may result in greater risks being assumed.

Legal risk

There are three main types of legal risk: **compliance risk, regulatory risk and litigation risk.**

Business strategy issues	
Compliance risk	Non-compliance with the law can have severe financial consequences.
Regulatory risk	Relates to changes in the law or regulations, which may affect the operations of a business.
Litigation risk	The risk that a business may face legal action or lawsuits.

International risks

Risks tend to widen when organisations operate internationally.

Assessing international risks using PESTEL & Porter's 5 forces

PESTEL

- **Political** – International politics, uncertainty and war. The political situation in each market operated in needs to be considered
- **Economic** – World economy and local economic conditions. Exchange rates, taxes and tariffs will vary. Credit risk may be higher
- **Social** – Cultural and demographic differences between countries must be adapted to. Differing education and skill levels may affect staffing
- **Technological** – Technological differences, particularly in developing nations
- **Environmental** – Attitudes and laws in relation to environmental issues may differ
- **Legal** – Each country has its own laws and regulations which must be abided by

Porter's 5 forces:

- **Customers** – Differing needs, or loyalties to existing brands or products
- **Substitutes** – There are likely to be different substitute products in each market
- **Suppliers** – New relationships will need to be built, while supply may not always be available
- **Competitors** – New local competition will need to analysed and threats considered
- **New Entrants** – Will the market become over-saturated with other new entrants?

Attitudes to risk

Differing companies have differing attitudes to taking risks.

Risk appetite

In organisations, the level of risk is often affected by attitudes of shareholders, directors and staff.

Definition

Risk appetite

An aspect of risk that looks at how much one risk one is willing to accept.

Types:

- **Risk averse** - Wanting to avoid risk
- **Risk neutral** - Balancing risk with reward to select the option with the highest long-term reward based on expected value
- **Risk seeking** - Happy to take risk if there are also possible high rewards

Factors which impact risk appetite:

- **The personal risk tolerance of board members** – As these individuals govern the organisation, they will make decisions that align with their personal risk appetites
- **The rate of change and development in the organisation's industry** – Fast-changing industries tend to be higher risk than slower changing ones, requiring a greater risk appetite

Risk tolerance

The lower the risk tolerance, the lower the risks that can be undertaken and the greater the level of control that needs to be exerted to stay within the expected tolerance levels.

Definition

Risk tolerance

The level of deviation from the norm that will be accepted.

Risk capacity

To meet its strategic needs, an organisation will need to take risks.

Definition

Risk capacity

The level of risk an organisation needs to take to achieve its strategic objectives.

Interaction of risks

Risks do not act in isolation; how they link to each other must also be considered as part of the overall risk management approach of an organisation.

Human decision-making and risk

Most decision are made by people, and are therefore affected by people's beliefs, values, fears and desires.

Link to governance

Corporate governance aims to prevent bias by individual directors or boards of directors.

And finally...

Stop!

By this stage you should know:

- What is risk?
- The difference between upside and downside risk
- When should a business take on risk?
- What are threats, assets and vulnerabilities, and how do they relate to risk?
- The difference between strategic, operational, financial and legal risk
- Why risk categorisation is useful
- How to use PESTEL and Porter's 5 forces analysis when considering risk
- What is the difference between brand and reputation?
- What reputational risk is
- What is business probity risk?

- About the different ways to respond to reputational issues
- What does industry variation of risk mean?
- What an operational risk is
- How project size impacts on risk
- What is fraud risk?
- What employee malfeasance risk is
- The types of financial risks
- About risk and return
- What are the different types of legal risk?
- How to assess international risks
- What are the different types of risk appetite?
- Factors which impact on risk appetite
- What is risk tolerance?
- What risk capacity is
- About the interaction of risks
- The role human psychology plays in decision-making

Got it?

If not, go back and re-read the study text before moving on.

Question Time

It's now time to practise questions.

If **you've signed up** for our practice questions or are on our fully inclusive course, here's a direct link to questions for this chapter:

Go to Practice Questions

If **you want to sign up** for our practise questions here's where you will find more details:

Sign Up for Questions