Recession-Proof Risk Management Strategies: A Primer for Business and Industry

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Sections of this primer were excerpted from *Smart Risk Management: A Guide to Identifying and Reducing Everyday Business Risks*, © 2009 AICPA Specialized Publications, by Ron Rael, CPA, or from *Risk Management Strategies for a Turbulent Economy*, © 2009 AICPA Specialized Publications, by Ron Rael, CPA. For more information or to order either of these publications, visit www.cpa2biz.com.

Stormy Weather

Few would argue with the fact that U.S. business currently faces the most troubled economic conditions in recent memory—possibly in history—and there is little doubt that rampant, unchecked risk-taking lies at or very near the heart of the crisis. In recent history, not a day has passed without a new story of crisis: the subprime meltdown, upheaval on Wall Street, a credit crisis of gargantuan proportions, entire industries on the brink of failure. Although large entities in need of a bailout may monopolize the headlines, companies of all sizes face possible impacts and heightened risks from the financial crisis.

Business leaders are aware of the grim situation they face. For the 4th consecutive quarter, results of the AICPA/UNC Kenan-Flagler Business and Industry Outlook Survey[1] are decidedly glum. An unprecedented 82 percent of participating respondents indicate they are pessimistic or very pessimistic about the economic outlook, up a full 20 percent from the prior quarter. Very few expect the situation to improve any time soon. Only 9 percent of respondents expect significant improvement before the second half of 2009. Almost half (49 percent) think it will be 2010 or later before things turn around.

In short, it's stormy weather out there, and it seems unlikely the storm will blow over any time soon. Although business may not be able to ignore or wish away current conditions, there are many steps that can and should be taken now to minimize negative impacts and improve an organization's prospects for weathering the storm. Risk management is a difficult balance. Fear of risk leads to stagnation. Taking on too much risk, as we've been reminded lately, has dire consequences. A well-considered, carefully calibrated risk management strategy may be more important now than it has ever been before.

The survey collected opinions from AICPA members from business and industry between November 5, 2008, and November 17, 2008, and had 1,606 qualified respondents. Almost half the respondents (49 percent) were CFOs, 25 percent were Controllers, and 17 percent were CEOs or COOs. Sixty-eight percent of respondents came from privately owned entities; 13 percent from public companies; 11 percent from government, education, and not-for-profits; and 4 percent from foreign owned companies. Nine percent came from organizations with annual revenues of $1 billion or more, 21 percent from organizations with $100 million to under $1 billion in annual revenues, 44 percent from organizations with $10 million to $100 million, and 27 percent from organizations with under $10 million in revenues. The AICPA and The University of North Carolina's Kenan Flagler School of Business conducted the survey. Full results are available from the AICPA's Business, Industry, and Government Team. For more information, visit http://fmcenter.aicpa.org.

As stated in the AICPA Financial Reporting Alert *Current Accounting Issues and Risks*—2008, business risks result from

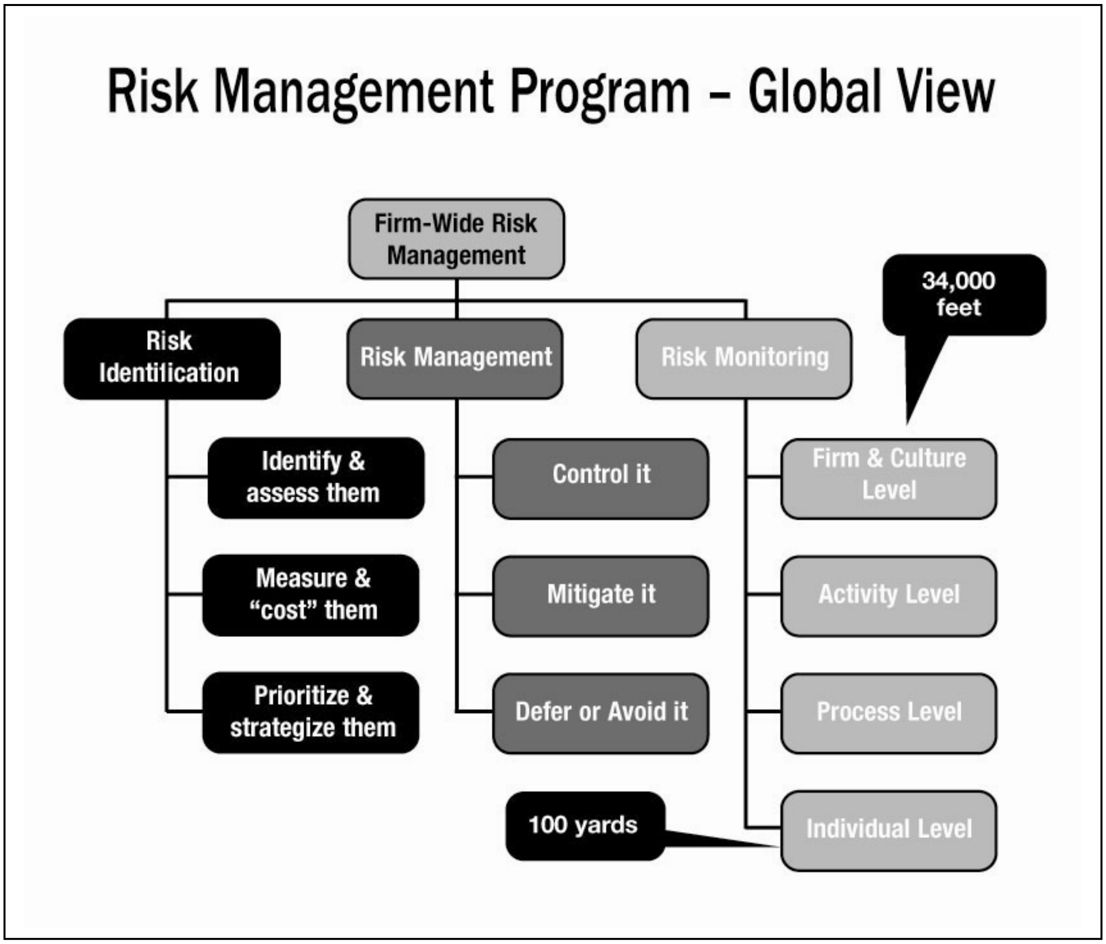
- significant conditions, events, circumstances, or actions that can adversely affect an entity's ability to achieve its objectives and execute its strategies; or
- the setting of inappropriate objectives and strategies (in light of current conditions).

Assume that you took your family on vacation somewhere distant and failed to study the type of weather you would encounter. You might pack for sun, and it turns out to be cold. You might pack for outdoor activities and have to spend the entire vacation inside. This is what your risk management program is about: matching your plans with the existing environment.

A global firm-wide risk management program consists of three prongs or strategies:

1. Identification of the specific risks. In this strategy, you identify and assess risks, measure them, and then use this information to prioritize and strategize each identified risk.
2. Arrive at specific ways of dealing with the risk (specifically, controlling, mitigating, or avoiding).
3. Monitor the risk. This is the most neglected strategy of the three because we have to slice and dice each identified risk in three different ways. We look at the potential risk at the macro level to determine its affect on the culture, at the individual level to see how employees view and handle the risk at the process level, and, finally, at the activity level where the actual decision takes place.

The following chart illustrates this three-pronged approach.



Your Business Plan Risk

A company’s business model is made up of two components:

1. The organizational structure and processes
2. The impact on operational risk from decisions made

In addition, if an organization is unable to perform or execute its strategy, the firm incurs execution risk. To assess and measure execution risk, a company focuses on the results it generates from the structure of its marketplace and its business model. Within the theory of your business model, three specific global risks reside:

1. Strategic risk
2. Operational risk
3. Innovation risk

Strategic Risk

Strategic risk is defined as the inability to align with competitive pressures and customer sufficiency. The following are eight categories of risk that threaten your ability to carry out your strategy:

1. Operational risks (execution of your strategy and goals)
2. Reputation risks (impact on your reputation and brand)
3. Financial risks
4. Hazard risks
5. E-commerce and technology risks
6. Intellectual capital risks
7. Ethical risks
8. Integrity risks

Risky Strategy Leads to Ethical Risk

Strategic planning is managing change and overcoming risks. It is a critical process in which risks can and need to be identified and dealt with in advance.

For your firm to manage your strategy risk, leaders must develop acceptable expectations for all products or services. A risk to your firm's ethical standards is involved here because there is intense pressure on the organization and the employees to meet a lofty goal, to achieve its business plan, and to satisfy creditors or investors. The more this pressure is applied, the more likely people will undertake unwarranted risk. If these wild, out-of-control leaps fail or do not meet the high expectations, people feel urged to cover them up. Thus, your integrity is at risk.

Risky Market Leads to Integrity Risk

In market risk, firm integrity is involved and can be damaged when your research or studies are flawed or when your assumption of the customer's needs are skewed in favor of the organization. Many market studies have been accepted as true without consideration of the realities of the market place or without obtaining true customer buy-in. Facing this risk requires you to get your input about the competitive environment from the source.

Risky Capability Leads to Integrity Risk

The capability or internal risk is another contributer when extreme pressure is felt when it is clear you will not achieve your goals. It is important to challenge people's ability and to test their capability to grow, expand, and improve. However, leader hubris leads to over-promising, and undue pressure is often applied when you have to under-deliver. People will want to massage the numbers, make up data, and of course, hide the internal faults. This last action leads to buck-passing and blaming. These, of course, negatively affect the profits and damage integrity. The net result is bad news for all!

Operational Risk

Operational risk management looks at the business from the operation itself and is defined as the risk of direct or indirect loss resulting from inadequate internal control, processes, people, and systems to react to external events. Financial information is not enough to gauge a company's overall business risk.

The value of managing operational risk is only slowly gaining recognition. One reason is that by the time financial impact for management's misjudgment affects the balance sheet or income statement, it is usually too late to do anything about it other than pick up the pieces. By tracking operational indicators and metrics, leaders can identify opportunities and threats before they affect the company's finances.

One approach to measuring operational risk requires firms to routinely review many nonfinancial factors such as the quality of corporate governance, employee morale, customer satisfaction, implementation of goals and their execution, application of technology, and deployment of those practices. Numerous tools already exist that enable you to easily measure operational risk, such as the balanced scorecard, activity-based costing, and driver-based forecasting.

Budgeting Hampers Operational Risk Identification

Most companies still rely on their planning and budgeting processes and historical reporting techniques created in the 1930s. To improve the likelihood of detecting operational risk, organizations can do the following:

- Update their technology
- Use advanced analysis tools
- Apply for ISO 9000
- Qualify for the Malcolm Baldridge Award
- Use a balanced scorecard reporting system
- Incorporate activity-based costing
- Invest in an enterprise-wide accounting system

Managing operational risk requires a systematic, objective, and comprehensive framework that assesses all of the nonfinancial variables that could contribute to an organization's risk portfolio.

All firms incur certain operational risk simply when choosing their marketplace and its customer base. The structure of the market directly affects business complexity and revenue volatility. Technology, regulations, the consumer, and the global economy all drive changes in market structure. You must factor all of these into your assessment and valuation of operational risk.

Key Drivers of Operational Risk in Your Market Structure

- Number of participants
- Degree of concentration
- Level of regulation
- Competitive environment
- Rate of business growth
- Capital intensity

- Barriers to entry
- Product life cycles
- Availability of alternative markets
- Risk of obsolescence

Key Drivers of Operational Risk in Your Business Model

- Governance model
- Organizational structure
- Product or service delivery model
- Process complexity
- Technology complexity
- Sourcing strategy
- Best practices utilization
- Management discipline
- Staffing and employee skills
- Leadership competency

Key Drivers of Operational Risk in Your Execution Efficiency

- Revenues
- Earnings
- Cycle times
- Growth
- Quality
- Service levels
- Productivity
- Market position or market share
- Management competency

Key to Measuring Operational Risk

The starting point to measuring operational risk is to make sure you are collecting the right data. This requires a complete and balanced view of your key business metrics across at least three dimensions and must include a mix of leading and lagging indicators. Your operational data must be able to describe how a key operation is conducted within your organization.

To overcome any information deficiency, your organization must effectively combine operational and financial data together to form a more complete and timely picture of operational risk and decrease your reliance on historical financial reports. Your leaders need to assemble a list of possible and predictive metrics for the business and then test those metrics to make sure that they correlate the time lag of the activity indicator to the time of its financial impact. The ultimate payoff is that you can use these operational risk metrics as targets for your budgeting process. Thus, you strengthen your budgeting process.

Regularly assessing your firm's operational risk profile benefits the shareholders. Of course, leaders and the employees of the organization grow in their ability to both spot and manage risks and, most importantly, convert them into opportunities. Understanding your risk profile is a benefit to your customers and suppliers as well. This insight gives your leaders clues into areas that offer the best benefit for allocating resources and making tough decisions.

Effective operational risk management has gone from an "I would like to do" attitude to a "we must do this" frame of mind.

Innovation Risk

Companies undertake three sources of risks when they believe themselves to be innovative and desire a culture in which employees think for themselves. In a culture of innovation and creativity, the three sources of risk are as follows:

- Strategy risk, and avoiding this risk requires clear direction setting and involvement to help the entire organization know where it is going and have the ability to measure progress.
- Market risk, which is the risk that the company fails to be in touch with the customer's needs and demands.
- Capability risk, which is the risk that the company will not be able to execute carefully designed plans and use the innovation to generate revenues.

Practical Solutions for Managing Business Model Risk

Strategy

The solution to making your firm less vulnerable is for your leaders to clearly define each of the firm's risks though your risk management program. It is particularly important to identify strategy risks early. This involves a matching of the role or purpose of your innovation with a specific strategic need for each new and existing initiative. Without such guidelines, new products, new ideas, and new services will misfire.

Market

For market risk, you need to prevent the risk that the innovation will not meet your market's needs. You need to ensure that you differentiate yourself from your competition or position yourself as separate from what everybody else is doing. Because market risk is harder than other risks to measure and monitor, companies usually end up paying less attention to this risk. The number one reason for new product failure today is the inability to compete in both the global marketplace and on Main Street.

Operations
To minimize the operational risk, such as insufficient internal capability to deliver what you promised or the inability to develop your new product within the desired time and budget, requires foresight and honest self-assessments. Defining your innovation risk up front will allow you to take the critical first step toward successfully managing it.

Innovation
All too often, leaders' expectations for new products go largely unspoken. They are in someone's mind but frequently not communicated adequately to others. Most importantly of all, there is no way to measure innovation and creativity. To help manage this risk more effectively, you need to develop and explicitly publish agreed upon expectations for all of your innovations. This process involves coordination of three separate and related tactics that allow you to effectively gauge how much risk you can afford to take.

$10^{1}/2$ Rules for Successful Business Risk Taking

1. Focus on trouble, and you will get trouble. Focus on success, and you will get success.
2. Trust that your people know what a risk is.
3. Recognize that your people may not know how to recover from the negative effects of a risk.
4. Know that no risk is worth undertaking when proper planning or analyzing cannot be completed beforehand.
5. Know that no risk is worth undertaking when a "lessons learned" cannot be completed afterward.
6. Recognize that every plan of action and strategy must have a feedback instrument built into it.
7. Understand the costs of your risk tolerance and your risk avoidance.
8. Know that no one is exempt from making errors in judgment.
9. Tell the truth about the risk and its implications. Accept the truth about the risk and its implications.
10. Be willing to live with the negative results of each risk undertaken.

$10^{1}/2$. Want more rewards? Take more risks! Want more success? Reward risk taking!

Summary: Risk Requires a Proactive Plan

Global perils can come from any place within the business model, your strategy, or a new marketplace. Each one can deeply affect your firm's

- profits,
- creativity,
- continuity,
- brand or reputation,
- leaders' integrity,
- employees' ethics,
- internal capabilities, and
- goal execution.

This is why the firm-wide plan for anticipating and dealing with these risks must become part of your everyday managing and leading.

Additional Resources

Publications

Smart Risk Management: A Guide to Identifying and Reducing Everyday Business Risks, © 2008 AICPA Specialized Publications, by Ron Rael, CPA. For more information or to order, visit www.cpa2biz.com.

Risk Management Strategies for a Turbulent Economy, © 2008 AICPA Specialized Publications, by Ron Rael, CPA. For more information or to order, visit www.cpa2biz.com.

Managing the Business Risk of Fraud: A Practical Guide. Available for free download at http://fmcenter.AICPA.org.

Current Accounting Issues and Risks—2008. For more information or to order, visit www.cpa2biz.com/AST/Main/CPA2BIZ_Primary/Accounting/PRDOVR~PC-029203/PC-029203.jsp.

COSO Enterprise Risk Management—Integrated Framework. For more information or to order, visit www.cpa2biz.com/AST/Main/CPA2BIZ_Primary/InternalControls/COSO/PRDOVR~PC-990015/PC-990015.jsp.

COSO Internal Control—Integrated Framework. For more information or to order, visit www.cpa2biz.com/AST/Main/CPA2BIZ_Primary/InternalControls/COSO/PRD~PC-990009/PC-990009.jsp?cm_sp=RHN-_-XSELL-_-CWPTPAB.

Web Sites

AICPA's Financial Management Center for Business, Industry & Government:
http://fmcenter.AICPA.org

AICPA Audit Committee Effectiveness Center:
www.aicpa.org/audcommctr/homepage.htm

AICPA Business and Industry Economic Outlook Survey:
http://fmcenter.aicpa.org/Resources/Resources+and+Tools/3rd+Quarter++2008+Economic+Outlook+Survey.htm