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What Risk Management Is and Is Not

Risk management is not simply having adequate insurance.

After reading this chapter, you should

- understand what risk management is truly about.
- understand the 5½ steps of proper risk management.
- be able to get yourself into the correct frame of mind about risk management.
- recognise the importance of being innovative in today's business world and global economy.

Getting Into the Risk Mentality

Exercise: Your Risk

To get you into the correct frame of mind, please write down a specific risk. Think of a risk that your organisation is undertaking or considering:

- What is the risk, both the upside and downside of it?
- Where is the greatest potential for costly risk?
- What makes this venture or activity risky?
- Why are you concerned about it (as the CFO, controller, or auditor)?
- What concerns do others in your organisation have around this particular risk?
- What are the implications or impact on your business or organisation if the risk fails?

Keep referring to this risk as you go through this book. You will be able to understand how the tools work by applying them to your specific risk.

No Insurance Selling Allowed

Whenever this topic is presented to management accountants or other business managers, the first thing they think is: "This person is trying to sell insurance." Having adequate insurance coverage is only one small piece of risk management, as you will soon discover. In fact, in this entire book, only one small section is devoted to insurance coverage.

Risk Is Something CFOs Often Ignore

A survey of 400 leading companies asked: "How prepared are you to protect your revenue drivers in case of a major business disruption?" The survey took the pulse of both risk managers and CFOs.

In the answers, the list of the greatest sources of risk was diverse. Especially telling was how much the risk managers and CFOs differed on the sources. It showed the gaps between how they each defined the management of risk.

The professional risk managers concentrated mostly on property-related risks, whereas the CFOs included improper management, employee practices, and product recalls in their list of greatest threats:

- 100% of the respondents said that a major disruption would have a negative impact on their earnings.
- 28% believe that such a risk would threaten their firms' ability to continue.
- 88% of the CFOs and 83% of the risk managers responded that their company's level or preparation to recover is *less than excellent*.

Anything Can Go Wrong

This is what real world risk management is about: *having a comfort level that whatever risks come your way, you have the ability to deal with them*. This confidence comes from these three factors:

1. Risk management requires having in place a system or methodology to examine risks before you take them—and I stress the word *before*. All too often, accounting and finance departments are consulted about a major risk after the risk has been taken. We are called upon to clean up the mess.
2. Employees have tools to examine and measure the impact of a risk. They know how to use them and apply them in their everyday decision-making efforts.
3. Leaders all across the firm use insightful information to confidently (as opposed to rashly) step into the unknown.

This is the theme of this book, and it will be referred to often:

> ***Every risk has a cost. Are you able to pay that cost?***

Process for Implementing an Effective Risk Management Program

Step 1: Defining what risk is (chapter 4)
Step 2: Examining your attitude toward risk (chapter 5)
Step 3: Analysing the firm's ability to handle risk (chapter 6)
Step 4: Minimising a risk's exposure or downside (chapter 7)
Step 5: Recovering quickly from the negative effects of a risk (chapter 8)
Step 5½: Learning something so you can accept even more risk with confidence (chapter 9)

Afford the Cost

Now some of you may be already thinking,

> *"But, you are focusing only on the downside of risk. In almost every risk there is an upside. Are you ignoring that?"*

This book was written particularly for management accountants because we often see the downside of risk. Before the upside of risk taking is addressed, consider this question and think seriously as you answer it:

> Let us pretend that you just won the lottery today: *"If you won $12 million and were now a multimillionaire, how different would your life be?"*

The following are some typical responses:

- "I will suddenly discover relatives I didn't know I had."
- "Every charity in the world will have my unlisted telephone number on its speed dial."
- "All kinds of people will be asking me for money, even people I do not know."
- "I will have to make serious choices about what I am going to do from now on."
- "I will have to decide if I should work or not."

Most importantly, you will have to decide how your life is going to be different from this day forward.

> *Do you see the cost for you in winning $12 million?*

Most of us would answer: "Yes, having access to $12 million is worth the cost."

This is the price you must consider whenever you buy a lottery ticket. Your costs include losing your anonymity, being in the limelight whether you like it or not, knowing that you will need to be more proactive with your investments, and having to gratefully pay another management accountant to give you financial advice.

Even in the upside of risk taking, costs must be assessed and weighed. This is what risk management is about and why we will most often address the costs and downsides. The tools discussed here will address both sides of the cost/benefit ratio for taking risks.

Analysis of Google's Risk

A *BusinessWeek* article focused on Google and what would happen to it after it decided to go public, in particular, the significant risks the firm faces. A major risk relates to its unique culture. Google currently has an extremely employee-friendly culture; employees enjoy many perks and high pay. Google hires for talent and not for positions. If it finds valuable talent, it hires those people and creates positions for them. The article questions whether that culture can continue in light of competitive pressures and analysts' demands for constant cost cutting.

Another risk is Google's culture of openness. As a public company, the firm will subject itself to the rules public companies face about disclosures, and those rules could affect share prices.

Another major risk is one faced by the two X-gens who started Google, Sergey Brandt and Larry Page. They both have a free-wheeling attitude as risk takers and (according to the article's author) are going to soon find out that they will have significantly more accountability for their actions.

None of Google's risks are good or bad—they just need to be addressed. A question to put before Sergey and Larry is: "In exchange for the millions you generated from going public, are you willing to pay the price of less openness, more accountability to others, and changes to your great company culture?" They would and have answered "yes" (the initial public offering was completed in 2005).

Google's culture will be very different, with less risk taking as time passes. That is part of the cost of being a public and very visible company. The entire leadership team of Google appears, according to journalists who follow Google closely, to have adjusted to the public scrutiny.

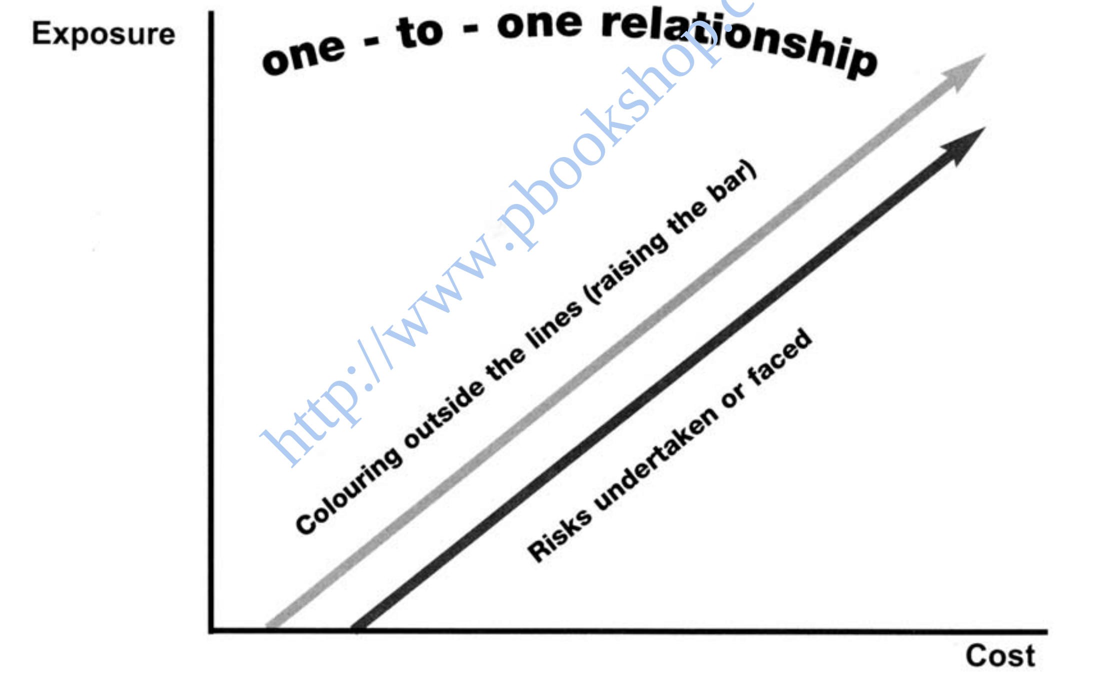
One major change in their culture is one predicted long ago as a risk—entitlement. For years, employees were given perks such as free lunches. Now that the costs of these “freebies” are being scrutinised, Google employees feel they are a right and not a privilege. This is causing employee dissension and unhappiness.

Even the simplest things can turn into a risk. This is what risk taking and management is about.

Relationship of Risk and Risk Taking

As shown in figure 1-1, a direct, or one-to-one, correlation exists between taking risks and the amount of the risks undertaken. The more a firm raises the bar or “colours outside the lines” on its reputation and requires employees have a willingness to stretch themselves, the greater the exposures and downsides to the risks taken. Unfortunately, many entrepreneurs and owners of small to medium-sized businesses do not find out about this one-to-one relationship until it is too late. The people who suffer from this expensive wisdom are the firm’s employees, investors, and creditors.

Figure 1-1
Relationship Between Innovation and Risks Faced



Innovation and Risk Management

Risk taking is fundamental to your firm’s ability to create value.

Organisation leaders have an important role in supporting innovation within their organisations. Innovation is defined as a novel way of doing something that is useful. Creativity refers to thinking in novel or new ways, but in today's global economy, creativity is not enough. Innovation—making creativity useable—is required in order to be competitive and maintain long-term strategic advantage.

Today, three kinds of innovations fuel economic growth:

1. Innovations in technology
2. Innovations in business models
3. Innovations in management practices

All three innovation types overlap to an extent, because management practices are the foundation for supporting the first two. In other words, if you have a strong, forward-looking, and strategically aligned management team, your firm will be more likely to have a culture of innovation that is built around a strong and viable business model. Because management practices are critical to innovation, this is where your leaders need to spend their time.

Update the Culture

Making many of today's organisations innovative requires nothing less than an entire revamp of all management practices. The old values of scale, efficiency, automation, and replication are being replaced by an era of imagination, experimentation, and flexibility. These newer values create today's market leaders. The old thinking of caution and careful analysis has been replaced by energy, ideas, and rapid execution. If you doubt this, take a look at those companies that have significantly increased in market value within the last decade: Nestle, AstraZeneca, Tesco, Univision, Cisco Systems, Vodafone, Amazon.com, Tata Steel, Starbucks Coffee, Google, Yahoo, Airbus, Virgin, GlaxoSmithKline, and Compass Group.

Understanding the Innovative and Risk-Taking Organisation

These are traits by which you can identify an innovative organisation. Apply this test to your firm. Do you have

- a compelling vision? _____
- entrepreneurial attitude? _____
- equity compensation? _____
- meritocracy (you earn your place)? _____
- decentralised decision making? _____
- people over policy? _____
- strategic alliances? _____

By putting all these management practices together, you will see that an innovative culture has these cornerstones:

- People are priority number one and are inspired by the big vision to come up with great ideas.
- People are given the support and resources to develop their ideas.
- People are financially rewarded for successful innovation or application of their creativity.
- People are given personal career advancement because of the quality of their ideas.

Survival Creates Infinite Sources of Risk

The world is moving way too fast to have only one set of plans. This is why innovation is not only important but necessary for survival. Today, businesses face a diversity of risks from a variety of sources that are rapidly increasing in magnitude and are driven by the type of business they chose to be in. Whatever the category—such as market, credit, operational, political, or compliance—a question must be asked for each specific risk is: "Is our company exposed to it?" If the answer is yes, the next question must be: "What proactive steps should we take to ease our exposure to that risk?"

There are so many sources of risk today that one could spend a full day just thinking about ways to deal with them. The major sources of risk are detailed in chapter 11, "The Wide World of Risks."

Summary: Risk Is Ordinary and Expected

Risk management is more than just worrying about tomorrow. In today's world, many things can go wrong and put you out of business, *and* if your company is not innovating, it will not survive. These two realities mean that every organisation must have a clearly defined risk management programme that gives its employees tools to anticipate the cost or downside of each risk faced.