Operating Risk

What keeps you awake at night?

Its usually the things that you can't easily control – that scare you the most

1 A Common Question – Uncommon Answers

nem Partners often ask clients "What keeps you awake at night? It is a nifty way to identify the crucial and most pressing risks and issues that a business is dealing with.

The answers can vary greatly; from staff retention, to loss of revenue, to capital protection, to succession planning to name a few; and while this question provides a segue into the areas that more than likely require some immediate focus, it also tends to focus the client on the risks they are dealing with - *every day* - as management of risks, is a daily (or nightly) activity for all business managers.

No business can avoid risk, obviously, however successful businesses are able to prosper and grow in the midst of a risk swamp.

We are all in the risk management business. For some the emphasis on risk is more obvious (e.g. crane operators) and for others it may be more subtle (e.g. financial planners), however ignore it at your peril.

The intent of this ebook is to provide some basic tools to assist businesses in managing risk, putting it in proper perspective and possibly using it to advantage in their marketplace.

2 Risk Swamp

External Risk

- ✓ Regulatory Risk
- ✓ Natural Disasters
- ✓ Vandalism
- ✓ Sabotage
- ✓ Resourcing

Resource Risk

Contract Risk

- ✓ Poor negotiation (suppliers favor)
- ✓ Key components overlooked (e.g. bonding)
- ✓ Inadequate penalties

Project Risk

- ✓ Stakeholder buy-in
- ✓ Project commitment
- ✓ Stretched resources
- ✓ Unrealistic timelines – time slippage
- ✓ Design change control
- ✓ Team Mechanics
- ✓ Cost accountability
- ✓ Cost management
- ✓ Resourcing

Insurance Risk

Market Risk

- ✓ Competition
- ✓ Reduced capacity off-take
- ✓ Pricing
- ✓ Legislation
- ✓ Staff retention
- ✓ Resourcing

Implementation Risk

Operational Risk

Political Risk

Legal Risk

- ✓ Contracts
- ✓ Litigation
- ✓ O.H & S
- ✓ Local legislation
- ✓ Resourcing

Supplier Risk

- ✓ Poor procurement process
- ✓ Team Resourcing
- ✓ Financial weakness
- ✓ Industry Reputation

Finance Risk

- ✓ Lack of Capital
- ✓ Debt finance
- ✓ Interest Rate Risk
- ✓ Currency Risk
- ✓ Timing
- ✓ Complexity
- ✓ Cost/Fees
- ✓ Fixed/Floating
- ✓ Finance management
- ✓ Resourcing

Environmental Risk

Country Risk

3 First - Know Your Risks

It's highly unlikely that the primary reason you are in business is to manage risk. Unfortunately, failure to do so becomes a primary reason you can go out of business. For example, only a minute number of investment managers understood the risks associated with the US property market in 2008 (watch "The Big Short" – a great movie), yet it caused the greatest financial crisis since the great depression. In hindsight the risks were obvious – but then, aren't they always?

Unless you are a hedge fund, the risks your business faces are usually easier to identify, although *not always*.

Regulatory Risk is an obvious risk that all businesses are exposed to, be it OH&S, industry regulation, financial regulation or even the law. Most businesses are adept at managing these risks as the downside can be catastrophic to the business, with regulators usually driving compliance with a strong arm.

Similarly, unless you are a sole practitioner, *employee risk* is ever-present – unexpected absences, pilfering and poor recruitment can become major issues for a small business that can be complex and time consuming to resolve.

These risks are obvious and generally well understood, if not necessarily always well managed, but what about lesser understood risk such as *credit risk, contractor risk, reputational risk or foreign exchange risk*. These could be just as damaging to a business but are often not even identified as risks until a risk event occurs – causing the inevitable transfer from *risk management to crisis management*, a dangerous place to be.

So, how do you get to know your specific risks?

They usually don't hide, but can often be difficult to see just the same. Unless you are Sherlock Holmes, you probably won't identify them all by yourself, so follow a process:

- Complete a risk audit by considering all aspects of your business and isolating the risks associated with each one. This may require a brainstorm session with your team as often they will know more about the risks they are exposed to than management. A simple question – "What can go wrong?" can be a great thought starter.
- **Create a risk register**, which should include detail of the risk, the likelihood of an occurrence (including a risk rating if possible), a primary person responsible to manage the risk and the risk mitigation strategy or actions to be implemented.
- Use traffic lights to assess the importance of a risk and/or the likelihood of a risk occurrence.
- Use industry associations, the internet and other information sources as a guide. You can rest assured that this has been done before.

4 Prioritise Risks

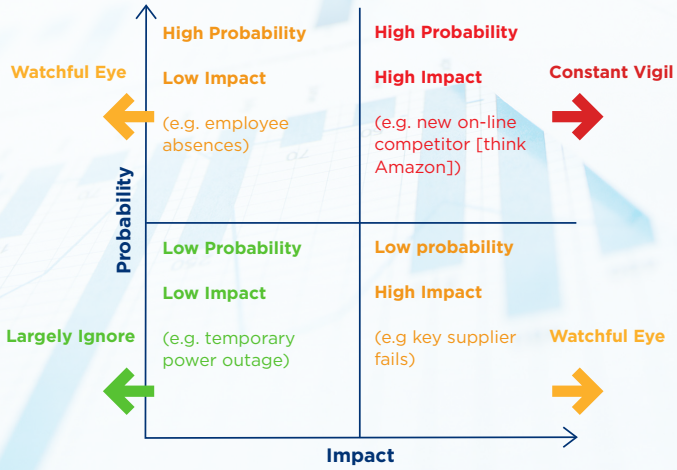
Not all risks have the ability to severely impact, or even destroy, a business. Conversely, some risk occurrences in isolation may have minimal impact on the business; however if they become commonplace, may have as much impact as a major risk. The following two examples of *reputational risk* highlight this point:

A fine dining restaurant needs only one evidence of poor kitchen hygiene, resulting in a number of diners becoming ill, to be forced out of business.

Conversely, one instance of a late delivery will probably have minimal impact on a manufacturing business; however if it becomes the norm, rather than the exception, then customers will likely start looking elsewhere and once this occurs it is extremely difficult to resurrect the relationship.

The same risk can have very different impacts – depending on the business and severity or longevity of the risk occurrence.

A simple **risk matrix** can assist in understanding each risk, which in turn enables appropriate resources to be allocated responsibility (and accountability) for managing it.



5 Plan to Fail

If you know what failure looks like - then you are well advanced towards avoiding it.

Allocate risk responsibility – TO EVERYONE. If they are accountable – they will take it seriously.

Conduct "What-if" scenarios and risk assessments/testing.

Continually refine processes to improve risk minimisation (and performance).

Test the skills of the team - is it strong enough?

Seek customer feedback *They can be a valued resource in identifying risk issues.*

6 Communicate

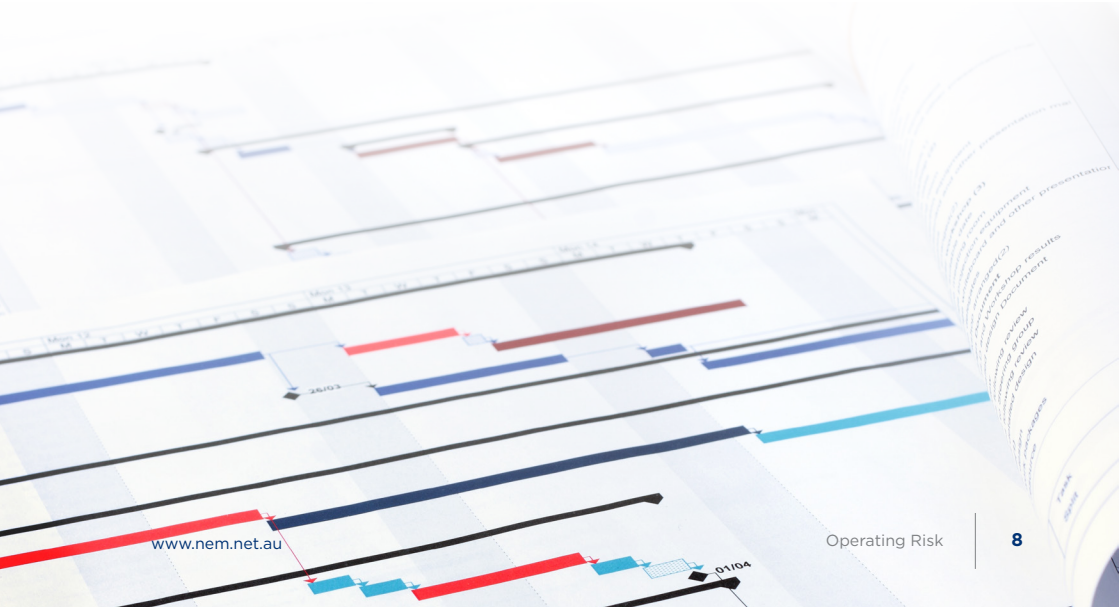
The cleaner may be the one that spots the problem first, but if the workplace culture is one where the cleaner feels uncomfortable in raising the matter, then it will remain unknown, *until an event occurs.*

Make risk a *key component* of all team meetings – and not just a cursory final item on the agenda. Ensure discussions on risk are two way – there is no point emphasising the importance of risk, without seeking meaningful discussion on the topic.

Reward risk identification – and penalise lack of communication in risk matters.

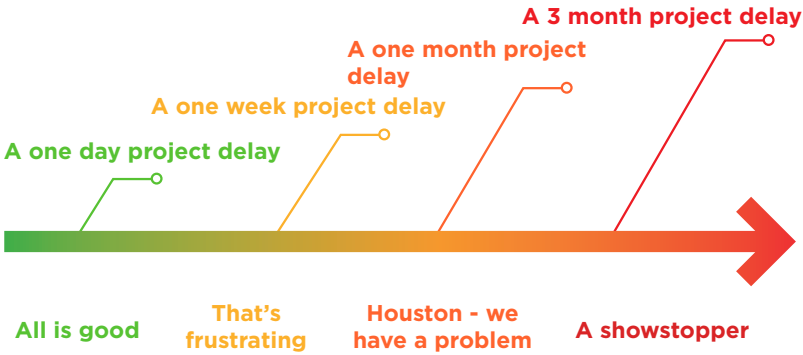
Make it clear that your business is taking risk management seriously and that all risks are on the table, not just those that are easy to see. Loss of a major customer could be large risk, but is the topic of *customer relationships* discussed as a risk topic?

Conduct risk training, particularly in areas of regulatory compliance where training may be a requirement of regulators.



7 Monitor and be Vigilant

The nature of risk can vary over time and time can create a belief that no-one cares.



Beware the "Broken-Window Syndrome"

8 Plan Responses - Deal with it

In need, establish a *Contingency Plan or a Disaster Recovery Plan (DRP)*. For example, if your business is dependent on quality bandwidth, what happens if internet is unavailable for an extended period? Is a back up readily available? Who should you contact?

Know what to do should the unexpected happen. A strong actionable plan will avoid panic situations.

If appropriate, rehearse the plans. Ensure those accountable for implementation know what this entails and are properly trained and prepared. Depending on your industry, a robust DRP may even be a regulatory requirement - and one that is often not taken seriously enough.

Detail a Plan B, or C or .....The best laid plans sometimes don't work. Having a *viable alternative* is a good way of succeeding regardless.

9 Risk as an Opportunity?

Having a robust risk management process can provide a jump on the opposition.

One of the first hedge funds in the USA, Princeton Newport Partners, based its entire investment strategy on risk minimisation – no risk that could be adequately hedged was ignored. The fund outperformed the S & P 500 in its 20 years of operation by a factor of 5 (2,700% vs 545%).

It used risk management, or more importantly risk minimisation, as a key market differentiation – to great success.

To be able to state to your client base *"we deliver on - time – always"* and to meet that objective – always, should be a distinct market advantage, that can even override price. The key though is always meeting it and ensuring that the market believes it.

Clients can be very risk averse as a *major risk event for your business can create a major event for them by default*, which is why many conduct credit checks; with a recent trend being a full-on risk assessment of a business prior to contracting.

Some businesses are even adept at passing on some of their own risks to their suppliers and customers - just ask a supplier to a major retailer or read your health insurance policy fine print.

Having a strong risk culture not only provides market opportunity, but can also provide price advantage.

10 Seek Assistance

If this all seems too daunting, you are not alone.

Usually, the larger the business or the longer it has been in operation, the bigger the impact a risk event can have, and as a result, the greater the importance of a robust risk management process. Very few businesses, if any, had risk management as a key area of focus when they were established and once it becomes necessary, it is unfair to assume your business has the requisite skill to do justice to the process.

nem Australasia can provide support and assistance with the following at its disposal:

1. An extensive list of Partners with strong experience in all manners or risk management, including financial, reputational, manufacturing, OH&S, regulatory, resourcing and insurance risk, to name a few. Refer to the **nem** website at **www.nem.net.au** for specific detail of individual Partners' risk and industry background.
2. An extensive network of referral partners that can provide more detailed risk and compliance audits, risk software packages and tailored compliance systems for each business.

Outsourcing skills is an economically sound practice and the complex area of risk management falls well within this category.

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This ebook is based on research and opinion available in the public domain.

Click here if you would like nem to contact you.

11 What Next?

So you have completed a *risk register*, assessed the impacts of the risks, allocated responsibility and conducted what-if scenarios, You have confidence that a robust risk management process exists. How do you use this to advantage? Aside from the potential market advantages it can provide, the process should also be used to advantage with your lenders, board of directors and investors

The Business Plan and all financial presentations, should include as a key component, the risk management process, a summary of the risk register or at a minimum, the risk matrix.

Leverage it to advantage. Investors and lenders are risk averse. If they see a risk that is not managed to their satisfaction your task becomes harder.

Risk and Lenders

Lenders are normally well secured and have first claim on surplus cashflow, at a cost. Their returns are low compared to investors and as a result their appetite for risk is much lower, some would argue zero. Proving that risk is taken seriously and risks are both identified and properly managed, will be well regarded by lenders and may transpose to better access to capital and lower costs.

Risk and Investors

Investors possess a more holistic view of the world and see the common good. They have more patience, however, they will value a robust risk management process as it is their money you are managing.

Risk and Sleep

For a good bedtime read, a quality risk register may not be as riveting as a good crime novel, nor as relaxing as good golfing book, but it may help you sleep a lot better.