Information Booklet

Business Management

5

Risk Assessment and Planning for SMEs

SMEDA

NBDP
National Business Development Program for SMEs

Introduction

Small and Medium Enterprises Development Authority (SMEDA) works under the Ministry of Industries and Production, Government of Pakistan and was established in 1988 with the objective to propel economic growth through development of SMEs. SMEDA serves as an SME strategy-advisory body for the Government of Pakistan and facilitates partners in meeting their SME development agendas.

SMEDA envisions growth of a globally competitive SME sector, through creating an enabling environment and support services for increase in the national economy. SMEDA strives to achieve this vision by providing assistance in employment generation and value addition to the national income, through development of the SME Sector, by helping increase the number, scale and competitiveness of SMEs.

National Business Development Program for SMEs (NBDP) is a project of SMEDA which intends to provide hands-on support services to SMEs. The aim of this business development support provided by NBDP is to advance new businesses and improve efficiencies in existing SME value chains to empower them to contend in global market. NBDP expects to facilitate around 314,000 SME beneficiaries over the period of five years.

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Objective

- To define the importance, contents and the process of a good risk management plan in order to avoid unexpected situations and failures.

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a Concept and Importance of Risk Management

Risk is defined as any uncertain future event or situation which can influence the achievement of strategic, operational and financial goals of a business.

Risk management is the process of identification and evaluation of risk, followed by the best use of resources to monitor and minimize risks.

Risk strategy is a company's viewpoint towards various risks associated with the business. It includes the decision on the levels of acceptance, avoidance, tolerance or transfer of risks faced by the company.

Risk can be internal or external. External risks are those which are not in direct control of the management and come from outside the company. These include political issues, exchange rates, interest rates, climate change and so on. Internal risks, on the other hand, are from within the business and include non-compliance or information breaches.

Importance of Risk Management

Risk is the main cause of uncertainty in any business. Businesses increasingly focus more on identifying and managing risks before they even affect the performance of any business. The ability to manage risk helps businesses to tackle challenging situations and be better prepared for future decisions. If a business defines objectives without taking risk considerations, chances are that it will lose direction once any of these risks appear.

b Types of Risks

It is important to understand various types of risks that exist so that business owners are better equipped to take action to deal with these risks. Some of the types are listed and explained below:

1. Strategic Business Risk

Strategic business risk is the risk that a business strategy may become less effective and the business will struggle to meet its objectives as a result. It may be due to the use of obsolete technology, increase in competition due to new entrants, competitors gain advantage due to cost savings or product innovation, shifts in customer demand, price hikes of raw materials, single product line, rely on sole/exclusive vendor, loss of major clients or any number of other large-scale changes.

2. Risk for Standardization

Almost all the risks have a financial impact, in terms of extra costs or lost revenue. However, financial risks refer specifically to the cash flows of a business and the possibility of an unexpected financial loss. This includes extending credit to customers, debt load, insolvency, bankruptcy, income and revenue streams, interest and exchange rates.

3. Operational Risk

Operational risk refer to the chances of loss due to day-to-day operations of an organization. These may result from internal failures including insufficient processes, system failures, human resource management, information technology breakdown, human error, quality failure and other issues etc. Operational risks can also result from unforeseen external events such as transportation systems breaking down, or a supplier failing to deliver goods.

4. Legal Compliance Risk

Legal risk occurs when a business may break a law or violate a regulation due to lack of awareness or misunderstanding, ambiguity, or reckless indifference to the way law and regulation apply to the business. Legal risk may also occur due to non-compliance of certain legal rules and regulations.

5. Reputational Risk

Loss of a business' reputation or community standing might result from product failures, lawsuits or negative publicity. Reputations take time to build but can be lost in a day. In this era of social networking, negative review or feedback by a customer can reduce earnings overnight.

6. Other Business Risks

Apart from the risks mentioned above, there are also risks such as risks from the environment, natural disasters, political instability, changing economic conditions, climate change, seasonal business, terrorism, employees turnover and country risk etc.

C Three Steps of Risk Management in a Business

There are three steps in the process of risk management:

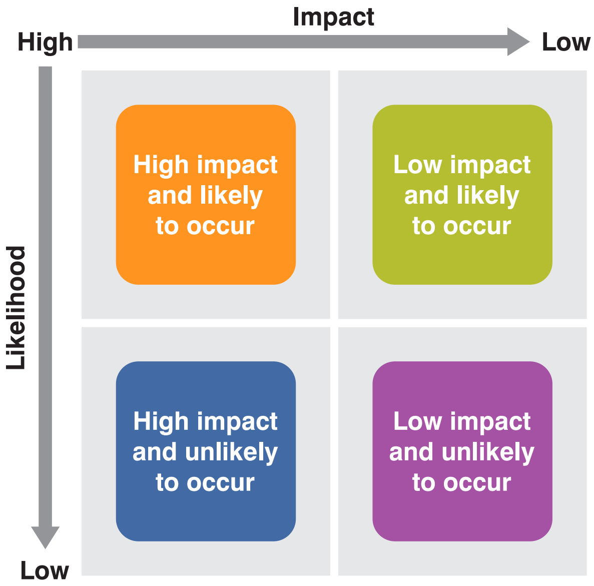
i) Risk Identification

Risk identification entails two aspects, identifying the source of risk and the problem itself. It is the process of listing potential risks and their characteristics. The source of risk can be explained with respect to the origin, category and reason.

ii) Risk Evaluation

After the first step of identifying the potential risk, the management then evaluates each risk based on the likelihood that a risk event will occur and the potential loss associated with it. However, not all risks are the same. Some risks are more likely to happen than others. The cost of various risks can vary greatly. Evaluating the risk's possibility of occurrence and assessment of potential loss i.e. the impact of risk to the organization is the second step in the risk management process. This is followed by development of a risk management plan and its implementation which entails instituting control mechanism to mitigate the risk.

Risk evaluation is an understanding of which potential risks have the greatest possibility of happening and can have the greatest negative impact on the business (Figure 1).



iii) Risk Mitigation

Risk mitigation is a strategy to prepare for and lessen the effects of threats that a business might face. Taking steps to deal with risk is also an essential step in risk mitigation. The ability to mitigate risk allows a business to proactively acknowledge and accommodate risks. Four different strategies to mitigate risk are:

1. Avoidance

The best way to deal with any risk is to avoid it. By keeping the business away from such activities that cause risk to business, one can possibly avoid the occurrence of the undesirable events.

For example, a business purchases some raw material from a vendor which is going to be bankrupted, blacklisted and can cause the risk of raw material shortage or can create a negative impact. In this case, the business should find some other vendor to avoid that potential risk.

2. Reduction or Control

If a business cannot avoid a certain risk, it may still reduce or control it. To reduce the possible risk is to diversify and thinking through the mix of products, technologies, markets, operations and supply chains. It enables the team to limit the high-risk opportunities to a manageable or acceptable level.

If it is not possible to reduce the occurrence or severity, then implementing controls is another option. Controls either detect causes of unwanted events prior to the possible risk consequences or helps in the detection of root causes that the business can avoid.

3. Transference

Another method to deal with risk is to shift the burden of risk consequence to another party. This may include giving up some control, when something goes wrong for which a business is not responsible.

For example, business insurance is a typical way of transferring risk to another business. This may require a careful analysis of presenting risks and possibilities yet it is a viable option in some situations. Moreover, contract terms with suppliers, vendors and contractors etc. may provide a means to shift risk away from the business.

4. Acceptance

When a business cannot avoid, control, reduce or transfer a risk, then it has to accept it. However, even in case of acceptance, the business must explore the alternatives. For accepting the risk, businesses need to devise a strategy to deal with the effects of a risk on the business.

d Risk Management Scenarios

Risk management scenario is an important concept within a qualitative risk assessment. Once the risk assessment team has identified and collated all of the relevant information to be used during the risk assessment, the assessment itself starts by identification of the risk scenario to be considered. The "risk scenario" is chosen by reviewing the potential incidents that could occur within the scope of work or situation and selecting one at a time for consideration during the assessment.

Following are a few scenarios that can be reviewed for risk management:

1. Identify Risks

Junaid runs a catering business and is thinking about buying a new delivery van. He evaluates the risks of buying a van, such as extra expenses if the van breaks down. However, Junaid should also focus on other opportunities he could avail with the same amount of money. His other choices include buying new equipment or hiring more staff. If he buys a van instead of hiring more staff, he risks missing out on the benefits of having more staff, such as faster customer service in his business. He should try to compare the future impacts of each possible choice before making his decision.

After identifying the risks, Junaid can prioritize which ones are urgent.

To analyze the risks related to an event, one should first look at:

- The damage that the risk would cause (for example, the risk of fewer customers means lower sales for the business).
- The likelihood of the risk happening (for example, think about how similar the competitor's business is, and how loyal the customers are?)
- Work out a rating system for damage and likelihood. For example, one could have:

Ratings of 1 to 4 for damage (1 for slight damage and 4 for severe damage).	Ratings of 1 to 4 for likelihood (1 for not likely and 4 for extremely likely).

To work out the level of risk for an event, use this formula:

Risk Level = Damage x Likelihood

Based on the example above, the lowest risk level one could get is 1 (1 x 1), and the highest risk level one could get is 16 (4 x 4). One can use the risk levels to rank the risks from least urgent to urgent.

2. Evaluating Risks

Sara runs a clothing retail store. She worries about the rise in theft during the busy end of year period. To manage this, she conducts a detailed assessment. She works out that she lost PKR 75,000 to theft last December. As a result, she has security cameras installed in her store which leads to a 40% reduction in loss due to theft. She works out the expected loss at:

Expected Loss (Current Year) = PKR 75,000 – (PKR 75,000 x 40%) = PKR 45,000

She expects similar levels of theft this year. To further reduce the risk of theft, the next step will be to hire a security guard during working hours. The cost of hiring a security guard for a month will be PKR 60,000 which is more than the expected loss, so she decides to accept the risk.

Instead of hiring a security guard, Sara meets with her staff to brainstorm possible ways to reduce the theft. They decide to move the shelves so staff can see customers more clearly. She also hires more staff for peak times to check on theft.

Bina's Story

Bina, a business owner has PKR 3,000,000 in the bank at an interest rate of 2.5%. She chooses to buy new equipment for her business to increase the efficiency of her workers. The risks of this choice include:

Missing out on a higher interest rate in the future	The equipment does not increase efficiency as expected

Salman's Story

Salman runs a clothing retail store in the shopping area of a suburban. Most of his sales come from people walking past his shop. Recently, a new shopping center opened about 1 kilometer from his shop. This new shopping center decreases the number of people who pass by Salman's shop. He has to decide if he should move his business to the new shopping center or stay where he is and increase marketing to attract new customers. He must think about the opportunities and the risks of changing location.

Salman notes the possible opportunities of changing location:

Increase in sales as more people will walk past his new store	Lower marketing expenses because of the busy location and co-marketing with other stores

And the risks of changing location:

Increase in competition from similar clothing stores within the shopping center	Loss of regular customers and damage to business goodwill in the local community

Salman must decide if the opportunities are greater than the risks of moving to the new location. He also has to think about whether increasing his marketing budget will give him a better return on investment than relocating.

Rehan's Story

Rehan owns a takeaway restaurant. He understands the risks to his employees from hot cooking surfaces and sharp objects in the kitchen. He trains his staff to use appliances and knives safely to reduce the risk of injury. However, Rehan did not anticipate the decrease in sales when a new restaurant opened nearby selling similar food.

Rehan had noted a common risk to his employees, but failed to plan for a less obvious risk to his business.

Ahmad's Story

Ahmad runs a suburban bakery. He wants to introduce some new menu items to increase revenue. Before deciding on the menu change, he carries out a thorough risk assessment and identifies two risks. He sees that some new menu items will contain ingredients with a short shelf life but the current supplier does not stock the ingredients throughout the year.

Ahmad is concerned about the risk of food poisoning due to short shelf life. He is also worried about unsatisfied customers due to the lack of new menu items.

After Ahmad discusses these concerns with his staff and suppliers, he decides not to add the new items to the menu yet and looks for other menu items he can add instead.

e Risk Management Plan

A risk mitigation strategy takes into account not only the priorities and mission critical data of each organization, but any risks that might arise due to the nature of the field or geographic location. A risk mitigation strategy must also factor in an organization's employees and their needs.

When creating a risk mitigation plan, there are a few steps that are fairly standard for most businesses. Recognizing recurring risks, prioritizing risk mitigation and monitoring the established plan are vital aspects for maintaining a thorough risk mitigation strategy.

The following steps can be followed to develop a risk management plan.

Make a List	The first step is to make a list of potential risks. It is important to pay attention to the minutest of details. At times, it may be that a minute threat can transform into a potential risk in the future.
Prioritize the Risks	Arrange the risk in order of priority. Those that need to be dealt with first are listed first. Risks are prioritized on the basis of degree of impact and the likelihood of occurrence.
Developing an Action Plan	Plans are designed to minimize the impact of the risk and to check the occurrence. In addition, an action plan is developed against each risk i.e., in event of occurrence how to respond to the risk, who will be responsible and what are the backup options.
Required Resources	Identify and enlist the resources required to address the specific risks in terms of finances, human resource, tools and equipment etc.
Responsibilities & Timing	Assign specific roles and responsibilities to people at specific times. The team works in close coordination to undertake planned actions in case the anticipated risks come true. These actions are to be taken at specific points in time; a timeframe is necessary.
Communication	Communication of the plan to stakeholders (both internal and external becomes necessary). Present the plan to those who are responsible for key interventions. Explain the time-frames along with actions and responsibilities.
Performance Measures, Reporting & Monitoring Requirements	The required actions are then evaluated on the basis of planned objectives of risk management plan. Reports are formed and risk monitoring is carried out to assess the functioning of risk management components and the quality of performance on an ongoing basis.

Name of Business					Date			
Prepared By								
Problem Area or Activity	Risks Identified	Description	Probability of Occurrence	Impact Intensity	Existing Measures	Mitigation Strategy	Additional Measures	Contingency Plan

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