Developing Risk Management for SME

ERM – Enterprise Risk Management.

- Risk is an event which can prevent, hinder, fail to further or otherwise obstruct the enterprise in achieving its objectives.
- Risk is the product of probability of occurrence of an event and the financial impact of such occurrence to an enterprise.
- Risk based approach integrates strategic planning, operations management and internal control.
- Integrates risk in strategy to have appropriate balance of risk and return
- It supports reduction of uncertainty and exploitation of opportunity.

Objectives of Risk Management

- Improve Managerial Decision Making
- Effective Use of Capital
- Develop strategy to anticipated problems
- Coordinating activities of various departments

Stages of Risk Management

<u>Basic Understanding</u>

- Many of the approaches are being used already by the more successful SMEs, often without knowing it: the challenge here is to codify good practice and enshrine it in well designed, SME-specific tools and methodologies which can be applied in a rapid, reproducible way by firms and their advisors.
- Enterprises in the same industry, facing similar risks, will often choose different risk management strategies.

<u>What are the Stages?</u>

Each Company may organize it separately. The process will generally involve following steps -

- External and Internal context - Conducting SWOT and Developing Overall Goals
- Identify Risk that affects objective
- Analyse and Quantify risk
- Choose your Risk Management Response
- Take Action – Implement Controls, MIS and Monitor

<u>Establish and Internal Context</u>

External

- A simple SWOT (strengths, weaknesses, opportunities, threats) analysis.
- Includes, looking at new market developments and the current and likely future state of competition.
- Simple Benchmarking exercise – With competitor, Best practices.
- Links a firm's internal competencies and capabilities with external environment.

Internal

Simple self assessment process. Puts issues in open for wider participation.

- Developing Vision and Mission Statements

- Identifying key performance indicators of the business
- Exploring risk appetite of the Organization

<u>Identifying Risks</u>

Grouping
It generally involves *grouping* risks in following categories –
Strategic
Operational
Financial
Compliance

- Strategic Risks are associated with primary long term purpose, direction of the Company and arise from competition (product, other company), industry cycle and development.
- Operational risks arise from the various operational and administrative day to day activities that the business uses. Factors responsible are technological changes, service failure, relationship with supplier, customer, employee quality, internal controls etc.
- Financial risks arise from the financial structure of the business, from transactions with third parties and from the financial systems in place. Factors responsible are – leverage, debt servicing ratio, liquidity, financial standing etc.
- Compliance risks derive from the necessity to ensure compliance with laws, regulations and other less formal societal expectations which, if infringed, can damage a company. Health and safety risks are sometimes straightforward and can be considered as a subset of compliance or operational risk, but in many industries (eg transport) health and safety are key areas which require major resources and concentration.

Identifying
The most important task is to identify Risks faced by the Enterprise. This is done through self assessment procedure. It is done through survey, interview, questionnaire.

Analyse and Quantify

- The identified risks are then evaluated in terms of their likelihood of occurance and severity of impact
- It may be done by risk mapping wherein Severity of impact is shown in one axis and likelihood in another.
- Impact can be measured in many ways – ultimately there will be a financial effect, but as this is often extremely difficult to calculate with any certainty a best estimate is made.
- Suggested values for various impacts are –
    1 Insignificant
    2 Minor
    3 Moderate
    4 Major
    5 Catastrophic
- Measuring likelihood is similar exercise. Suggested values for various impacts are –
    1. Remote
    2. Unlikely

3. Possible
4. Likely
5. Almost Certain

- Generally series of categories like daily, monthly, yearly, once in five years chosen.
- Once plotted chart can be divided into four parts –
    1 Prevent at source
    2 Detect and Monitor
    3 Monitor
    4 Low Control

<u>Choose your Risk Management Response</u>

Once risks are mapped, risk response approach is developed.

- Concept of 4T – Terminate, Treat, Transfer, Tolerate
- Appropriate response strategy depends on risk appetite of the company
- Sometimes the risk may be inherent in business and complet avoidance may not be possible.
- Methods use to achieve 4T are avoidance (is risk is too high and not sensible to proceed), diversification, hedging, insurance

<u>Take Action – Implement Controls, MIS and Monitor</u>

Having evaluated and finalized risk management approach, it is time to put it in action. This is done through –

- Introducing internal control
- Designing reporting and monitoring structure to manage initially and continuously
- Introducing audit (i.e. beyond self assessment)
- In smaller organization risk management is spearheaded by Finance Head