Objective A

So What?

What Might Happen

You might not think of yourself as a dare-devil, but you face risk every single day! You could fall and twist your ankle as you hurry downstairs in the morning. Your car could break down on the way to school. At lunch, you could buy a stale sandwich. Before you leave, you could lose your car keys somewhere in your locker.

If any of these things happened, you'd be frustrated. So you try to keep bad things from happening—or you try to protect yourself against them. Businesses do the same thing—just like you, they don't want to lose out! Read on to learn what business risk is and how businesses handle it.

Objectives

A Explain types of business risk.

B Explain how businesses deal with risk.

Businesses can lose, just as people can. When you go out to a restaurant with your friends, you risk wasting your money on a disappointing meal. The restaurant, on the other hand, risks losing money if you demand a refund. And, if you write a negative review of the restaurant on a site like Yelp, the restaurant risks losing additional customers. One meal can be pretty risky!

Business risk is the possibility of loss (failure) or gain (success) inherent in conducting business. With free enterprise, business-people have the right to risk everything. They may lose it all, or they just may make a fortune. But if a business owner can lose everything

▲ Business risk can lead to success, but it can also lead to failure. That's why learning to effectively manage risk is so important.

by gambling on a risk, you might ask, why would s/he even take the chance? Because taking risks, even if those risks can result in loss, is the only way for a business to be successful. Hiring new employees, introducing new products, and buying new equipment are all risks that businesspeople have to take from time to time. However, that doesn't mean taking *every* risk is a good idea. Ultimately, effectively managing risk is what separates successful businesses from unsuccessful ones. That's why it's so important to understand the risks businesses can face—and what factors influence those risks.

Classifications of Business Risk

Most of the risks that businesses encounter can be classified as hazard risks, operational risks, strategic risks, and financial risks. Let's take a look at the characteristics of each category.

Hazard Risks

Hazard risks are potential events or situations that can cause injury or harm to people, property, or the environment. Most hazard risks can only cause business losses, not gains. Types of hazard risks include:

- **Natural disasters.** Tornadoes, earthquakes, floods, blizzards, hurricanes, and other natural phenomena are considered hazard risks. These disasters can cause significant damage to a business. They can even wipe out entire buildings—and years of hard work along with them. Even the threat of natural disasters can be a hazard risk. For example, think of how business owners along the East Coast were forced to board up their businesses and evacuate before Hurricane Sandy hit. Even if their businesses weren't physically damaged by the storm, they still lost significant revenue while they were closed.
- **Property damage.** A significant cause of property damage is fire, which can destroy buildings as well as important paperwork and equipment. Other property damage can occur as equipment and facilities age and wear out—for example, an older shop roof might begin to leak, which would cost money to repair (plus the additional financial burden of replacing any water-damaged items inside the building). Damage can also result from human activity, such as vandals spray painting graffiti on the side of a business.
- **Employee issues.** Inadequate safety equipment or hazardous working conditions can cause injuries that may cost a business big money. For example, if your company doesn't provide safety goggles and an employee gets something in his or her eye, s/he may have to take time off work. If an employee isn't at work, that means the business may have to hire someone new, pay another employee overtime, or train someone else to cover the absent worker's duties. Even worse, the employee may sue the company and be entitled to worker's compensation benefits. Or, for example, what about an employee who's been harassed or discriminated against? An employee in this situation could sue the company as well.
- **Customer issues.** Employees aren't the only ones who can get injured at work. Let's say a company's sidewalk is icy because an employee forgot to salt it. If a customer slips and falls, s/he may sue the company. Or, if an employee says something rude or inappropriate to a customer, that customer may leave and never come back.
- **Crime.** Whether it's robbery, check fraud, an employee pocketing money, or a customer stealing merchandise, crime is a hazard risk for every company.

Operational Risks

Operational risks are the possible events and situations that can result from employee actions, core processes, and daily business activities. Unfortunately, people and processes aren't perfect—as long as your business deals with people, you'll always have some degree of operational risk. Operational risks are often things that can go wrong in the short term. They include:

- **Human errors.** If your employees haven't been properly trained, or if they simply can't do their jobs correctly or effectively, this is an operational risk. Good employees add financial value to the company, but incompetent employees are just another way for a business to lose money. The same is true of careless employees. If an employee makes a mistake and orders the wrong supplies, s/he could cost a business serious money.
- **Production problems.** What if a manufacturing plant can't obtain needed parts from a supplier? What if one of its machines breaks when it has a big order to fill, and it can't get the products to its customers on time? These problems with core processes can lose customers and profit.
- **Leadership problems.** Company leaders are just as capable of making mistakes as employees who are lower on the totem pole. If a leader makes bad decisions or isn't trusted by employees, it can be hard to maintain a productive and profitable working environment.
- **Labor relations.** If a union strike occurs, it can upset production for days, weeks, or months, making it difficult or impossible to fulfill customer orders.
- **Insufficient information management.** It's hard to make good business choices when you can't find the information you need. Disorganized files and out-of-date data can lead to bad decisions.

▲ Union strikes are just one kind of operational risk. They can upset production and make it impossible to fulfill customer orders.

Strategic Risks

Strategic risks can have significant impact on the company's long-term plans. Strategic risks are much broader than the other types of risks we've discussed, and they often concern the overall business environment. Some types include:

- **Reputation damage.** Let's say you've heard that a local restaurant doesn't follow safe hygiene practices and, as a result, several people have gotten sick after eating its food. Whether this is true or just a rumor, you're not likely to eat there again, right? This kind of negative publicity can make a business lose money or even go under. Or, on another note, consider a business whose owners commit fraud and bilk investors out of thousands of dollars. Even if new owners attempt to keep the company going, typically the reputation damage is too great to overcome.
- **Competition.** If you own a toy company and your competitor introduces a new toy that every kid wants, you have two options. You can either introduce a new, better toy, or you can lower your prices. Developing, producing, and marketing a new toy can be a significant expense, and lower prices can result in lower profits. Either way, you run the risk of losing out to your competitor.
- **Obsolescence.** How many brick-and-mortar stores in your city sell CDs? Probably not as many as did 15 years ago. Advances in technology, including the iPod and downloadable music, have made CDs a thing of the past for a lot of people. That's the effect of obsolescence—the fading away that occurs as new products or processes are introduced. These introductions are often influenced by technology. If a business can't keep up, its days are numbered.
- **Regulatory and political issues.** Every business is influenced by the government in some way. Revenues—and profits—are affected by what governments require. Companies often have to invest time and money to comply with tax standards, environmental regulations, employee protection laws, and many other government guidelines. For example, if the Food and Drug Administration (FDA) bans the sale of a specific medicine, companies that manufacture that medicine would have to quickly adapt. If they didn't, they'd run the risk of suffering financially.
- **Changing customer needs.** What customers want today may not be what customers want tomorrow, and businesses need to keep up with changing needs. Think about the changes in styles of clothing from year to year. If a clothing manufacturer doesn't pay attention to what's in fashion, it can be left behind.

▲ Most people today listen to music on mp3 players instead of CDs. This is the effect of obsolescence—the fading away that occurs as new products or processes are introduced.

Financial Risks

Financial risks are possible events or situations that directly influence a company's cash flow. Businesses face both external and internal financial risks.

- **External.** Businesses can't control many financial risks, including inflation and interest rate fluctuations. Inflation, which occurs when the prices of goods and services rise, can make it hard for businesses to afford the supplies they need. Inflation also results in decreased spending power; in other words, customers can't afford to buy as much, making a company's profits go down. Interest rate fluctuations can be a financial risk, as well—if interest rates are high, businesses often can't afford to borrow money.

  While both of these financial risks can negatively affect a business's cash flow, there are some external financial risks that can actually help a company. For example, when the value of the U.S. dollar increases, items purchased from overseas suppliers will cost less. The flipside of this is that when the value of the U.S. dollar decreases, overseas goods become more expensive.
- **Internal.** Internal financial risks are those risks that are controlled by the business. Consider a business's budget—if a company is not honest and thorough, the budget won't be very helpful. For example, if a company is too optimistic about the earnings it expects or underestimates its costs in its budget, it can find itself without enough cash to cover its expenses. Other internal financial risks include inaccurate financial data and inadequate accounting processes.

▲ External financial risks, like the value of the U.S. dollar, are those that can't be controlled by businesses.

It's important to note that business classifications overlap, and sometimes a business risk fits into more than one category. For example, an incompetent employee (an operational risk) may do a company's accounting incorrectly (a financial risk), resulting in a violation of government regulation (a strategic risk).

Pure vs. Speculative

All business risks—regardless of type—can be put into two categories: pure risks or speculative risks. What's the difference? With pure risk, there are two possibilities—loss or no loss. Either something bad happens or nothing happens. Hazard risks and operational risks are considered pure risks. Think about a natural disaster, such as a tornado. A tornado could strike your building and damage it. Or, your building may never be hit by a tornado at all and suffer no damage. In this situation, you're faced with damage (loss) or no damage at all (no loss). There's no possibility of a gain in a pure risk situation—if a tornado avoids your business, that's great, but your business won't actually gain anything. Pure risks are considered insurable risks, meaning that businesses are able to take out insurance policies against them. For example, a business can take out insurance against dishonest employees (referred to as fidelity insurance), or it can get auto insurance to protect company vehicles.

Speculative risks, however, bring the possibility of loss, no change, or gain. These risks encompass strategic and financial risks. Think about opening your own restaurant. You might earn money, you might just break even, or you might go totally bankrupt. Buying shares on the stock market is also considered a speculative risk. If you invest $1,000, you may earn a return, but you could also earn nothing or even lose your investment. Unlike pure risks, speculative risks are not insurable. In other words, because the risks are unpredictable, companies cannot take out insurance to protect themselves. For example, a company can't purchase insurance to protect itself against its product becoming obsolete.

Pure risks vs. speculative risks

Pure:	Speculative:
Two possibilities	Three possibilities
Loss or no loss	Loss, no change, or gain
Hazard risks and operational risks	Strategic risks and financial risks
Insurable	Uninsurable

Summary

Risk is a regular part of doing business. Classifications of business risk include hazard, operational, strategic, and financial. All business risks are either pure (insurable) or speculative (not insurable).

1. Describe business risk.
2. Describe the classifications of business risk:
    a. Hazard risk
    b. Operational risk
    c. Strategic risk
    d. Financial risk
3. Distinguish between pure and speculative risk.

The Gray Zone

The responsibility for business risk is not always a clear issue. Say a construction company sets up a safe working environment at a building site and trains its workers in taking appropriate safety precautions, but Bob (a construction worker) still falls from the scaffolding. Whose fault is it? The construction company's, you might say—because the dangers of working on a building project are business risks.

If you knew, however, that the construction worker had ducked under a barrier to jump from one scaffolding platform to another, would your answer change? Would you still lay the blame on the company? Or, would you say that the company should not be held responsible for this worker's actions?

Objective B

Worth the Risk?

Imagine your town's been hit by a massive snowstorm and the roads are in terrible condition. Would you drive to the movie theatre? Probably not—you don't want to get in an accident. But, if you have an emergency, you'd probably attempt the drive to the hospital, even on dangerous roads. In other words, you're willing to do something risky (in this case, drive on bad roads) because you think it's worth the risk. Businesses do the same thing. They consider if the actions they want to take are worth *more* to them than the possibility of loss or failure. If so, they proceed, handling the risks involved in one of four basic ways:

- Avoiding
- Preventing/Controlling
- Transferring
- Retaining

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▲ Would you attempt to drive somewhere during a blizzard? That depends on whether or not you think it's worth the risk.

Avoiding

Sometimes, the best way to handle a risk is to simply avoid it. This is the first and best way for a business to stay out of trouble. If, for example, the owners of a business fly on an airplane that crashes, the business loses its owners. But, if the owners do not fly at all, the business avoids the plane-crash risk altogether.

Avoidance is also demonstrated by *not* opening a store in a new location, *not* introducing a new product, and *not* expanding a business overseas. It's simple: A risk *not* encountered presents no danger. However, if a business were to avoid every risk, it would have a very difficult time expanding or succeeding.

Preventing/Controlling

Sometimes, a risk that cannot be avoided can be prevented or controlled. When businesses identify a risk they face, they often take measures to prevent or reduce that risk. You see this in how businesses deal with things such as safety, security, employee incompetence, product selection, credit, changes, and weather extremes.

Safety. No business wants its customers or employees to get injured, and safety procedures are an especially important way to reduce that risk. To ensure a safe environment, businesses try to keep their hallways clear so that people don't trip. They remove known hazards, inspect equipment regularly, and provide safety training for employees. For fire risks, businesses install fire extinguishers, store flammable materials in appropriate places, and instruct employees in emergency procedures.

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▲ Sometimes when a risk can't be avoided, it can be prevented or controlled. One way businesses can prevent or reduce the risk of break-ins is by installing security cameras.

Security. To secure their buildings (and products), businesses install security cameras, dead-bolt locks, security bars, and burglar alarms—preventing or reducing the possibility of break-ins. They also hire guards to protect against shoplifters and dishonest employees.

Employee incompetence. To reduce employee incompetence, it's best to take action before the employee is even hired. Businesses carefully screen all applicants to weed out incompetent workers and then provide effective employee training to those who make the cut.

Product selection. To offer the right products in the appropriate quantities, businesses need to know (ahead of time) what customers want to buy. Once they know what to provide, businesses need to assist customers in determining which product will best suit their needs. This can help reduce product returns, an expensive risk that most companies want to avoid. When a product is returned, not only is the money refunded to the customer, but the company must also pay to repackage, restock, and resell the item.

Credit. Businesses carefully screen all credit applications and follow up on past-due accounts. This helps them control the reckless use of credit accounts and pursue the payments owed to them.

Changes. To keep informed, businesses pay attention to what is happening in the economy, community, and industry—with population trends, political events, competition, etc. Businesses that anticipate changes are better able to reduce the risks involved in adapting to change.

Weather extremes. Businesses protect themselves (as much as possible) from weather extremes that can damage company property. Whether it's a hurricane, flood, or tornado, smart businesses keep their products and information safe and make sure their employees are out of harm's way.

How Do Businesses Handle Risks?

Avoiding: Sometimes, the best way for a business to handle a risk is to simply avoid it. A risk not encountered presents no danger.

Preventing/Controlling: If a risk can't be avoided, businesses can take measures to prevent or reduce the risk. Some examples include safety equipment and careful employee screening.

Transferring: Businesses can shift risks to another person or business with contractual agreements, business organization, or insurance.

Retaining: Businesses can keep the risk involved in doing business. In this case, they do nothing to reduce or eliminate the risk.

Transferring

Certain risks may be reduced or eliminated by transferring (or shifting) those risks to another person or business. This option enables businesses to move forward with their decisions without bearing the risks involved. These businesses use a risk-transfer method, such as entering into a contract, selecting a particular form of business ownership, or purchasing insurance.

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▲ Businesses can transfer, or shift, risks to another person or business by signing contractual agreements like surety bonds and rental/lease agreements.

Contractual agreements. Contracts are agreements between two or more people or businesses. One party provides the product, and the other pays something in return. For example, a builder is hired to construct a building for a particular price, or a web designer is hired to design a new website for an hourly fee.

Common contractual agreements for transferring risk are guarantees/warranties, surety bonds, and rental/lease agreements. Let's take a look at each.

- **Guarantees/Warranties.** The seller or manufacturer sometimes makes a promise concerning the performance or quality of a product. With a warranty, the promise is to repair or replace a faulty product. With a guarantee, the promise is to give customers their money back if something goes wrong. You might receive a warranty when buying a car or a computer. And guarantees are relatively common in everyday life—whether you're buying clothes or fast food, many businesses promise to give your money back if you aren't satisfied.
- **Surety bonds.** Businesses can protect themselves from breaches of contract by requiring the contracted company to purchase a surety bond. Then, if the contract is broken, the surety bond would be paid to the company suffering the loss. Surety bonds are commonly used in the construction industry. Imagine that a business wants to build a new office. It would probably require its contracted construction company to purchase a surety bond. That way, if the construction company doesn't complete the project in the manner specified in the contract, the business would get money from the surety bond to cover its loss.
- **Rental/Lease agreements.** If you don't want to commit to buying a car, you might decide to lease one. Many businesses do the same thing when it comes to equipment, buildings, or real estate. This is an especially good option for a start-up business that hasn't yet achieved financial stability.

Business organization. How the business is organized can affect the risks that business owners bear. Three basic forms of business ownership are sole proprietorship, partnership, and corporation.

- **Sole proprietorship.** In a sole proprietorship, the owner (or proprietor) bears all business risks alone.
- **Partnership.** In a partnership, the partners share all the business risks, together.
- **Corporation.** In a corporation, the owners, as shareholders, limit their losses (risks) to what they've invested in the corporation.

Insurance. Insurance is probably the most frequently used option for transferring risk. Every year, businesses spend a lot of money on insurance to protect themselves from the risk of damage or loss. Some examples of insurance coverage include:

- **Property.** Businesses buy property insurance to protect against property destruction. Merchandise, business fixtures, and equipment can be lost or damaged by theft or fire, for example.
- **Transportation.** A business that transports and stores goods may purchase transportation insurance, so that the risk of loss or damage is covered while goods are in transit or being stored.
- **Robbery or theft.** Businesses can buy specific robbery or theft insurance. For businesses that want to protect against the risk of employees' stealing from the business, there are fidelity bonds that cover employees who handle money and other valuables.
- **Personal injury.** Losses from accidents or injuries (occurring on business property) can be covered by liability insurance.

Retaining

In some instances, businesses may keep, or retain, the risk involved in doing business. To put it simply, a business may do *nothing* to reduce or eliminate a risk. Why would a business choose to do nothing? Usually because the business is unaware of the risk, underestimates the risk, feels that the risk is small (in monetary terms), or believes there is a chance of return.

Is unaware of the risk. Sometimes, risks are not obvious. A business that does not know that an employee is stealing, for example, is not going to address the issue. Keeping the dishonest employee on the payroll is risky, but the business doesn't know it.

Underestimates the risk. Other times, a business knows about a risk but doesn't evaluate it accurately. If a company thinks a large risk is actually small, this can lead to problems! Say a company expects the parts of a machine to last for 10 years, but the parts actually wear out after five. The business would have to pay for parts earlier than it had planned.

Feels that the risk is small. If a risk is financially small, businesses often choose to absorb it. You can see this when a bookstore puts its shelves of clearance books outside on the sidewalk. It could rain, or someone could steal a book, but those risks bring minimal losses when inexpensive items are involved.

Believes there's a chance of return. A business is sometimes willing to retain a risk for the potential of making a profit—such as through a business investment. Businesses often invest company money in real estate or stocks with the hope of making a significant return.

Summary

Businesses take risks only when they feel that the risks are worth it. To handle risks, businesses choose to avoid, prevent/control, transfer, or retain them.

TOTAL RECALL

1. Explain how businesses avoid risk.
2. Explain how businesses prevent/control risk.
3. Explain how businesses transfer risk.
4. Explain why a business might choose to retain risk.

Make It Pay!

Your last visit to a theme park may have been exciting, but did you think about the risks the park faces every day? Employees could make mistakes, visitors could break safety rules, machinery could break down, or rides could cause serious injuries. Identify three risks you think the theme park could face and recommend (for each) whether the park should avoid, prevent/control, transfer, or retain the risk.