Risk and Uncertainty in Business

Prof. AJAZ AHMED KHAN
Research Scholar, Department of Commerce,
Bangalore University, Bangalore
India.

Dr. M. RAMACHANDRA GOWDA
Chairman and Professor, Department of Commerce,
Bangalore University, Bangalore.
India.

Abstract— **In living memory, as little as two or three generations ago, people lived in stable communities where they knew everyone else. While the natural environment has always been uncertain (earthquakes, volcanoes, hurricanes, floods and other so-called 'acts of God'), the social environment in which we live has changed dramatically in many respects, particularly in the industrialized (Western) world, and the old certainties of previous generations no longer exist. . A proper emphasis on this positive side of the risk equation will bring significant benefits as we emerge from the global financial crisis and move forward into the new unknown. Still, misunderstanding risk can spell disaster.**

This paper has been discussed in sections such as, the introduction, uncertainty in business, risk includes opportunity, managing risk, risk management in banks, risk management in projects, the value based ERM approach, risk-based audit, wrong assumptions about risk, how misunderstanding risk can spell disaster, overestimating risk and the concluding remarks.

***Key words:** Uncertainty, risk audit, Enterprise risk management,*

Introduction

There can be little doubt that we live in a world characterized by uncertainty. It was not always so, at least in some important aspects. While the natural environment has always been uncertain (earthquakes, volcanoes, hurricanes, floods and other so-called 'acts of God'), the social environment in which we live has changed dramatically in many respects, particularly in the industrialized (Western) world, and the old certainties of previous generations no longer exist. In living memory, as little as two or three generations ago, people 1 lived in stable communities where they knew everyone else.

Each person understood and (for the most part) accepted their position in society, and their relation to others. For most individuals, their job choices were prescribed by their family position, and the concept of 'career' was alien to many. The choice of marriage partners was limited and sometimes even absent. It was possible for the majority of people living in that society to look ahead for 2, 5, 10 years or more, and predict with reasonable certainty where they would be living and what they would be doing. Boundaries were fixed, horizons were limited, and both were largely known, understood and accepted.

Even beyond the local community, there was stability in large areas of the world, reinforced by the international power bases of the British Empire and Commonwealth, the United States of America, NATO, and the USSR and Warsaw Pact. Technology was slow-moving, and business practices and structures remained largely stable, with business planning cycles typically looking ahead by 5– 10 years. While these societal characteristics can still be found in some parts of the globe, it is not the case in the developed world today. We are experiencing unprecedented volatility, with huge degrees of flexibility and choice in all levels of society, including families, local communities, businesses and nations. Individuals have very few fixed points, and the degrees of freedom and mobility for many have increased dramatically.(Hilson, 2009)

Uncertainty in business: Uncertainty affects all investments. However, uncertainty can often be considered in terms of probability provided sufficient information is known about the uncertainty. Probability is based on the occurrence of any event and thus must have an effect on the outcome of that event. The effect can be determined on the basis of the cause and description of an occurrence. For example, the cause, description and effect can be illustrated by the following: 'Crossing the road without looking' will most likely result in 'injury'. (Merna, 2008)

Risk includes opportunity: Risk includes opportunity. Not all risk is bad, and aggressive attempts to reduce risk too far will prevent us from exploiting the upside and capturing the rewards that appropriate risk-taking offers. Seeking opportunities through the risk process can create competitive advantage, maximise value and provide innovative solutions. A proper emphasis on this positive side of the risk equation will bring significant benefits as we emerge from the global financial crisis and move forward into the new unknown. We face an uncertain future and no-one can be sure what the post-crisis world will look like. We can however be sure that being successful will require an effective approach to dealing with uncertainty, and risk management will play an important part in that success. (Hilson, 2010)

Managing risk: If you can't manage risk, you can't control it. And if you can't control it you can't manage it. That means you're just gambling and hoping to get lucky. (J. Hooten, Managing Partner, Arthur Andersen & Co., 2000) The increasing pace of change, customer demands and market globalisation all put risk management high on the agenda for forward-thinking companies. It is necessary to have a comprehensive risk management strategy to survive in today's market place. (Merna, 2008)

Risk management in banks: Managing risks has always been at the heart of any bank's activity. The existence of financial intermediation is clearly linked with a bank's advantage in evaluating the riskiness of potential borrowers and in building well-diversified portfolios. A bank's ability to survive adverse economic cycles (and phases of high volatility, as far as market risk exposure are concerned) is linked both to the quality of its risk selection and management processes and to its capital endowment. Capital is therefore a key resource for both shareholders and managers who are interested in a bank's ability to survive while offering an attractive return for shareholders. At the same time, capital is important for financial system supervisors who are interested in safeguarding the stability of the system by reducing the risk of bank failures (Berger, Herring, and Szëgo 1995). (Saita, 2007)

Risk management in Projects: All decisions about which projects an organization should choose are taken without certain knowledge of what the future will hold and how successful the project will be. Whilst decisions are taken in conditions of uncertainty, we can attempt to predict the factors that can impact on a project. Once we can identify these factors and their possible impacts we can call them risks and attempt to analyze and respond to them. Risks can be both positive, such as embedded opportunities, perhaps to do more business with a new client or customer in future. However, most people think of risks as negative, things that can go wrong, and those indeed require more focus in most risk management processes. (Harris, 2009)

The value-based ERM approach: The value-based ERM approach is designed to have a built-in business case for its adoption. At its core, it is a synthesis of ERM and value-based management. This synthesis provides the missing link between risk and return. It is this connection that transforms ERM into a strategic management approach that enhances strategic planning and other business decision making. As a result, the value-based ERM approach is seen by internal stakeholders— business segment leaders, senior management, and the board— as a way to help them achieve their goals of profitably growing the business and increasing company value. The value-based ERM approach has several other advantages as well. It works equally well in all industry sectors.Risk Governance and the ERM framework constitute the two elements of ERM infrastructure. The ERM framework provides the functional structure, which is part of the basic ERM infrastructure and must be in place before implementing the four ERM process cycle steps. Risk governance provides the hierarchical structure, which includes the way in which the ERM roles and responsibilities are divided up among individuals and groups; the organizational structure, including reporting relationships and authorities involved in ERM; and the policy and procedure documents that instruct key elements of the ERM process. Until the company completes one full ERM process cycle, only the most basic risk governance structure is warranted. The way ERM evolves, is adopted, and becomes integrated into a company's key processes differs from company to company. (Segal, 2011)

Risk-based audit: Risk-based audit is a process, an approach, a methodology and an attitude of mind rolled into one. The simplest way to think about risk-based audit conceptually is to audit the things that really matter to your organisation. The issues that really matter, are probably those areas that pose the greatest risks. If your organisation has already identified its key risks then you already have the basis for risk-based auditing. Clearly, if risks have not been formally identified and assessed then there is a real opportunity for you to work with management to help create this information. The second way of looking at risk-based audit is as a process.

Traditionally audits begin and end by looking at controls, often regarded as the main expertise that the function has. The problem with this approach is two-fold. Firstly, management do not really understand controls, which can be an alien concept for them. If they do understand the nature of controls they tend to consider the need for more controls as an unnecessary additional burden. Secondly, it is unlikely that your Internal Audit function is an expert in control. One cannot really say that one understands the controls in all aspects and all activities within a business. It is necessary, if you are going to demonstrate your eagle-like qualities, to be able to talk to management in a language they understand and appreciate. To fully engage management you need to talk to them about something that is important to them. If you start by discussing their objectives, what they need to achieve and how this is measured you will attract their attention.

Having created the common ground (and it is preferable if you have first given some thoughts to the objectives in the area under review before the meeting), you can now go on to discuss the threats to the achievement of those objectives, the barriers to success; these are, of course, the risks. Again management should be able to elucidate many of the risks or threats, but theoretically, if you have tried to anticipate the types of threat beforehand this will act as a positive spur. (Griffiths, 2005)

Wrong assumptions about risk: Here are some wrong assumptions about risk:

1. 'Risk is only something for finance and insurance to worry about'. This is clearly untrue, risk is everybody's responsibility; everybody can and should be seen as a risk manager because each employee has objectives that need to be achieved.
2. 'Risk comes up on the agenda once a year'. A very big mistake made by a number of organizations was to regard risk management as a 'tick the box' exercise. Risk management is not a passing fad and clearly risk is not like Christmas, it doesn't just happen once a year, it is a continually evolving and changing process. As the organization changes so does the risk profile.
3. 'Business risk management is just another layer of unnecessary bureaucracy. It is just another initiative'. Embraced fully and enthusiastically, the opposite is true, it is a way of reducing bureaucracy, identifying the unnecessary controls, identifying areas that are over managed or over-engineered, and creation of value rather than failure. (Griffiths, 2005)

How misunderstanding risk can spell disaster: Ratners, the jewelry empire and its charismatic owner, Gerald Ratner, when he had his ill-fated 'off the record discussion' with the press and he described the products and services he sold as 'crap'; he brought his company to its knees very, very quickly. I worked in the retail sector at the time and went to a presentation Gerald gave to other retailers a week before the above 'faux pas'. The same sentiments expressed there were clearly recognized as a joke, but not so it would seem by the public who did not like to be considered idiots. Perrier, a few years ago when they had the scare with contaminated product; in some parts of the world it was dealt with brilliantly, in others it was a total nightmare. Perrier thought they had a consistent process for dealing with such crises, but they did not. It took them over 18 months to build back market share. Think about Barings Bank, how one rogue trader brought down a bank. Think of this demise from an audit point of view. Leeson said in his book that when an inexperienced auditor was sent out to Singapore from London: I didn't know what the auditor knew but I realized he was asking me a question rather than accusing me of fraud and wrestling me to the ground and, that if he was asking me a question, he might not know the answer. So I made something up. He said it made no sense at all but it was the best he could come up with under pressure. He apparently had to pinch his leg under his desk to stop himself from laughing as the statement was patently ridiculous but the auditor believed him. (Griffiths, 2005)

Overestimating risk: Overestimating risk can also be disastrous.

1. Avoid over-regulation. There is an increasing call for much tighter regulation of the sectors that caused the problems. This may be a mistake for two reasons. Firstly, regulations are usually developed in response to a specific set of circumstances. In particular they are designed to prevent a recurrence of the current difficulties. However like generals who tend to use the strategies and tactics of the last war to fight the next one, such retrospective action is likely to be ineffective. Future challenges will be different from past ones, and they will need to be addressed using different approaches.
2. Secondly, over-regulation can stifle creativity and innovation, and prevent us from developing the new ways of thinking and doing business that will be appropriate for the future. We need a level of regulation which is appropriate: not so restrictive that it will hold us back from the right level of risk-taking, but not so loose that it will allow the mistakes of the past to be repeated.
3. Recognize the role of risk management. Senior management must view the contribution of their risk specialists as valuable input to both strategic and tactical decision-making. The risk management function must no longer be seen as the "Business Prevention Department", always raising objections and trying to stop people from making progress or profits. Instead the insights and recommendations that arise from the risk process should be welcomed, providing early warning of those uncertainties that matter, and allowing proactive action to be taken. This may mean raising the profile of risk management within the organization, setting it on an equal footing with the business lines, with board-level representation and accountability.
4. Talk the same language. Too often risk practitioners use their own jargon and fail to communicate their message clearly. Risk specialists need to express their findings and advice in language that will be understood by those who need to hear it. This means not talking about Risk Registers, Monte Carlo simulation, sensitivity analysis or Probability-Impact matrices. Instead they must present risk results in terms of what matters to the people who receive the information.

5. Senior management are interested in strategy, business value and competitive advantage. Technical experts are more concerned with functionality and performance. Risk communication should not be an afterthought but should receive careful attention and planning.

Concluding remarks: The argument is that since risks are merely uncertain future events that may never happen, there is no need to spend time and effort (and therefore cost) on identifying, assessing and managing them. Instead the organisation should ensure that its fundamental structures and processes are sound and resilient, and should only react when it is absolutely necessary to do so, if risks materialise into actual events. Reducing the effort spent on risk management produces cost savings in two ways. Firstly, staff are not spending time on the risk process, attending risk workshops, producing Risk Registers or reports, or reviewing risk assessments to keep them up to date. Secondly, time and money will not be spent on new actions that are deemed necessary to respond to identified risks. Cut risk management and you can remove the dual costs of assessing risks and of addressing risks, or so the argument goes. (Hilson, 2010)

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AUTHORS PROFILE

Prof. Ajaz Ahmed Khan, is a research scholar pursuing a research programme in the Department of Commerce, Bangalore University, Bangalore. He is an associate professor of Commerce in the Department of P.G. programmes in M.Com, MBA and MFA, Govt. R.C. College of Commerce and Management, Bangalore.

Dr. M. Ramachandra Gowda, M.Com., M.Phil., Ph.D. is chairman and professor, Department of Commerce, Bangalore University, Bangalore. He is a research guide and has produced many Doctorates in the Department. He is a member and office bearer in various academic bodies and also President of of the Indian Commerce Association. He has published research articles both in national and international journals.