IDEAS

DECISION ANALYSIS

ARE COMPANIES TAKING UNNECESSARY RISKS?

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How to identify the risks faced, the extent to which they can be neutralized, and how to mitigate the consequences if they are unavoidable. Risks can also be converted into opportunities if handled correctly.

DECISION ANALYSIS • STRATEGY • INNOVATION AND CHANGE

Fifty percent of the 500 companies that made up the Fortune 500 list 25 years ago no longer exist. What this shows is that, however established a company is, it is always exposed to risks. Some of these are direct or indirect consequences of the decisions we make, but there are others for which we can't be blamed. Either way, being exposed to them is inevitable – so the question is, are we fully prepared to deal with them when they arise?

There are three types of risk: avoidable, strategic and external.

AVOIDABLE RISKS

Avoidable risks are those that result from doing things badly, and things tend to be done badly through a lack of professional rigor or simply a lack of attention.

So when British Petroleum spilled more than four million barrels of crude oil into the Gulf of Mexico in 2010, the company had taken a risk that it could have avoided. There were many indicators that should have set the alarm bells ringing on the oil platform, but the well digging was 43 days behind schedule. So they were in a hurry to move forward and took some shortcuts that led to disaster, a disaster that could have been avoided if, at the first sign of problems, BP had taken action instead of turning a blind eye.

On other occasions, risk can be avoided if we are aware in advance of a series of determinants. It is well known that we tend to put too much trust in our ability to control what is at hand and faced with a situation where we are making a loss we make decisions that are riskier than we think and give too much attention to the short-term consequences, to the detriment of the long-term. If you bear in mind these types of determinants when making decisions you can avoid taking unnecessary risks.

STRATEGIC RISKS

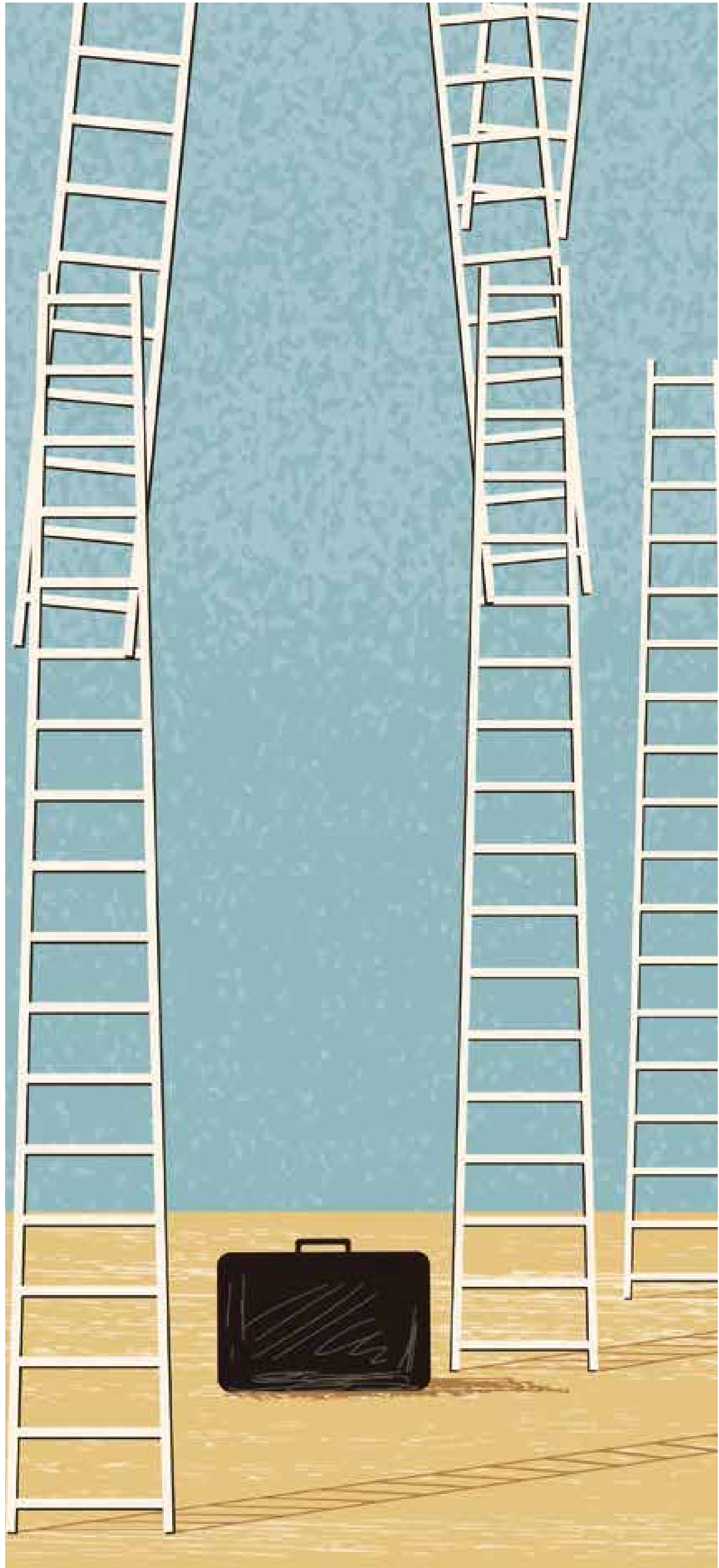
All companies face strategic risks. They occur when an opportunity is pursued with the hope of attaining a profit, but when this opportunity is fraught with uncer-

tainty, it can result in failure. In these cases, the prospect of making a profit compensates for the risk of failure. Examples of these risks are when a pharmaceutical company develops a new medicine, a movie producer makes a film, an oil company prospects for oil or when a company decides to expand out of its domestic market to new and emerging markets. These companies face many uncertainties, but detailed analysis leads them to conclude that it is worth taking the risks because of the potential profits.

Strategic risk management consists in taking the necessary precautions to reduce the possibility of failure, minimize the impact should the risk materialize and, at the same time, emerge strengthened from what has been learned from the experience. Scenario planning, the role of the devil's advocate, premortem analysis, risk maps and the drawing up of critical risk indicators are procedures that make it possible to face up to risk in the best possible way.

● **Scenario planning** is a technique used by those companies that are most experienced in managing strategic risk that has allowed them to deal with risk better than their competitors.

Let's take an example to illustrate this technique. Let's say that company X makes and sells sports goods in Europe and North America. These are already mature markets and the sales growth for the company is quite limited. Furthermore, the competition is pushing down the margins. As a result, the company is thinking about selling in an emerging market, specifically China. The first thing they have to do is to identify the major factors that determine the success or failure of this decision. They put them in order of importance and choose the two most critical. Let's say that these two variables are, firstly, the confidence in good distribution and, secondly, the potential popularity of the company's products among Chinese consumers.



MANAGING RISKS DOESN'T CONSIST ONLY IN ENSURING THAT THEY HAVE THE LEAST IMPACT BUT IN KNOWING HOW TO TURN THEM INTO AN OPPORTUNITY AND EMERGE FROM THEM STRENGTHENED

These two variables produce four possible scenarios: good or bad distribution of products combined with a good or bad reception of them by the market. We know the reality will correspond with one of these four scenarios. It's not a case of assigning probabilities to each scenario, but of studying how our strategy will function in each of them.

In this way, we have anticipated the possible risks that the strategy might encounter, we can take measures to act in the context of these future scenarios, refine our strategy in the light of them, and may even abandon the strategy if we see that it is too problematic.

The exercise can be continued by considering a third critical variable of success. The main benefits of this exercise is that it allows us to refine our strategy, improve it and make it more robust in the context of future situations. It also allows us to be prepared to act in a way that fits the circumstances.

One of the main advantages of scenario planning over strategic planning is that the latter draws up a plan and puts all of its resources behind the success of this plan but this means you only have one card on the table: the success of the plan.

Furthermore, sometimes the plan may have been badly conceived meaning that failure is the most likely outcome, unless luck intervenes. However, scenario planning looks at the flexibility of the chosen plan and leaves the door open to rectification in ways that have been planned in advance.

● Another way of better controlling risks is to take on **the role of the devil's advocate**. In analyzing strategy, assigning to a group of people the role of questioning all the suppositions and everything that the plan hopes to achieve helps to improve the strategy and to prepare for various consequences. It can also make clear when to abandon the chosen course of action if it is not worth the anticipated risks.

For the devil's advocate method to be effective, it's essential to believe in it and carry it out in a professional manner. If not, the participants will see it as merely annoying or just a gimmick. Taking the advice of a good professional the first time the method is employed will improve its chances of success.

● The **pre-mortem analysis** is a strategy that looks at the worst case scenario in which a company might find itself within a few years as a result of having chosen a particular strategy, and analyzes both the causes of the failure as well as the path that has led to it.

The object of the exercise isn't to discard the chosen plan, but to highlight problems that may arise and prepare oneself to face them by modifying those aspects that may make for a better adjusted strategy.

● Finally, drawing up **risk maps** consists in making a list of the principal risks that a company's strategy faces and assessing each of them on a scale of one to five, based on two criteria: the impact this risk might have on the company and the chances of it occurring. In short, a risk map facilitates making a qualitative assessment of the main risks a company faces.

EXTERNAL RISKS

External risks are those variables that can have a negative impact on a company and over which it has no control or influence. A rise in energy costs, a general strike of truck drivers in the country that paralyzes supplies, a significant variation in the price of basic raw materials and, especially, a global economic crisis are all possible factors in external risks.

Identifying external risks is the first step towards managing them, as is understanding that external variables are critical for the company's operation. It doesn't matter that up till now these variables haven't been an issue. It's enough that they could seriously affect the business in the future.

Once these variables are identified, it's a case of drawing up action plans should any of these risks ma-

terialize. For example, in the case of an airline, the price of aviation fuel is critical for its results. Does the company know how to cope with a possible 50 percent rise in the price of aviation fuel? It's dangerous to be complacent and assume that, because this rise will affect all the companies in the sector and they will all therefore have to raise their prices, the status quo will not be affected. What is necessary is to assess what to do so that a rise in the price of aviation fuel will have less impact on our airline than on the others and in this way we can profit from this possible risk.

Managing risks doesn't consist only in ensuring that they have the least impact but in knowing how to turn them into an opportunity and emerge from them strengthened.

It could be argued that there are many and unpredictable external factors that can affect a company: a natural disaster, a terrorist attack, a war or a cyber attack. The company cannot anticipate everything that might happen, of course, but these unpredictable risks can lead to the company's operations being interrupted for many days and, say, a 40percent reduction in annual turnover and, whatever the cause, the question is: is the company prepared for these possible consequences?

The procedures described for strategic risk management are also useful for dealing with the external risks that a company faces. Imagining the different scenarios dictated by external factors that the company could face and preparing to deal with them should they materialize is a good way of managing external risks.

Identifying them, neutralizing them as far as possible, mitigating the impact if they can't be neutralized and, finally, turning them into an opportunity should be the attitude the company takes to risk.

All companies and individuals face the risk of an economic crisis. In recent years we have learned a lot on a practical level about the impact that the economic cycle can have on companies. A company needs to know its exposure risks arising from changes in the economic cycle as well as the intensity of the risk.

Strategies need to be developed that reduce exposure to the economic cycle or, at least, the intensity of this exposure, as it is not possible to consider both things at once. And not just this, but there must be active management of the risk that the economic cycle may bring to the company so as to make the most of it.

This question is so important that it goes beyond the limits of this article, for which reason we will look at it in the future. In any case, one thing is certain: sooner or later there will be a new economic crisis. When it happens, the companies that are conscious of risk management will be prepared to confront it and those that aren't will suffer.

FINAL THOUGHTS

Companies pursue objectives and in order to achieve them they define strategies. For the strategy to be successful, they put all of their resources into them and therefore it is logical to ask: why divert resources to avoid things that probably won't happen?

If a company doesn't defend itself against things that might really put its viability at risk, however well it goes for a while, it will eventually succumb.

Without risk management, the likelihood of being exposed to a serious problem over the next few months is quite small, but the probability of having a serious problem over the next 10 years is very high. Furthermore, money not lost is money won, which means it's a good idea to be aware of things that might go wrong.

Avoiding things that might turn out badly doesn't usually figure on an executive's agenda, which only lists things to achieve. As a rule, no one gets recognition for avoiding something negative that might arise but rather for achieving objectives.

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