Different Categories of Business Risk

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Abstract: Every business organisation involves some element of risk. Unmitigated risks can result in lost opportunity, financial losses, loss of reputation, or loss of the right to operate in a jurisdiction. Like any other risk type, understanding business risks is quite important for every business to garner profits instead of facing losses. A business risk is a universal risk type; this means that every business in the world faces business risks. Therefore, it is imperative to understand the different categories of business risk in order to create the appropriate strategies. The aim of this paper is to describe the most important categories of business risks and to make sure that every type of risk receives equal treatment and consideration.

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Introduction

Risk implies uncertainty of profits or danger of loss due to some unforeseen events in the future. An entrepreneur may encounter risks in every area or function of a business [1]. Defining risk in the context of the business means that the risk must somehow be systematically related to how the business runs. Universally, every organization is measured financially and operationally. It stands to reason then that if we are going to measure risk in the context of the organization we must use business terms and conditions to express that risk—because every organization is a business because they all take in money and they all disperse money. So it does not really matter whether the organization is a governmental body, or a non-taxable or taxable corporation. Each of these is a business and prepares measurements of their success or failure just like any other business [2].

Every organization has to define its own risks. If we are going to successfully evaluate risk in any business situation, we are going to have to use the parameters that are most closely associated with the subject matter. It is no secret that every business and organizational structure is unique in their own special ways. Therefore the data that is used to measure the risk will vary by organization, process, and functionality.

Risk is defined as the probability of an event and its consequences. Risk management is the practice of using processes, methods and tools for managing these risks. Risk management focuses on identifying what could go wrong, evaluating which risks should be dealt with and implementing strategies to deal with those risks. Businesses that have identified the risks will be better prepared and have a more cost-effective way of dealing with them [3].

These risks are inevitable in a business and cannot be eliminated completely but they can be controlled through proper preventive and corrective measures of risk management. The process of management of risk involves:-

- Identification of the risks
- Evaluation of the risks
- Choice of the right method for handling of risks
- Evaluating the aftermath of the chosen method [4].

The types of risk a business faces

Business risks are of a diverse nature and arise due to innumerable factors. These risks may be broadly classified into two types, depending upon their place of origin:

- Internal risks
- External risks

Internal Risks (like: human factors, technological factors, physical factors...) are those risks which arise from the events taking place within the business enterprise. Such risks arise during the ordinary course of a business. These risks can be forecasted and the probability of their occurrence can be determined.

External risks (like: economic factors, natural factors, political factors…) are those risks which arise due to the events occurring outside the business organisation. Such events are generally beyond the control of an entrepreneur. Hence, the resulting risks cannot be forecasted and the probability of their occurrence cannot be determined with accuracy [5].

The following seven categories of business risk are critical for any business:

1. operational risks
2. financial risks
3. strategic risks
4. market risk
5. country risks
6. compliance risks (legal liability)
7. natural risks (environmental risk)

This is not to say that these are the only categories of risk that can or should be used, but they do encompass virtually all types of business risk that can be experienced. Bearing this in mind, we must consider all types of risk relative to these environments in any type of evaluation process.

Operational risks

Operational risks result from internal failures. Any transactions or processes will fail due to poor design or inadequately trained personnel; can also result from unforeseen external events such as transportation systems breaking down, or a supplier failing to deliver goods. It also covers the risk of fraud and the possibility that the business will fail to meet a contractual obligation due to operational reasons. In this category of risks are also included: IT risk and data protection that are increasingly important to business. The Basel Committee defines operational risk as: "The risk of loss resulting from inadequate or failed internal processes, people and systems or from external events."

Financial risks

Financial risks are associated with the business' financial structure and systems and the transactions that the business makes.

Identifying financial risk involves examining the daily financial operations, especially cash flow. If the business is too dependent on a single customer and they became unable to pay the debt, this could have serious implications for the business' viability. The manager might examine:

- how we extend credit to customers
- who owes our money
- how we can recover it
- insurance to cover large or doubtful debts [6].

Financial risks also include:

- credit risks - is an investor's risk of loss arising from a borrower who does not make payments as promised. Such an event is called a default. Other terms for credit risk are default risk and counterparty risk;
- market risks - is the risk that the value of a portfolio, either an investment portfolio or a trading portfolio, will decrease due to the change in value of the market risk factors. The four standard market risk factors are stock prices, interest rates, foreign exchange rates, and commodity prices. The associated market risks are: equity risk, interest rate risk, currency risk (foreign exchange), commodity risk;
- capital risk - the risk that an investor faces that he or she may lose all or part of the principal amount invested and the risk that a company faces that it may lose value on its capital. The capital of a company can include equipment, factories and liquid securities [7];
- liquidity risk - is the risk that a given security or asset cannot be traded quickly enough in the market to prevent a loss (or make the required profit).

Financial risk is the possibility that a business will not have adequate liquidity to meet its ongoing obligations, and this has both short- and long-term implications. Financial obligations include debt repayment, payroll requirements, dividend payments, government licenses and taxes. Obligations can also include more complex transactions, such as the ability to settle financial transactions in the capital or debt markets.

Financial risk encompasses the possibility that external sources of finance, such as debt or the ability to access the capital markets, may not be available when needed. This lack of availability could be due to poor credit ratings or operations in remote locations that are too risky for financial institutions to fund. The risk categories are not listed in the order of importance or prioritization. If they were, ''Financial'' would probably be last on the list of critical risks. The reason for this is that very few, if any, risks within an organization arise out of something that is purely financial.

There are some risks that are very financial in nature which in many cases are out of the control of the organization. These would be such things as adverse economic conditions, and others such as significant shifts in interest rates and foreign exchange fluctuation. However, these types of risk must be mitigated and/or eliminated by operational strategic initiatives within the organization itself [2].

Strategic risks

Strategic risks are those risks associated with operating in a particular industry. They include risks arising from:

- merger and acquisition activity
- changes among customers or in demand
- industry changes
- research and development.

Strategic risk is the current and prospective impact on earnings or capital arising from adverse business decisions, improper implementation of decisions, or lack of responsiveness to industry changes. This risk is a function of the compatibility of an organization's strategic goals, the business strategies developed to achieve those goals, the resources deployed against these goals, and the quality of implementation. The resources needed to carry out business strategies are both tangible and intangible. They include communication channels, operating systems, delivery networks, and managerial capacities and capabilities. The organization's internal characteristics must be evaluated against the impact of economic, technological, competitive, regulatory, and other environmental changes [8].

Market risk

Market risk is the risk that the value of a portfolio, either an investment portfolio or a trading portfolio, will decrease due to the change in value of the market risk factors. The four standard market risk factors are stock prices, interest rates, foreign exchange rates, and commodity prices.

The four standard market risk factors also include:

- equity risk, or the risk that stock prices will change.
- interest rate risk, or the risk that interest rates will change.
- currency risk, or the risk that foreign exchange rates will change.
- commodity risk, or the risk that commodity prices (i.e. grains, metals, etc.) will change.

Sometimes a fifth risk factors is also considered: equity index risk, or the risk that stock or other index prices will change adversely.

Market risk is typically measured using a Value at Risk methodology. Value at risk is well established as a risk management technique, but it contains a number of limiting assumptions that constrain its accuracy. The first assumption is that the composition of the portfolio measured remains unchanged over the single period of the model. For short time horizons, this limiting assumption is often regarded as acceptable. For longer time horizons, many of the transactions in the portfolio may mature during the modelling period. Intervening cash flow, embedded options, changes in floating rate interest rates, and so on are ignored in this single period modelling technique. Market risk can also be contrasted with specific risk, which measures the risk of a decrease in one's investment due to a change in a specific industry or sector, as opposed to a market-wide move.

Country risks

Country risk relates to the likelihood that changes in the business environment will occur that reduce the profitability of doing business in a country. These changes can adversely affect operating profits as well as the value of assets.

Country risk reflects the ability and willingness of a country to service its foreign financial obligations. Such risk may be prompted by country-specific and regional economic, financial, political and composite factors. Country risk is of critical concern in the world today, with almost every economic, financial and political crisis or conflict threatening to exceed their initial borders. In the current state of world affairs, the economic and financial wealth and political power of a country are decisive for its dominant position in the international financial community and political status [9].

Causes of country risk include political, macroeconomic mismanagement, war or labor unrest resulting in work stoppages. Political changes may come about due to a change in leadership, control by a ruling party, or war. New economic policies may be instituted resulting in expropriation of assets, nationalization of private companies, currency controls, inability to expatriate profits, higher taxes or tariffs, and a host of minor impacts. On a macroeconomic level, countries may pursue unsound monetary policy resulting in inflation, recession, higher interest rates, and shortages in hard currency reserves. Country risk varies from one country to the next. Some countries have high enough risk to discourage much foreign investment. Country risk can reduce the expected return on an investment and must be taken into consideration whenever investing abroad. Some country risk does not have an effective hedge.

Countries are placed into one of five tiers, ranging from Country Risk Tier 1 (CRT-1), denoting a stable environment with the least amount of risk, to Country Risk Tier 5 (CRT-5) for countries that pose the most risk and, therefore, the greatest challenge to an insurer's financial stability, strength and performance.

Compliance risks (legal liability)

Compliance risks are those associated with the need to comply with laws and regulations. They also apply to the need to act in a manner which investors and customers expect, for example, by ensuring proper corporate governance. The risk that legislation by the government could significantly alter the business prospects of one or more companies, adversely affecting investment holding in that company. This may occur as a direct result of government action or by altering the demand patterns of the company's customers.

Compliance risk is the possibility that the business will not comply with laws and regulations in the jurisdictions where it operates or that the organization will violate a legally binding contract. Noncompliance can be willful, or it can result from being unaware or local legal requirements [10].

It's important that the products or services could be made less marketable by legislation or taxation - as has happened with tobacco and asbestos products. For example, concerns about the increase in obesity may prompt tougher food labeling regulations, which may push up costs or reduce the appeal of certain types of food [6].

Natural risks (environmental risk)

Natural factors are the unforeseen natural calamities over which an entrepreneur has very little or no control. They result from events like earthquake, flood, famine, cyclone, lightening, tornado, etc. Such events may cause loss of life and property to the firm or they may spoil its goods. For example, Gujarat earthquake caused irreparable damage not only to the business enterprises but also adversely affected the whole economy of the United State.

The incident or catastrophe can be temporary or permanent in nature. It can occur incrementally or totally stop operations immediately. This risk category has to be recognized as a major exposure point for most organizations today. The unfortunate reality of the world today is that we must be prepared to deal with any and all undesirable circumstances. This includes, but is certainly not limited to, any type of business interruption and/or other type of catastrophic occurrence.

This has always been one of the most ignored areas of risk. It has always been the position of many corporate executives that ''it will never happen here.'' That position, of course, is no longer valid and as a result cannot be the answer when a discussion of this type of risk is brought to the table. Hopefully, the government, educational institutions, and all other major organizations have learned a lesson from the events of the past. The importance of this category of risk cannot be underestimated nor ignored. Anyone who makes that type of uninformed decision is seriously undermining his credibility as a leader or is simply ignoring his fiduciary responsibilities and reality [10].

Conclusions

Defining these categories of business risk is one of the most important exercises to be conducted when building a risk model. Everyone has his own version of risk categories and in many cases has developed them to coincide primarily with his line of business instead of being cognizant of a much broader base of risk.

Thus, business risk takes a variety of forms. In order to face such risks successfully, every businessman should understand the nature and causes of these risks as well as the various measures which must be taken in order to minimise them [5].

If risk management is to be effective and efficient, the board needs to understand the major risks that its strategies involve, and the major problems that could occur with its operations. Risk and initiative cannot be separated from business decision making; however, directors can ensure that a wide view is taken of risk management and thus limit the trouble that risks can cause.

There are not many organizations of any type that can sustain a long-term withdrawal from their customer or client relationship. It is essential for any type of organization to be deemed a going concern that is able to produce and sell a product to the satisfaction of their customers on a continuous basis. Any organization that fails to manage and/or mitigate significantly deep-rooted operational risks is in peril; there should be no mistake made about that.

It is important to bear in mind that no matter which types of risk categories we may use, it always comes back to one fundamental thing. The key to success lies in the ability to recognize the risks for what they are and to not fail to take the necessary actions to mitigate the risks or manage them effectively. We may classify the risks in any way that we may feel is appropriate, but the real issue is what we are doing about them.

The various risks that can be experienced by an organization are numerous, but the key to the success is determining a highly effective way of evaluating and managing them. We are striving to make sure that every type of risk receives equal treatment and consideration. Every organization has to define its own risk universe. This is not an exercise that can be done generically across a number of organizations. Every organization has a unique and distinct business model under which it functions. The uniqueness of the business model is what necessitates the custom nature of the risk assessment that is performed. Without a custom-based approach to the risk assessment exercise, any accuracy relative to the risk assessment will be suspect. When we talk about the risk universe of any organization, we are discussing all of the logical business subsets that could and do encounter risk. In addition, defining the risk universe means that we must take an inventory of all of the potential risks each of these logical business subsets can encounter. When doing this, a great degree of caution must be exercised.

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