

## MANAGEMENT OF THE RISK AS THE COMPANIES' STRATEGIC CHALLENGE

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### Abstract

It can be observed in the world economy, that almost all the activities take different kind of risk, and the risk in the undeniable way, is included in an absolutely every aspect of activity. In connection with this it should be for sure the object of management. If, in companies more and more attention is drawn even though to human capital management, or production - why not to manage the risk as well. The general purpose of this thesis is to introduce the essence and the meaning of the risk management in the sector of small and medium companies.

It is necessary to adapt the risk management system for specific, often very individual needs of particular company, therefore uniform model solution does not exist. In general terms, the management of the risk consists of several basic steps, like: awareness of impact of risk on company strategies, identification of risk factors and their effects, record and assigning the way of individual risk pointers measurement, monitoring and analysis of pointers, introducing corrective actions and the regular reporting to the management board.

**Key words:** Analysis - Company - Economy - Risk - Strategic management

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### Introduction

Risk is one of the basic economic phenomena - each market participant is exposed to it. Moreover, since dozens of years, we can observe the increase of the risk connected with main market variables: exchange rate, interest rates, prices of raw materials ([http://www.zgora.pte.pl/pliki/2/1/IBnGR\\_Publikacja.pdf](http://www.zgora.pte.pl/pliki/2/1/IBnGR_Publikacja.pdf) access April 15, 2014). The effect of advancing deregulation of the largest world economy is reducing predictability of these variables. In the world, where prices and rates are no longer publicly controlled by government and international institutions, the risk management is an indispensable element of economic activity.

## 1 The analysis of the risk occurring in the SME sector

Risk is a popular concept in the economic language. Every day situations are described by the risk, usually in the context of danger, and it is used as the term defining one of the main phenomena of economic life. It is difficult to determine one unequivocal definition of the risk, we can, however, specify it by defining criteria of using this term. And these criteria are:

- fact, that the effect, that will be achieved in the future, is not known, but it is possible to identify future situation,
- probability of realization particular results in the future is known (Tarczyński et al. 2001, p. 12).

For an enterprise, risk, is the basic element of the environment in which it exists - in fact, the existence of risk means uncertainty of future results, but it can be the source both of losses and profits. If the risk occurs, it may in fact mean, that there is a chance both for worse and better result, than it was expected (Tarczyński et al. 2001, p. 15).

The primary partition of risk in economic activity is extracting its systematic part - which covers all the strength that is out of company's control - and the specific one, where we have the uncertainty as far as the results of actions are concerned, which is the effect of the company's factors, such as methods of management, quality control etc. (Tarczyński et al. 2001, p. 16).

The last criterion of distinction the types of risk are the methods of its management. While indentifying the risk's source, the enterprise has following possibilities for action:

- risk retention - taking on the possible financial losses, but also leaving oneself a possibility of taking advantage of extra profit,
- risk transfer - passing on the responsibility for covering losses to the other entity, so the financial management of the risk.

It is so called the financial control of the risk. The company may also use the physical control of the risk by avoiding risky situations or controlling, and also reducing the risk by using appropriate organizational solutions. Business risk is the only one, that the enterprise must stop. Transfer or avoiding this kind of risk could mean loss of possibility for making profit from basic activity. On the other hand, the market risk, which has systematic and speculative character, comes under risk management methods by financial market.

Risk measurement is one of the basic elements of risk management process. However, there are a lot of methods for risk testing, and each of these methods has both its advantages

and disadvantages. Market risk measurements can be generally divided into (Tarczyński et al. 2001, p. 53):

- volatility - such as standard variation, measuring fluctuations in the variable,
- sensitivity - defining the influence of one variable over the changes of another one, or the whole set of variables,
- downside risk measures - defining the probability of loss occurrence.

Risk management undeniably requires dedicating some financial and human resources by the company in order to create the structure responsible for the activity. Moreover, only the use of risk restricting techniques is practically always connected with costs. In connection with that, the company can make a decision to keep all the risk, especially when it implements very low margins and the costs of restricting the risk would exceed the potential profit from transactions (Krzyżaniak 2000, p. 45). What can discourage the company to use security is, besides high costs, also difficulty in the access to risk management incentives (for example: the high level of minimum transaction amount required by the bank), high level of provision deposits, difficulties in obtaining information necessary for self-valuation of incentives, and professional financial forecasts, and also low market fluency of derivative incentives. Moreover, when the company decides to protect from financial risk, it exposes to danger of great losses caused by control procedures system that is not precise enough, or fraud of employees who are responsible for transactions at futures markets. Numerous examples of bankruptcies or great losses caused by abuse in the banks and transnational corporation in the last decade, make us aware enough of the risk extent

([http://www.ryzyko.biz/standardy\\_zarzadzania\\_ryzykiem.pdf](http://www.ryzyko.biz/standardy_zarzadzania_ryzykiem.pdf) access April 15, 2014).

With reference to the above qualifications, the company, before making decision about protection of financial flows, should answer the following questions (Hollwell 2001, p. 3):

1. *What kind of risk is it exposed to?*
2. *Is the risk big enough to be afraid of it?*
3. *Is there anything that will protect the company against the risk?*
4. *How much will risk reduction cost?*

Taking into consideration these questions, we should also add the aspect of studying the fact if the competitive enterprises use protective techniques as well. If not, so if we are protecting against the loss as the result of unprofitable prices movements, we will gain competitors, as far as prices will change according to our expectations. However, otherwise, we will suffer a loss, not gaining anything from the change.

The risk of the second situation may be a sufficient premise to discontinue the risk management (Hull 1998, p. 126).

On the other hand, stabilization of the cash flow in the company may give measurable benefits, owing to the risk management. Reducing variability of financial result can be introduced as the change of its distribution.

The advantages of the risk management are as follows (Froot et al. 1992, p. 2-5):

1. *increasing the possibilities to obtain the capital,*
2. *the possibility to increase financial leverage,*
3. *lowering the cost of capital,*
4. *avoiding the costs of bad temporary financial situation or bankruptcy,*
5. *tax benefits,*
6. *ensuring stability of measures for company's strategic investments.*

The first three advantages are the result of investment risk's reduction into the enterprise. The bankruptcy risk's limit seems to be the obvious profit, however, we should pay attention to the fact that this argument also indirectly refers to shareholders, or investors of the enterprise. Since investing in the shares of the company applying risk management, they do not have any risk of additional transaction costs connected with the bankruptcy of the company, they may be willing to estimate its stocks and bonds higher.

Reducing tax liabilities is the result of two factors: tax progression and problems with deduction of losses. In other words, the company, which profits are highly volatile, pays high taxes in the profit period, and in the losses period it can deduct only part of the tax. As a result, it is profitable for the company to keep profits at constant level. However, it is important to remember that this conclusion is true, only when the tax sum is the convex function of company's income (Froot et al. 1992, p. 5).

The last of the listed advantages is of particular importance for companies which rely on investments in innovative products as the base of their activity. As an example, we can discuss pharmaceutical companies, which expenses on research and development absorb a significant part of the income. As the acquisition of additional outside measures in proper quantity is not always possible, and always means increasing the cost of capital, the enterprise has to stabilize its income. In this way, it will ensure the implementation of the planned, strategic investments, which have crucial influence on the competitive position of the company. Shareholders, customers and employees can also be interested in using the risk management by the company. Although, there is no legal requirement, in the United States of America there were trials against enterprises brought by small shareholders for the

unreasonable failure in the risk management (Smithson et al. 2000, p. 91). Theoretically, shareholders have in fact the opportunity to protect against diversify of their money, making in this way the risk management by the companies pointless. However, in practice, such a situation does not occur because of market's imperfection (Culp 2001, p. 69-94). Stability of the company affects also the evaluation of its products by the potential buyer - if the product of durable use is not a standard one and can be serviced only by the producer, the buyers will be sensitive to security of service in the future. They will not be willing to risk and buy the product, which they will not be able to repair later (Smithson 2000, p. 140). Other arguments for protection will be introduced by the employees, who will take into consideration the security of their employment, and managers' aversion to the risk can be the basic reason to use the risk management (Froot 1992, p. 4); (Raposo 1999, p. 41-51). The risk management process in the enterprise should be based on the coherent strategy and procedures set approved by the company's authorities. Otherwise, the company is exposed to serious financial consequences of transactions made by people who are responsible for the risk management. The best solution is to create the document which specifies purposes and rules of the risk management, and people responsible for particular elements of this process. Clearness of the risk management system, both internal and external (for example, for shareholders' and contractors' use) is considered as an essential requirement, providing safety of the work (Socik 2000, p. 50).

Creation of the risk management strategy should be the effect of extensive consultations, and the agreement of entire authorities of the company (Kendall 2000, p. 30-38).

According to the research done for the commission of General Motors, which included 31 biggest world corporations, about 2/3 out of them created Risk Management Boards (Wallace 1998, p. 48-58).

The basic rules, which should reflect in the risk management politics, are as well:

- the complex strategy of the risk measurement for the entire organization, not only for particular departments or branches,
- the detailed internal rules concerning the risk taking, so the admissibility of maintaining open positions in speculative purposes,
- efficient informatics systems, used for gathering external and internal information (standardization of the reports for the risk management's needs supplied by particular departments and branches),

- distinct indication of person, or groups responsible for the risk estimation and management within particular departments (Riehl 2001, p. 341),
- specification of frequency of incentives' valuation, and methods of the independent verification of the valuation (Kendall 2000, p. 60),
- separation of the function of back office (valuation and accounting the bargains, estimation of profits and losses) from making a bargain (front office),
- setting both limits of the transaction for individual dealers and big transactions' approval procedures (Kendall 2000, p. 69),
- creating effective methods of control and protection against abuse and defalcation.

Special features of action of small and medium enterprises (SME) make these enterprises particularly susceptible to the negative effects of various kinds of risk occurrence. Fluctuations and the dynamics of change in further and closer enterprise's environment designate the risk's field, under which the enterprise comes. The source of potential danger is also the internal situation of the company - the type of processes that are being realized, technologies or resources that are being used. Often inability of the enterprise to pay for events of a random, is connected with the necessity of limiting the business process (lack the capacity to increase) or even to close the business. In connection with the above, some questions appear: if small and medium enterprises take any action to minimize the effects of the risk? If yes, so are these actions effective? What is their size?

Management of the risk is an important component of the enterprise management (or organization management in general meaning). Its extended procedures are most often used in large enterprises' work (Kendall 2000, p. 70). The verification of their effectiveness follows during internal crisis periods and collapsing of economic situation. As an example we can mention the crisis, which effects appeared on a global scale in 2006, but also the progressive process of globalization and internationalization (changes in the field of international competition) - these situations certainly create reasons also for the owners of SME to think about the changes' effects and the risk that may occur. Making them aware of the fact, that the management of the risk may be adapted with certain limitations for SME's needs, is particularly difficult in the situation where SME sector entrepreneurs use various forms of support (training, consultancy) in a limited way, and their activities are mainly intuitive (Safin 2003, p. 40). Especially important is the fact, that the small enterprises concentrate, in their practice of management, on the information from the close surroundings -

the smaller organization, the bigger attention is drawn to the closest and the easiest recognizable elements of the environment.

An entrepreneur concentrated on key competences, very often does not notice the need of changes in the current way of management. Assessment of the situation is rather subjective (an entrepreneur thinks: 'It has never happened to me, and the conditions are predictable, I have known this market for many years'), and the increase is not the purpose of the action of all small companies' owners (Wasilczuk 2005, p. 78-79). Not noticing the risk may be dangerous for the possibility of implementation of undertaken projects, but its demonization and lack of control skills - may discourage to entrepreneurial action. The awareness of the possible risk control is very important, as well as the structure of incompetence as the result of learning how to manage the financial and nonfinancial risk.

What possibilities of reducing the effects of potential risk do sector SME entrepreneurs have at their disposal? They can protect both resources, and the processes, having at their disposal following possibilities:

- Preventive actions, based on avoiding or minimizing the impact identified for particular risk undertaking. They are universal, because they can be used both for insurable and uninsurable risks.
- Method of insurance based on using the insurance services offer that is available on the market. This method concerns risks' protection, so called insurable. In the range of events specified by the insurer, he takes the risk and pays all the costs on the terms specified in the insurance contract (for SME, this offer often covers all the risks excepting exclusions).
- Self-insurance, which requires protection of the resources in the form of the reserves, to cover the potential loss. From the SME's specificity point of view the instrument difficult to use - SME often faces the problems with lack of capital and lack of financial fluency.
- The creation of an insurance company in the form of Mutual Insurance Association. The creation of subordinate association is rather unreachable for a single company, especially for a small and medium one, unless we are talking about the activity in a certain organization, for example, in the cluster area.

The most purposeful, from the point of view of the SME sector's possible evaluation, seems to be the use of the insurance method in the risk management, supplemented by preventive actions. The following arguments enforce this fact:

- the insurance method is available for SME by competitive market offers of the insurance associations, insurance agents' service (especially insurance brokers) is the source of knowledge about the potential risk and the probability of its occurrence;
- property insurance, for example, or insurance of particular financial operations allows to minimize the risk at relatively low cost of obtaining the insurance protection (in the case of property insurance, the premium is in per mille of value of the insured property, in the case of financial insurance - in percent, and the costs are relatively higher);
- prevention can lower or in some cases even exclude the costs of insurance protection, although preventive actions require some costs, but they can be rationalized, taking into consideration intensity (importance) of particular risks. The preventive actions can be introduced at any stage of the enterprise's organization, taking up those actions is very often an essential condition of taking over the risks by the insurer, that is why they are called as complementary, in relation to the insurance.

Decisions about the property and processes insurance have strategic and operating importance. The strategy in the small and medium enterprises is a kind of reaction to particular situations (Safin 2003, p. 112), indicates rather the direction of the chosen actions than formalized procedures. Decisions, which are strategic, are the ones concerning the choice of the way of property and processes protection against the adverse effects of random events. Such an importance may also have decisions about the use of advantages from financial insurance offer, for example, when new risky projects are undertaken (vadium protection, guarantees, custom insurance). The operating assessment of the decision concerning the insurance, refers to the scale of costs for preventive activities, the range choice of insured risks, the choice of insurance association and its offer, negotiation terms of the insurance contract, and in the case of damage - cooperation with insurance association in the damages liquidation (bringing back the condition of the insured property, as it was before the damage).



## **Conclusion**

No matter what direction we will take (survival, stabilization or increase) small and medium enterprises should be subordinated to rigor of risk management. Protection of the resources as well as certain risky situations, is essential to all kinds of actions as far as continuity in enterprise's functioning and its increase is concerned. The fact that entrepreneurs undertake risky actions (set in the conditions of uncertainty), should us push to rationalize the level of this risk. All the entrepreneurs' competences (ownership, managers and technical) can be involved into the risk management. In case of lack of these competences, such tasks should be directed to the managers who control particular projects and undertakings. For small and medium enterprises' needs, insurance brokers can successfully act as the risk managers.

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