



# Risk management guide for small to medium businesses

think+create



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# Risk management guide for small to medium businesses

## Introduction

This guide is not an exhaustive publication on risk management. You may therefore need to seek external advice specific to your business circumstances to implement suitable risk management strategies for your business.

Small to medium businesses are exposed to risks all the time. Such risks can directly affect day-to-day operations, decrease revenue or increase expenses. Their impact may be serious enough for the business to fail. Most business managers know instinctively that they should have insurance policies to cover risks to life and property. However, there are many other risks that all businesses face, some of which are overlooked or ignored.

Every business is subject to possible losses from unmanaged risks. Sound risk management should reduce the chance that a particular event will take place and, if it does take place, sound risk management should reduce its impact. Sound risk management also protects business wealth.

Risk management starts by identifying possible threats and then implements processes to minimise or negate them.

Sound risk management can produce the following benefits:

- lower insurance premiums
- reduced chance that the business may be the target of legal action
- reduced losses of cash or stock etc.
- reduced business down time.

This guide identifies some of the risks and areas where risks may emerge and it provides some strategies to manage them.

## Identifying risks and how to respond to them

Undesirable events, the probability of their occurring and their possible impact vary considerably from business to business and from industry to industry. How does a business identify and manage these particular risks?

- The first step is to identify the events which could cause a loss or disruption to the business.

- Those events should then be analysed to ascertain the likelihood of their occurring and how serious the result would be if they did occur. Start simply by assessing each event as 'very likely', 'moderately likely' or 'very unlikely'. Prioritise them by putting a dollar value on each one (e.g. the replacement cost of a critical piece of machinery; or in the case of potential bad debts, the total value of amounts owed by customers).
- Attend to the most likely and the most expensive events first.
- For each possible event, develop procedures commensurate with the level of risk the business is willing to accept.
- Once a procedure is put in place, it should be monitored to ensure it is properly implemented and is effective.

For further information on developing policies and procedures, see [Developing policies and procedures for your business](#) or seek expert external advice.

## Risks posed by customers

**Question:** Is the business highly-dependent on a small number of major customers? For example, you could have one customer who generates 65 per cent or more of total revenue, or you could have a group five customers who collectively generate over 65 per cent of total revenue. Do you have customers that take up a lot of your time but are less profitable than other customers?

**Risk:** If the business relies on a small number of major customers, profit and cash flow may be affected in the short term (one to six months) if one of them stops yielding revenue.

### Risk mitigation strategies include:

- locking in major customers through long-term service contracts, regularly visiting them, or continually asking their views about the business's products and services
- spreading the risk by developing smaller, existing customers so they become larger customers
- seeking new, profitable customers
- finding lower-cost ways of servicing the less profitable customers

## Risks posed by suppliers

**Question:** Is the business highly dependent on a small number of major suppliers? For example, do you have one supplier that provides 30 per cent or more of the total product requirements, or is there a supplier whose failure to supply could stop the business?

**Risk:** If the business depends on a small number of major suppliers, production, profits and cash flow could be affected if one of them fails or stops dealing with the business.

### Risk mitigation strategies include:

- locking in major suppliers through long-term service contracts
- seeking alternative suppliers capable of supplying similar items

## Risks posed by staff

**Question:** Do employees see the business as a short-term employment option? For example, would they describe it as 'a good place to learn for a while' or 'a nursery for the industry'?

**Risk:** If the business is seen as a short-term employer, high staff turnover could result in disruption to the business and the expense of finding and training new staff who won't deliver a return to the business if they also leave after a short time.

**Question:** Are there employees in the business who are critical to its success?

**Risk:** If an employee is critical to the business's success, then sales and profits may suffer if the employee sets up a business in competition or goes to work for a competitor.

**Question:** Do some employees largely govern or control dealings with key suppliers or customers? For example, some employees may control who your business sells its goods or services, or pricing.

**Risk:** If some employees are largely autonomous when dealing with key suppliers or customers, there is a risk of fraud or collusion, or there could be significant disruption to the business if they leave.

**Question:** Do staff face occupational health and safety (OH&S) risks? For example, are they working in a dirty or hazardous environment, or do they have to travel extensively by car?

**Risk:** If staff work in an unsafe environment, the business is at risk of fines and penalties and, the absenteeism, injury or even the death of an employee.

### Risk mitigation strategies include:

- implementing selection procedures that increase the probability of finding the right staff for the business
- putting in place confidentiality agreements and / or reasonable restraint of trade agreements signed by key staff or where appropriate all staff
- implementing a robust performance development system for communication of performance expectations and goals, monitoring performance and setting remuneration
- providing ongoing training for staff consistent with the needs of the business
- allocating several people to fulfill key tasks and provide backup in the event of illness or sudden departure
- rotating employees through various functions or departments to familiarise them with other areas of the business
- implementing suitable OH&S policies to minimise risks. For example, safe driver training and regular maintenance of vehicles and other equipment
- using equity interests, profit-sharing or other incentives to help retain key personnel and let them share the success they create for the business. But be careful how such incentives schemes are designed, as they could encourage unintended behaviour
- reviewing the period of notice required of staff who resign. Once again, be careful with this as it could have unintended legal consequences

## Risks posed by the business premises and its location

**Question:** How dependent is the business on its current location?

**Risk:** If the business depends significantly on its location to generate sales, a move to premises outside the immediate vicinity of the current location may disrupt the business by affecting customer, staff and supplier access. Another risk of being highly dependent on the premises is that in the event of a fire, flood or other disaster, the business may not be able to restart trading if the premises (including stock, equipment, materials and records) are destroyed. Another risk is the possibility that customers may move away from the location.

**Question:** Is the business growing strongly at present, or is it relatively stable? If it is growing strongly, how long can this be expected to continue for and how big will the premises need to be in two, five or 10 years' time?

**Risk:** Unless plans have been made to expand the current premises, the business may not be able to grow to its full potential and it could be overtaken by competitors.

**Risk mitigation strategies include:**

- identifying a number of suitable alternative premises which would suit customers, suppliers and staff
- where the premises suit the business's long-term needs, consider securing a long-term lease or right of first option when the lease expires
- managing the business to predict future space requirements early
- only businesses that are established, have good prospects and are growing should consider purchasing a property and then only if the property has sufficient capacity to allow for future expansion, otherwise it is preferable to rent. Renting also helps to preserve working capital for business operations

## Threats to goodwill and reputation

**Question:** How exposed is the business to a threat to its reputation or goodwill? For example, what would happen if there were a product recall, or if the business delivered bad customer service or advice or there was a major fraud?

**Risk:** If there is a large-scale product recall, a fraud, or other similar event, there would be a lot of bad publicity. This could cause immediate distress to the business including putting it to the trouble and expense of reworking. It would probably also cause longer-term damage to the business's reputation.

**Risk mitigation strategies include:**

- incorporating robust review processes and quality assurance systems to avoid a situation that may damage the business's reputation
- investing in research and development and keeping up-to-date with technological advances
- compulsory training and development programs for staff

## Risks posed by information technology

**Question:** To what extent does the business rely on information technology (IT)? Have you ever noticed how little work is done in an office when 'the server is down' or power is temporarily disconnected? The level of risk created by using IT increases as the business becomes more reliant on it.

**Risk:** If the business is heavily reliant on IT, the business might not be able to operate without it, for example, if the EFTPOS system fails during a high sales period.

There are many other risk areas associated with IT, including:

- IT service delivery: do all the software applications (including spreadsheets) work as intended? Are they all accurate?
- IT solution delivery: do you try to integrate IT solutions into daily work processes, so that the business runs more efficiently and predictably?
- IT benefit realisation: consider not only the cost of an application, but also consider the cost of not implementing that application. Some IT outlays are essential simply to keep pace with others in the industry

**Risk mitigation strategies include:**

- protecting laptops and desktops
- keeping data safe by performing backups and storing those backups offsite
- using the internet safely
- protecting networks
- protecting servers
- securing the line of business applications
- ensuring appropriate IT support is available within an acceptable timeframe
- having an uninterrupted power supply unit
- conducting appropriate IT training for staff

To help the business to assess its level of IT-related risk, see page 15 of the [IT Governance Guide](#).

## Risks posed by financial transactions

Financial transactions create risks for companies. They can be classified as liquidity, foreign exchange, interest rate, commodity price and credit risks. Each will be examined separately below. Skip any which do not apply to your business.

### Liquidity risk

**Question:** Does the business have enough funds to pay its debts as they fall due?

**Risk:** If the business does not have enough funds, or is running out of money, there could be significant risks to the business and to the owner or directors who might become personally responsible for the debts of the business. If liquidity is not improved, the chances getting a loan will be drastically reduced.

#### Risk mitigation strategies include:

- managing cash flow on a daily, weekly and monthly basis by monitoring the flow of cash in and out of the business
- forecasting cash flow to identify any periods when it is not strong. Good forecasting will include 'what if' analysis; for example, 'What if my sales were to drop by 5 per cent?'
- seeking a committed line of credit from a financial institution. It is preferable to have two possible providers in case one does not provide credit when needed
- maintaining a strong relationship with a banker or financial institution to ensure they understand the business and are kept up-to-date with potential loan requirements
- monitoring market conditions to anticipate seasonal fluctuations in cash flows
- preparing aged debtor reports to monitor debtor collections (and regularly contacting the slow payers)

For further information read [Managing in times of financial difficulty](#).

### Credit risk

**Question:** Does the business sell its products or services on credit?

**Risk:** If products and services are sold on credit there is a risk that debtors will be unable to pay for them. This might result in either slow receipt of cash or even the need to write off a bad debt.

#### Risk mitigation strategies include:

- checking the credit status of the customer before making the sale
- checking publicly available registers to verify that the customer's business is real and to find out who is behind the business
- Insisting that customers sign a 'terms and conditions of trade' prior to supplying goods or services to them
- imposing credit limits to restrict your firm's overall exposure; obtaining personal guarantees where possible
- including a 'retention of title' clause for the goods you supply
- maintaining strong relationships with the debtor to ensure their current liquidity status is always known

For further information read [Guide for identifying financial risks](#) and [Guide for managing financial risk](#).

### Foreign exchange risk

**Question:** Does the business use foreign currency to buy raw materials or equipment, or receive it from sales of its products and services to overseas customers?

**Risk:** If the business does use and receive foreign currency in this way, then it is exposed to fluctuations in the value of foreign currency which, if not properly managed, can lead to the business making unexpected gains or losses. The size of this risk depends on the size of transactions, the number of transactions and the length of time between ordering and paying for the goods or services.

#### Risk mitigation strategies include:

- consulting your bank for assistance in managing foreign exchange exposure
- matching foreign currency revenues with foreign currency expenses through a foreign currency bank account
- buying or selling foreign currency in advance (i.e. at the time of the agreement) to lock in the foreign currency rate
- buying or selling a foreign currency option or similar

## Interest rate risk

**Question:** How dependent is the business on borrowed funds or income generated from interest-bearing deposits (e.g. bank accounts or investment accounts)?

**Risk:** If the business is dependent on borrowed funds or income generated from savings, movements in interest rates will affect the overall profitability of the business through increases in interest expenses or reductions in income from interest.

### Risk mitigation strategies include:

- consulting your bank for assistance in managing interest rate exposure
- borrowing or investing at a fixed rate to provide certainty of interest expenses or income
- matching interest income against interest expense to net the exposure
- utilising available bank products that may help manage exposure

For further information read [Understanding and managing interest rate risk](#).

## Commodity price risk

**Question:** Is a key input or output of the business buying or selling commodities?

**Potential risk:** If buying or selling commodities is a key input or output of the business, fluctuations in commodity prices can adversely affect the business's financial performance.

### Risk mitigation strategies include:

- consulting your bank on how they can assist in managing commodity price exposure
- entering into fixed price contracts with suppliers or customers
- using a number of financial market instruments provided by financial institutions

## Risks posed by competitors

**Question:** Do competitors pose a threat to the business? For example, are competitors likely to start up nearby? Are they likely to significantly reduce their prices? Are they likely to be first to market with a new product? Are they likely to expand their business or to find new ways of getting their products to market?

**Risk:** Virtually every business has competitors. However, if competitors (current and potential) pose a significant threat to the business, then the viability of the business is at risk.

### Risk management strategies include:

- continuing to build on relationships with clients and the local community. Providing great service as a way of combating competitors!
- researching industry trends, and adopting new products and services – or ways of delivering those products and services – to customers
- investing money in developing new products and services
- protecting intellectual property assets by registering them where possible (trademarks, designs, copyright, patents)
- continually monitoring competitors, including the prices they charge

## Risks posed by the market or the economy

**Question:** Is the business exposed to risks from changing tastes and trends or from the impacts of an economic downturn? For example, while the business itself may be relatively immune from an economic downturn, a downturn may impact on your customer base.

**Risk:** If the business is at risk from changing tastes and trends, or from an economic downturn, the viability of the business is at risk.

### Risk management strategies include:

- researching consumer trends and tastes so that the business can respond to change
- continually testing the market to see what products and services consumers prefer. This provides an understanding of changing consumer sentiment during changes to the economic cycle
- promoting products and services that sell better during an economic downturn (these can be determined by testing the market)
- promoting stock or services that sell well and are profitable
- using financial statements to benchmark financial and operational performance against industry averages

For further information read [Checklist for managing in times of financial difficulty](#).

## Unexpected exit of the business owner

**Question:** What would happen to the business if the owner or one of the partners died or became incapacitated? If there is no will or succession plan in place, would the business close, would it be inherited and run by someone inexperienced, or would it be sold?

**Risk:** If there is no plan to deal with the death or incapacity of the business's owner or one of the partners in a partnership, the business might have to close or be sold to a competitor to avoid putting undue pressure on the remaining owners or new owners.

### Risk management strategies include:

- consulting advisers who can assist in business succession, wills and estate planning
- preparing a business succession plan and a will that is consistent with the plan
- implementing appropriate insurance that provides income or a capital sum in the event of the death or incapacity of the owner or a key employee
- where there are two or more unrelated owners in a business, consider a buy/sell agreement and funding agreement for the eventual transfer of the business
- documenting key processes and critical information so that other people can continue to run the business
- training employees so that more than one person knows how to perform each task

## Other risk areas

### Internal controls

It is important to have controls in place to protect the business's assets. The controls needed will vary depending on the business's goods and funds, the type of industry it is in and its potential to suffer from loss or fraud.

The business's key areas should be reviewed to ensure that policies and procedures are in place to manage risks in areas such as those listed below.

### Sales

What are the procedures for the delivery of goods? Are delivery instructions recorded? How do you ensure that all sales are recorded? What are the procedures for handling cash, cheque and credit sales?

### Accounts receivable

Are outstanding payments from customers reviewed on a regular basis? What procedures are in place to follow up on late payments? Are procedures in place to check who is receiving early-payment discounts?

### Purchasing

What procedures are in place to ensure purchases are in line with what is required? Are suppliers' details checked on a regular basis to ensure the details (i.e. addresses or bank account numbers) are correct and not a staff member's? What procedures are in place for checking goods received against goods ordered?

### Accounts payable

Are payments checked to ensure they are not duplicated or identical? What procedures are in place to ensure that payment is made on agreed terms? Can rapidly increasing purchases from one supplier be identified?

### Payments

Does the business have controls in place to ensure that all invoices are appropriately approved before payment? Who is authorised to make payments? Are the duties for banking and bank reconciliation separated?

For further information read [Internal controls for small business](#).

## Insurance

One of the most important ways to protect the business against risks is to carry sufficient insurance. With insurance you can decide which risks you must insure against and which can be covered by the business or its owners.

### Building and contents insurance

This insurance should cover the business's buildings as well as contents and stock against loss.

### Business interruption or loss of profit insurance

The business should be covered for interruption due to damage to property by fire or other insured perils. The cover should ensure that ongoing expenses are met and that anticipated net profit is maintained through a provision of cash flow.

## **Public liability insurance**

Public liability insurance should cover the owner and business against the financial risk of being found liable to a third party for death or injury, loss or damage of property or economic loss resulting from the business's or the owner's negligence.

## **Key person insurance cover**

This type of insurance should help cover the loss of a key member of staff.

## **Workers' compensation insurance**

In Australia, it is compulsory to maintain appropriate accident and sickness insurance for all employees and certain contractors you engage in your business.

## **Personal accident and illness insurance**

This insurance is important for self-employed business operators who are not covered by workers' compensation insurance.

## **Motor vehicle insurance**

It is compulsory to insure all company or business vehicles for third party injury liability in Australia.

## **Burglary cover**

Business assets should be protected against burglary by this type of insurance.

## **Professional indemnity insurance**

This type of insurance is important for businesses giving professional advice.

## **Fidelity guarantee**

Losses resulting from misappropriation by employees who embezzle or steal should be covered by this insurance.

## **Machinery breakdown insurance**

This insurance should cover the business for any losses incurred if plant and machinery break down.

## **Product liability insurance**

This insurance provides cover for injury or damage caused by goods the business sells, supplies or delivers — even in the form of repairs or services.

As the type and level of insurance cover needed requires an assessment of the particular needs of the business, it is necessary to speak to an insurance specialist to ensure your business is adequately protected.



