

Risk management guide for small and medium-sized business



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Introduction

Risk management is about highlighting possible business-threatening incidents which might occur in small and medium-sized business, and identifying responses to minimise or negate those potential risks.

This guide is designed to assist in identifying and analysing threats that may cause loss to businesses, as well as providing a general guide to the methods of dealing with those potential threats. The guide is not exhaustive, and seeking external advice may help to identify and mitigate risks further.

Introducing appropriate risk management strategies can lead to a reduction in:

- › insurance premiums
- › the chance of being successfully sued
- › property loss, including cash and stock
- › the time the business is unable to operate at full capacity

To begin the process of identifying threats, consider the business's operations and these questions:

- › What could cause a loss?
- › How serious — in terms of costs — could that loss be?
- › How likely is that loss to occur?

The following questions and potential risks will help identify possible threats to the business and strategies that can be used to mitigate or negate such threats.

Risks posed by customers

Question: Is the business highly-dependent on a small number of major customers; for example, does the business have one customer who generates 15 per cent or more of total revenue, or a group of top five customers who collectively generate over 65 per cent of total revenue?

Potential 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 a major customer stops dealing with the business.

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 that may become larger customers
- › seeking new, profitable customers

Risks posed by suppliers

Question: Is the business highly dependent upon a small number of major suppliers; for example, does the business have one supplier that provides 30 per cent or more of the total product requirements, or a supplier that provides a product where lack of supply could stop the business?

Potential risk: If the business is dependant upon a small number of major suppliers, production, profits and cash flow could be affected if a supplier 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

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Risks posed by staff

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

Potential risk: If the business is seen as a short-term employer, high staff turnover may result in disruption to the business, and a high cost of finding and training new personnel 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?

Potential 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 if they leave to work for a competitor. With sales and profits suffering, there is a risk that this will force the business to quickly resize, for instance by moving to a smaller premises, or retrenching staff.

Question: Do some staff largely govern or control dealings with key suppliers or customers; for example, staff may control the supply of goods or services, or pricing?

Potential risk: If some staff are largely autonomous when dealing with key suppliers or customers, there may be a risk of fraud or collusion, or significant disruption to the business if they leave.

Question: Do staff face occupational health and safety (OH&S) risks; for example, a dirty or dangerous environment, or extensive car travel?

Potential risk: If staff face OH&S risks, the business may be at risk of fines and penalties, and more importantly injury or death of an employee as a result of an unsafe workplace.

Risk mitigation strategies include:

- › putting in place confidentiality agreements and / or reasonable restraint of trade agreements signed by all staff or by key staff
- › allocating several people to fulfill key tasks so that backup is available in the event of illness or sudden departure
- › rotating staff through various functions or departments to expose employees to other areas of the business
- › implementing suitable OH&S policies to prevent and minimise risks; for example, safe driver training and regular maintenance for vehicles or 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
- › reviewing the period of notice required of staff who resign

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Risks posed by the premises the business operates from

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

Potential risk: If the business is dependant on its current location, a move to premises outside the immediate vicinity of the current location may disrupt the business by affecting customer, staff or supplier access. Such disruption may affect cash flow, goodwill and staff turnover. Another risk of being highly dependant 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) is destroyed.

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

Potential risk: If the business will outgrow the current premises and planning for larger premises is not made, it may impair the growth of the business and create opportunities for competitors.

Risk mitigation strategies include:

- › identifying a number of suitable alternative premises in the business's immediate area which would suit customers, suppliers and staff
- › managing the business to predict future space requirements early, which will allow an easier response to business requirements for a premises. Only businesses that are growing strongly and have substantial expansion capacity should purchase a property, otherwise it is preferable to rent. Renting also helps preserve working capital for the business operations

Risks posed to goodwill / reputation

Question: How exposed is the business to a risk to reputation or goodwill; for example, a product recall (ignore occasional reworks which might be required to keep a customer happy) or major fraud?

Potential risk: If there is a risk of large-scale product recall, fraud, or other similar event, there may be media coverage or knowledge of this event may be spread by word of mouth. Such publicity will not only cause immediate distress to the business around re-working and cash flow, but may cause longer-term damage to the business's reputation.

Risk mitigation strategies include:

- › reviewing quality assurance systems and policies to ensure they are robust enough to avoid a situation that may risk the business's reputation or goodwill

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Risks posed by information technology

Question: Does the business rely on information technology (IT); for example, through computer systems or EFTPOS? The level of risk created by using IT is directly related to how reliant the business is on it.

Potential risk: If the business is reliant on IT, there is a risk that the business may not be able to operate without it; for example, if the EFTPOS system fails during a high sales period.

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

Risks posed by financial transactions

The risks posed to businesses by financial transactions can be broken up into liquidity, foreign exchange, interest rate, commodity price and credit risk.

Liquidity risk

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

Potential 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 (as they may become personally responsible for the debts of the business). If liquidity is not improved, the probability of the business getting a loan is also drastically reduced.

Risk mitigation strategies include:

- › managing cash flow on a daily, weekly and monthly basis to ensure a continual review of the flow of cash in and out of the business
- › forecasting cash flow to determine the business's future cash flow needs. Good forecasting will include 'what if' analysis; for example, what if my sales drop by five per cent
- › seeking a committed line of credit from a finance 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 finance institution to ensure they understand the business and are kept up-to-date with potential loan requirements

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

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Foreign exchange risk

Question: Does the business use foreign currency to buy inputs into the business or receive foreign currency from the sale of products and services?

Potential risk: If the business uses foreign currency, then the business is exposed to fluctuations in the value of foreign currency. Not properly managing this can lead to the business making unexpected gains or losses. The importance of mitigating such a risk is dependent on how reliant the business is on such transactions.

Speak to a bank about how they can assist in managing foreign exchange exposure.

Risk mitigation strategies include:

- › 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 dependant is the business on borrowed funds or income generated from, for example, bank accounts?

Potential risk: If the business is dependent on borrowed funds or income generated from other sources, movements in interest rates will affect the financial performance of the business through increases in interest expenses or reductions in income from interest.

Speak to a bank about how they can assist in managing interest rate exposure.

Risk mitigation strategies include:

- › borrowing or investing at a fixed rate to provide surety to interest expenses or income
- › matching interest income against interest expense to nett the exposure
- › utilising available bank products that may help manage exposure

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

Commodity price risk

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

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

Risk mitigation strategies include:

- › entering into fixed price contracts with suppliers or customers
- › using a number of financial market instruments provided by financial institutions

Speak to a bank about how they can assist in managing commodity price exposure.

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Credit risk

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

Potential risk: If products and services are sold on credit there is a risk that debtors will be unable to meet their financial obligations to the business.

Risk mitigation strategies include:

- › checking the credit status of the debtor before entering into a sale contract
- › checking publicly available registers to see if the debtor's business is real and who is behind the business
- › imposing credit limits to ensure the overall exposure is limited
- › maintaining strong relationships with the debtor to ensure their current liquidity status is known

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

Risks posed by competitors

Question: Do competitors pose a threat to the business; for example, by opening a rival business nearby, significantly reducing prices, getting a new product to market first, expanding their business or finding new ways to get a product to market?

Potential risk: If current and potential competitors can pose a threat to the business, there is a risk to the viability of the business.

Risk mitigation strategies include:

- › continuing to build relationships with clients and the local community
- › 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
- › continually monitoring competitors, including the prices they charge

Risks posed by the market / economy

Question: Is the business prone 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 upon the customer base?

Potential risk: If the business is at risk from changing tastes and trends, or from an economic downturn, there is a risk to the viability of the business.

Risk mitigation 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 (which can be determined by testing the market)
- › promoting stock or services that sell well and are profitable

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

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Risks posed by the death of the business owner

Question: What would happen to the business if the owner or one of the partners died or became seriously ill; for example — would the business close, would it be inherited and run by someone inexperienced, or would it be sold? What if the business is the owner's or remaining partners' only source of income?

Potential risk: If there is no strategy in place to deal with the death or serious illness of the business's owner, or one of the partners, there is a risk that the business will have to close, or that undue pressure will be placed on the remaining or new owners of the business.

Risk mitigation strategies include:

- › making a will that includes a business succession plan
- › having in place appropriate insurance that gives a stream of income in case of serious illness

Speak to a legal adviser about making a will that includes how the business should continue, be disposed of or closed in the event of death.

Other risk management issues

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, type of industry it is in and the 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 potential risks. These areas include:

Sales

What are the procedures for shipping goods? How is it ensured that all sales are recorded? What are the procedures for cash, cheque and credit sales? Are delivery instructions recorded?

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 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 not a staff member's details? 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?

Bank payments

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

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

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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. These types of insurance include:

Building and contents insurance

This insurance should cover the business's building(s), as well as contents and stock, against loss due to a number of circumstances.

Business interruption or loss of profit insurance

The insurance covers 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

Accident and sickness insurance for employees should be covered by this insurance, which must be held by businesses in Australia.

Personal accident and illness insurance

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

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 should cover the business from legal action taken for losses incurred as a result of the owner's or employees' 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 protect the business against plant and machinery break down.

Product liability insurance

The insurance covers against claims of goods causing injury or damage if it sells, supplies or delivers goods — even in the form of repair or service.

Speak to an insurance company or broker about the insurance that may be needed for the business.

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