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P. Bruce Buchan

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*Every company takes risks daily, and every company should be geared to run risks. It is the degree of risk exposure and the sources of willingness to accept chances that must be watched, says this author —*

# CORPORATE RISK POLICIES

*by P. Bruce Buchan*
*Queen's University*

All companies have policies regarding the risks their managers should take. Few, however, are well defined: most are simply "implied" by what the company is willing (or not willing) to tolerate. They emerge "after the fact." The manager learns as he sees what happens to his colleagues when their risky ventures fall flat. If the company is particularly harsh with failures this will tend to squelch risk taking and innovation, *especially if top management judges performance based on 20-20 hindsight rather than knowledge of the circumstances at the time the decision was made.* Unfortunately in the absence of a clearly defined and clearly communicated risk policy, a specific occurrence at a given point in time, will tend to distort the picture for the whole company for months, even years, thereafter. In one instance, a medium sized manufacturing company went through a difficult financial period and cut back severely on proposals for new products and new methods. Long after the difficulty had been resolved lower and middle management were exceedingly reluctant to make any innovative proposals—"those guys upstairs always turn them down anyway."

Risks facing a corporation vary greatly in form and stem from a variety of sources. Currently, the actions of the Government regarding the price freeze, currency revaluations, and import/export restrictions add to the uncertainty of the environment in which the manager must operate and add to the riskiness of his decisions. In 1961, the president of American Photocopy saw the firm's main competition coming from Minnesota Mining and Eastman Kodak. Earnings dropped sharply in the ensuing years but not because of the actions of either of these two firms but rather a newcomer on the scene, one with the strange name "Xerox." In short, the name of the corporate game is "risk taking."

Companies should have an explicit "risk policy" and it should have the following characteristics:

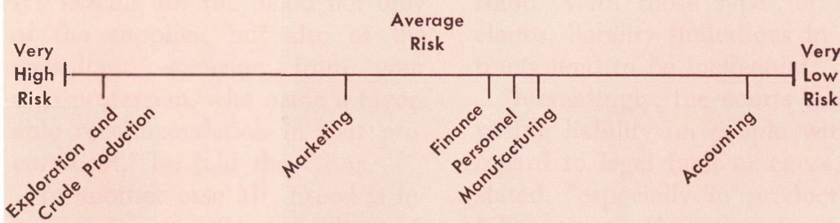
1—It should be *dynamic* not *static.*

2—It should differentiate between levels of management.

3—It should differentiate between functional areas.

4—It should be quantified as much as possible.

5—It should be communicated effectively to all in the corporation and it should differentiate between right and wrong outcomes.




It is important to avoid a policy which does not change or which will give the manager the opinion that risks are something which are beyond his control and/or just a matter of luck.

Managers should not be risk-takers but rather risk-makers. The term "risk-taker" has a passive connotation—it seems to imply that the manager sits back and either accepts or rejects proposals depending on the risk involved. This infers he can do little to affect the chances of success. Quite the contrary, however, the major responsibility of the manager is not simply to accept the risks but rather to go out and influence them, to endeavor to swing the odds in the company's favor.

This appears to be a source of confusion among the critics of the businessman (such as J. K. Galbraith). They accuse managers of being risk averters or risk minimizers. In fact, the manager is simply endeavoring to improve the chances of success—he launches a promotion campaign in order to improve the acceptability of a new product. Is *risk minimization* the same as *success maximization?* The corporate actions are the same, the interpretation seems to depend on whether one is "pro-" or "anti-" business.

Managers should not accept risks as a "given," a static situation, but rather a variable which has got to be altered in the company's favor. Their primary function should be to improve the chances of success.

Another dimension of the manager's responsibility is to innovate, to seek out new and better ways of doing tasks. Change, deviations from proven ways, always involve elements of risk. These kinds of risk should be taken, they just don't happen, they are caused by aggressive, perceptive managers, managers who, in effect, are risk-*makers*, rather than risk-*takers*!

Because the business environment is continually changing as is the particular circumstances of the company, the company's risk policy should also change. Clearly, the kinds of risks, which a company can undertake are different when it is struggling for survival, compared to when it is extremely profitable. In the former circumstances, the philosophy should emphasize the *avoidance* of ventures, (risks) which might not succeed; in the latter circumstances the philosophy should stress the *search for* new methods, techniques, products which can lead to still higher profits. Note both philosophies are still positive in that they both stress the importance of success.

There are two factors to be considered when determining the degree of risk you wish a manager to assume:

1—The possible impact on the survival of the company, and

2—The impact on the morale, enthusiasm, innovative spirit of the employees.

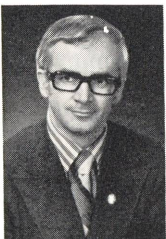
Unfortunately, the higher one rises in the organization the greater the impact his actions will have on both accounts. The key, then, seems to be—how to encourage risk taking on the part of the junior (subordinate) managers while, at the same time, not taking risks which will imperil the company. Too often, in avoiding the latter, the senior manager is put in a position of squelching the proposals of the junior members.

### *Encouraging race horses early*

This presents us with another dichotomy. Can a manager, who is inclined toward risk taking, (this is probably a prerequisite for advancement; as one senior manager put it, "I would rather have race horses which need restraining than donkeys which need kicking") become more conservative as he ascends the managerial hierarchy? It certainly seems possible. With age, experience, and maturity there seems to be a natural shift towards a more conservative stance.

In order, therefore, to have a vibrant, responsive, innovative organization, the lower and middle managers have got to be race horses; they have to live in an environment which encourages risk-taking and they have to have a matching instinct for risk-taking.

Upper level managers, on the other hand, should be more conservative. Their perspective is that of the total company. Their decisions are more significant in terms of the potential impact on the economic health of the company. Further, the time horizon of the senior managers is usually much longer than that of the junior. The results of decisions made by top management often are not seen for several years after the decision, whereas the results of decisions made at lower levels can usually be seen almost immediately. Because of the greater degree of un-



P. BRUCE BUCHAN is an associate professor at Queen's University, School of Business, Kingston, Canada. He has also conducted courses in management sciences for the Canadian Institute of Chartered Accountants. Dr. Buchan received his B.S. and master of commerce degrees from the University of Toronto and his Ph.D. from the University of Michigan. He is a member of the Association of Professional Engineers of Toronto, the American Economic Association, and the Institute of Management Sciences.

Corporate risk policy should reflect a more conservative profile at the upper executive level than at the lower.

certainty associated with events to take place in the distant future, decisions of that kind should be more cautious.

According to a recent *Fortune* article,[1] senior managers are conservative, as evidenced by one who said:

"I would not bet the company even if the prospects of the bet were very good, . . . I put a high value on survival, the highest value. It is almost human nature to be conservative in this respect. In a corporation you are trying to conserve a critical mass."

In a recently completed study for The University of Michigan's Bureau of Business Research an independent test found the senior managers of a large integrated oil corporation to be more conservative than their juniors.

In summary, the corporation's policy should reflect a more conservative profile at the upper level than at the lower level, in keeping with the magnitude of the financial risks these men will ordinarily be dealing with. However, the company must be extremely careful to see that this conservativeness is not carried, as an example, down into the lower reaches of the organization. The risky proposals, the bright ideas, have got to rise up from the roots; if cut off at that level, the plant is sure to wither and die.

A manager is a manager, is a manager, is a manager. Although the accounting manager is often vilified by both the marketing manager and the production manager for being too conservative, it is unlikely they would want him to be any other way. In the best interest of the company, the accountant should not eschew accuracy and certainty for innovation and uncertainty. On the other hand, in the marketing area, risk, uncertainty, and innovation are the name of the game. Clearly too, we would want to match the person's proclivity towards risk taking with the degree of risk involved in the job. Marketing people should be able to live comfortably with uncertainty, so should the exploration manager of an oil company. The accountant, however, either by nature or training, or both, would probably be quite uncomfortable in that environment. Hence, the company's risk policy should recognize the different degrees and kinds of risks which exist in the various functions.

One consensus of managers in a petroleum firm ranked the risk *environment* of the functional areas as shown in Exhibit 1 on page 46.

The exploration department was clearly seen to be in a major risk area, i.e., there was a high degree of uncertainty as to success. This was followed by the marketing department, but, interestingly, it was seen to be considerably less risky than the exploration operations, and only somewhat above "average risk." Why? Being a large, successful integrated oil company, it was not felt that there was much chance of failure, even in the marketing function. Sales continued to grow steadily year after year with no serious dips taking place.

The finance, personnel, and manufacturing functions were all considered to be slightly below average in risk proneness, while accounting was felt to be very low in risk.

Within each of these areas, however, it was possible to identify varying degrees of risk. For example, in the finance area, the decision regarding the granting of credit is quite risky, while in personnel the selection of new employees is done in an atmosphere of high uncertainty (selection techniques are notoriously unreliable). In the other direction, it is unanimously agreed that in certain areas no risk whatsoever should be tolerated; e.g., where the health and safety of the employees are concerned.

Even in accounting, however, it is not felt desirable to eliminate all risks. Talking to a senior officer of one company, he emphasized that it was absolutely essential for

1—McDonald, John, "How the Man at the Top Avoids Crises," *Fortune*, January, 1970.

his people to be constantly on the lookout for new and better systems:

"Don't be hidebound by convention. Look for new, better, more meaningful ways of obtaining; presenting 'information' in its broadest most meaningful sense."

This reflects the changing attitudes of corporate accountants as opposed to the external auditor who is still strongly committed to the established ways and also reflects the nature of the conflict which must become more and more apparent as the emphasis swings from that of providing financial facts for the sole benefit of the shareholders (and the tax collector) to that of providing management with meaningful information in order to make more effective decisions.

It would be a good idea to carry out an evaluation of the "risk attitudes" of the people who work for you, in order to clarify what is the nature of the risks involved in their work. How do they see the risks involved in other departments? A format similar to that used to derive the information in Exhibit 1 would be useful. It is an open ended type of question which permits the individual to discuss a wide variety of risks (note it is the discussion which emerges from his selection which is particularly important, the actual selection is only useful as a general guide and as a basis for comparing departments, and/or functions).

Having clarified the different perspectives between groups in the company, this information can be used to improve the understanding between departments as to the real nature of the kinds of uncertainties which the various departments face.

This will serve as an effective basis for discussion. It gives the employer (manager) a chance to project his views and opinions. This is what you primarily want. Find out what exists first and then take steps to improve it if the slant is not as you desire. More directly, it will help managers to pinpoint the variation in risks which exist within the department among the various jobs, and lead to a better understanding of the nature of the risks and their causes.

### *Controllable risks*

It is essential that the company differentiate between those risks which are within the control of the department and those which are outside. The latter may be due to the actions of other departments (which can then be clarified and lines of communication laid down which may help to minimize the degree of the uncertainty) or may be directly or indirectly due to forces completely outside the company. The latter can be classified into two kinds, rational and nonrational. Rational forces are those which result from a "rational" opponent. "Rational" is used quite loosely here. The important aspect is that it is the act of a "thinking" individual or group such as your competitors, the government, or customers. You do have some leeway (but, perhaps, very little), in influencing their decisions or at least in being able to anticipate their actions. In contrast, the nonrational forces are "states of nature" which are completely unpredictable, such as hurricanes, floods, snow storms, etc., about which you can take no direct preventive actions. Notice that the latter can be protected against through insurance, but you can't influence the chances of such an event taking place.

You now have a profile of the risk environment within and between departments. Its greatest benefit is that it has given you and all the members of your department a chance to clarify the kinds of risks which have to be faced. This in turn will help you to cope with risk.

a. You will be less inclined to wrongly accuse a man for making an improper decision when the outcome is not as desired.

b. You will be able to trace the sources of the uncertainty and if they are caused by "rational" forces there is probably some course of action at your disposal. If it is caused by Nature, consult your insurance company.

c. You will improve your employees' understanding of other departments and of the sources and nature of the risks which you face. With more enlightened "colleagues" this should at least improve the tolerance level, if not the sympathy level, for your difficulties.

d. Being more aware of the problems of others should enable you to avoid aggravating the situation or creating new difficulties.

### *Quantify the risk*

This is a most difficult task, particularly in the "behavioral" areas of management decision making. However, it is a good idea to develop a line of thought in which you automatically ask yourself: *"What are the chances of success?"* Then try to put a figure on it such as "one in ten" or "five in ten." Try to do something more than a general assessment such as "very good" or "fair." This would be better than nothing, but you will be able to make a better comparison of alternatives if you have a specific figure to refer to. Incidentally, for those of you who practice management by objectives, it is highly desirable that you consider with your employees the probability of success in their various "objectives" (usually it is inferred that the ob-

jectives *will be* reached with 100 per cent certainty). This will help to overcome the problems of the employees who are too ambitious, and set themselves impossible tasks, by getting them to think about the obstacles which have to be overcome and to gauge the severity of those obstacles. Similarly, for those employees who set themselves goals which have a 100 per cent certainty of being achieved, this may be a good opportunity to explore their motivation, their self-confidence and your ability to tolerate an objective which is not reached. Are you creating the proper atmosphere which encourages your employees to take on new tasks, to attempt new methods, or are you asking for only the "sure thing"?

### *Capital investment*

Perhaps the most obvious area for quantification of risk is in the investment field. Most companies do implicitly take into consideration the degree of risk associated with capital investment proposals, but in most cases there is room for improvement, for making the risk factor more explicit. Following is a suggestion for accomplishing this.

You should consider these factors in establishing the corporations' policy regarding investment:

a. *Payoff*—the rate of return the company anticipates receiving from the investment.
b. *Risk*—the chances that the designated rate of return will be realized.
c. *Expected Rate of Return*—the minimum rate of return the company is willing to accept.
d. *Investment*—the amount of capital required for the investment proposal.

Exhibit 2A, on this page, shows the combinations of risk and payoff which will yield a specified "expected rate of return," (in this case 10 per cent). It is based on the data shown in Exhibit 2B, above.

EXHIBIT 2A

**RISK PAYOFF**
**and**
**EXPECTED RATE OF RETURN**

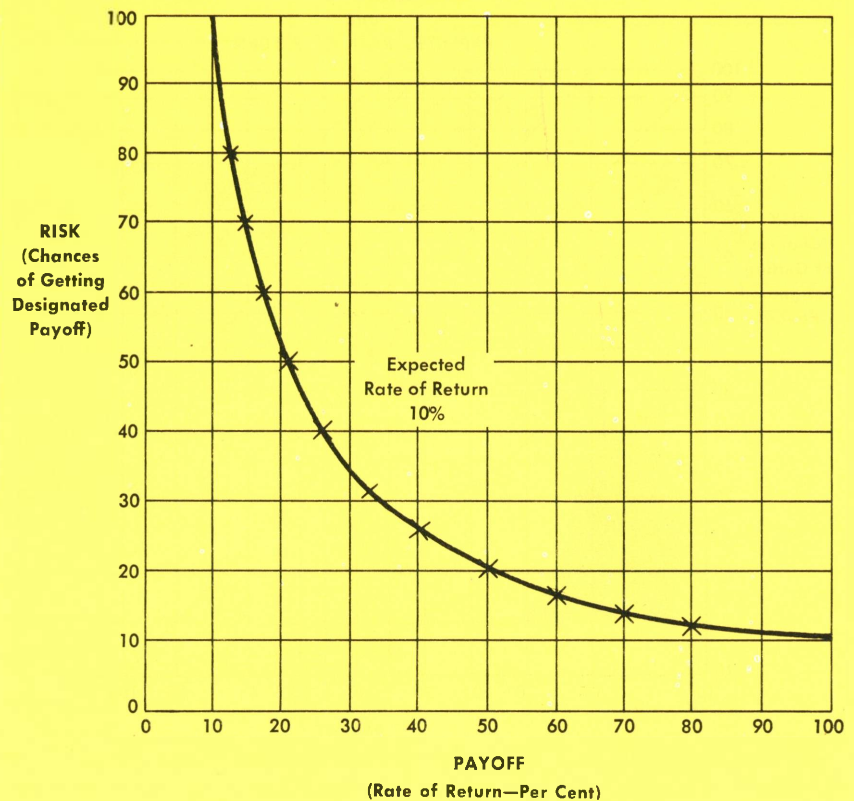



EXHIBIT 2B

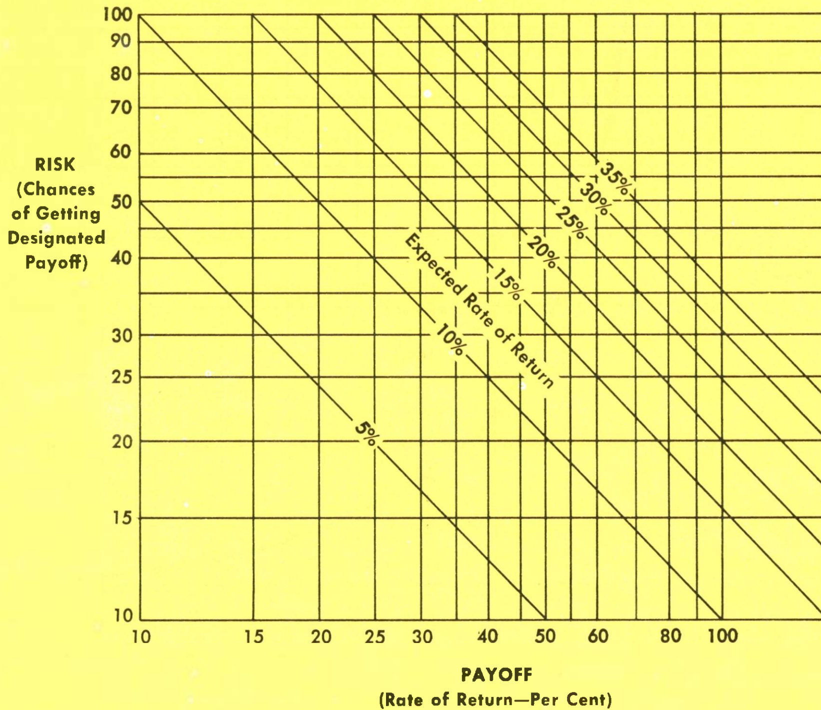
| RISK (Chances of Getting Designated Payoff) (1) | PAYOFF (Return on Investment) (2) | EXPECTED RATE OF RETURN (1) x (2) (3) |
|---|---|---|
| 100% | 10% | 10% |
| 67 | 15 | 10 |
| 50 | 20 | 10 |
| . | . | . |
| . | . | . |
| . | . | . |
| 10 | 100 | 10 |

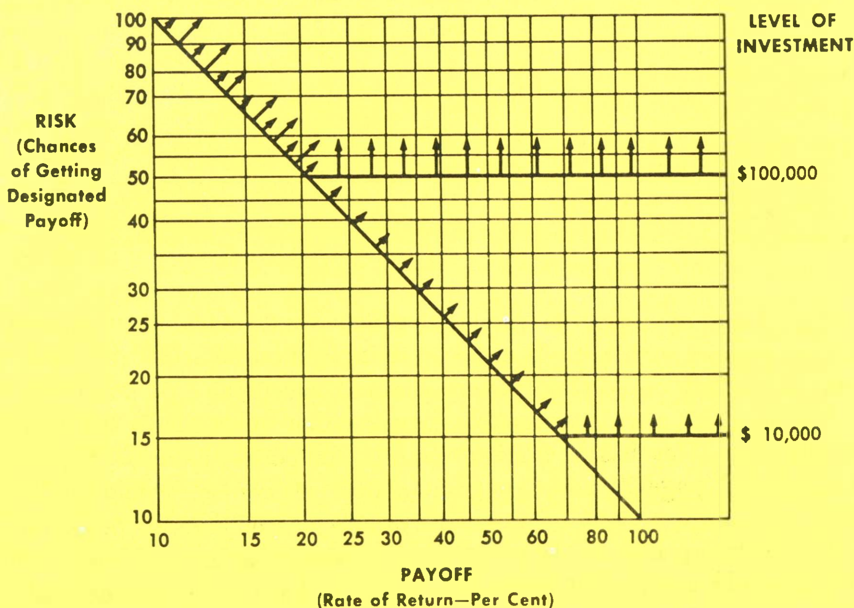
This shape of curve[2] is rather difficult to work with but when the data is plotted on log-log paper it becomes a more manageable straight line. This has been done in Exhibits 3, page 50, and 4, page 50.

If a company had as its policy that it would accept any proposal which would yield an "expected return" of at least 10 per cent it would accept any proposal which was either on or above the 10 per cent diagonal because anything above, of course, would yield a return greater than 10 per cent.

It would be unusual for a company to have an investment policy which did not vary with the amount of capital required for the project.

2—This is the familiar rectangular hyperbola, $YX = 10$.




Probably none do; however, it is also likely that few have a well-defined policy which spells out the differences between various sums. For instance, Carl Spetzler[3] found that there was a wide variety of opinions among the finance committee members of a large petroleum company, as to what was an appropriate return for different amounts of investment. Eventually, he was able to develop an "acceptable" explicit criteria for the corporate investment policy for sums up to $300,000, but for larger amounts, the company refused to become pinned down.

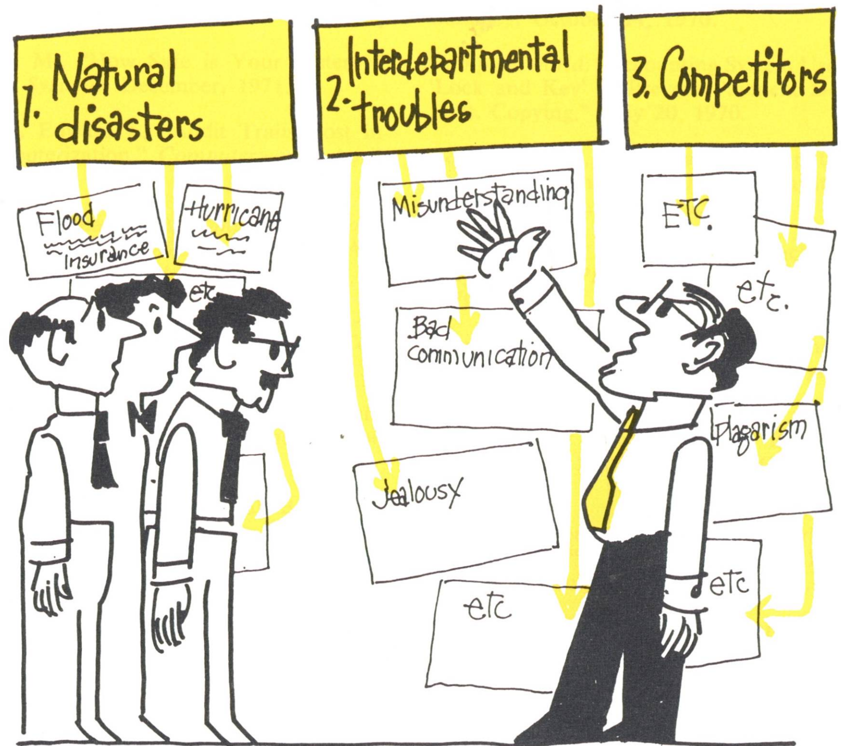
Exhibit 4 shows how the corporation can identify (spell out) its criteria for varying amounts of investment. To return briefly to an earlier theme, this policy (criteria) should be dynamic, not static. It should change with changing circumstances within the company, and it should change as rapidly as circumstances change. But, it should be an explicit change which is communicated quickly to those who need to be advised. The format revealed in this exhibit will serve as an excellent vehicle for finance committees to arrive at and evaluate their policies.

The values on the right of the diagram indicate the size of the capital investment being considered. The horizontal line running to the expected rate of return diagonal shows the cut-off point below which the proposals will not be accepted. In this example, if there is less than a 15 per cent chance of making a 67 per cent return the proposal will be rejected; anything to the right of the diagonal and above the horizontal line will be accepted because the expected rate of return will be greater than 10 per cent. Note that it is not necessary to stick to one "expected rate of return" for all investments. It may be appropriate to use a 10 per cent expected return for sums

3—Spetzler's work arose out of a suggestion made by Ralph O. Swalm regarding the need for a Corporate Utility Profile (*Harvard Business Review*, Nov.-Dec., 1966, pp. 123-136).

between $1,000 and, say, $500,000 but then to revert to either a higher, (say 15 per cent) or even lower figure (say 6 per cent). In any case, the finance committee should spell out the basis or criteria for the shift. These diagrams will be most constructive in focusing the committee's attention on the relevant factors for consideration.

One gremlin you should guard against is the "50-50" syndrome. Our culture is imbued with the concept that anything which has a 50-50 chance is "fair," "just," "equitable." Frequently this is carried over in the decision-making process and has a debilitating impact on the decision. For instance, suppose we had a "50-50" man applying the company's policy regarding the aforementioned "10 per cent rate of return." His interpretation would lead him to reject all proposals which had less than a 50-50 chance of success and to accept all those which had a greater than 50-50 chance. Thus, he would be wrong in all those instances when the odds were less than 50-50 but the payoffs were greater than 20 per cent (i.e., were either on or above the diagonal) and equally wrong in accepting proposals when the odds were greater than 50-50 but the payoffs were less than 20 per cent (i.e., below the diagonal). This "fair," 50-50 concept is so pernicious that one has to be on his guard against using it subconsciously in the decision-making process.




When you have a "risk profile" of departments, you have a chance to clarify the kinds of risks to be faced.

### *Communicate your policy*

Managers will respond to what they *believe* the company's risk policy to be: Hence, it is what they perceive which is important. To this end it is essential that what is perceived and that which "is," be one and the same.

A manager in a company was released after one of his projects proved to be a bust. This had a traumatic effect on many other managers. The company seemed to be saying that if your proposals do not succeed you will pay with your job. The net result was that the managers were not particularly inclined to undertake risky proposals because, by definition, there was a significant chance that they would not be successful. The company's actions plus the grapevine, spread a picture of the company's policy which would undoubtedly have an inhibiting effect on the growth of the company unless specific counter measures were undertaken.

The company can avoid this problem by being sure that its policies are carried to the managers clearly by means other than the grapevine. Consider the following lines of action:

- Give examples of risks taken by managers which have been encouraged and have paid off.
- Give examples of risks which have been taken, have flopped, but which have not impeded the progress of the manager.
- Do reward risk taking, innovation, hard work, success through promotions, pay increases, bonuses, profit sharing schemes, and, most importantly, verbal and written recognition.
- Do NOT punish financial flops, provided the cause was beyond the control of the manager—if based on the facts available at the time of the decision it was a "good" decision (i.e., differentiate between the right decision and the wrong outcome).
- Do penalize shoddy, incompetent, risk-averse managers. However, do not go overboard, be positive—concentrate on rewarding the right decisions, rather than penalizing those who make mistakes.
- Be suspicious of a manager who has never had a "flop," or at least will never admit to one. It might indicate he has never made a risky decision or that he perceives an atmosphere which will not tolerate risk taking.

Risks are an unavoidable part of the businessman's world. Without them, there really wouldn't be any need for a businessman—a decision maker. His job is to go out and confront the risks: however, it does pay him to think effectively about the nature of the risks which face him and his company and to govern his actions accordingly.