

ATLANTIC INTERNATIONAL UNIVERSITY

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MASTER OF BUSINESS ADMINISTRATION

IN PROJECT MANAGEMENT

Research Topic:

***“External and Internal Risk factors: Case of
small-scale business entities in Rwanda”***

SECOND PHASE OF STUDIES

COURSE: RISK MANAGEMENT

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ABBREVIATIONS:

- **AIRMIC:** The Association of Insurance and Risk Managers
- **ALARM:** The National Forum for Risk Management in the Public Sector
- **COSO:** Committee of Sponsoring Organizations of the Treadway Commission
- **IRM:** Institute of Risk Management
- **NIST:** National Institute of Standards and Technology
- **RRA:** Rwanda Revenue Authority
- **RWF:** Rwanda Francs
- **USD:** United States Dollars
- **VAT:** Value Added Tax

INTRODUCTION

Success in business, to a certain degree, requires owners and managers to take calculated risks. The most successful business is usually managed by people who know when to push forward and when to pull back, when to buy and when to sell, when to stand firm and when to compromise. The successful company is managed by people who understand what risk in business is, and how this risk should be managed and mitigated. Risk is an undeniable reality of doing business today, whether domestically or globally. A successful entrepreneur does not fear risk, but strives to understand it, to manage it, even to take advantage of it.

Unfortunately as the world of business becomes increasingly borderless, risk management becomes, likewise, borderless, more complicated, radically intensely more concentrated and thus devastatingly fast. Risk is any one of a myriad of contingencies that could negatively impact an enterprise, thereby altering its value, its cash flow, or its future. Today, more globalization, greater interdependence, immediate access to markets of choice, more sophisticated techniques, intensified competition are clearly the trends of the future which are sometimes associated with uncertainty. The challenge for management is to determine how much uncertainty to accept as it strives to grow stakeholder value.

Today, Taking and managing risk is part of what organizations must do to create profits and shareholder value (**Veronica Fredriksen, 2005**). In other words, the management of risk has become fundamental to the well being of business entities. However, researches have been made and found out that many organizations neither manage risk well nor fully understand the risks they are taking (**Kathryn Westover, 2006**).

Therefore, taking the case of small-scale business entities in Rwanda, the goal of this paper is to identify and explain risk factors facing an organization and its operations, and thus discuss approach on how managers should successful address them. Meanwhile, we should first define key concepts to the topic.

MEANING AND DEFINITIONS OF CONCEPTS

Events - Risk and opportunity

Events can have negative impact, positive impact or both. Events with negative impact represent risks, which can prevent value creation or erode existing value. Events with positive impact may offset negative impacts or represent opportunities. Opportunities are possibility that an event will occur and positively affect the achievement of objectives, supporting value creation or preservation (**Borodzicz, Edward P. 2005**).

According to the (**NIST, 2002**): "*Risk is the exercise of vulnerability, considering both the probability and the impact of occurrence*".

A risk is something that may happen and if it does, will have an adverse impact on the project (**Neville Turbit, 2005**). The important thing to consider from this definition is that risks "*will have an adverse impact*". If it will not have an adverse impact, it is not a risk. Suppose we said a risk was that we would find the project less complicated than we thought, and could finish early. Unless finishing early has an adverse effect on the project, it is not a risk.

Small-scale business entity

The meaning of small-scale business varies from country to country, but it is usually based on the following criteria: the number of employees, size of the initial investment, and the annual turnover rate. Universally, there is no definition of small-scale business because it depends on the above-mentioned criterion (**Michael Frese, 2003**).

In the case of Rwanda, there is no commonly accepted definition by all intervening institutions. According to **RRA**, small business units refer to the taxpayers whose the annual turnover falls below 15, 000,000 RWF (30,000 USD) and they are called voluntarily VAT registered.

For the purposes of this study, a strict definition probably does not matter. The types of firms that we shall be dealing with are those that are more substantial than the very small business.

Meaning and Purpose of Risk Management

Risk management is increasingly recognized as being concerned with both negative and positive aspects of risk. According to the (**COSO,2004**), *“Risk Management is a process, effected by an entity’s board of directors, management and other personnel, applied in strategy setting and across the enterprise, designed to identify potential events that may affect the entity and manage risk to be within its risk appetite, to provide reasonable assurance regarding the achievement of entity objectives”*. This definition is purposefully. It captures key concepts fundamental to how companies and other organizations manage risk, providing a basis for application across organization. It focuses directly on achievement of objectives established by a particular entity and provides a basis for defining organizational risk management.

Carol, A. and Sheedy, E. (2004) said that:” *It is a structured approach to managing uncertainty through, risk assessment, developing strategies to manage it and mitigation of risk using managerial resources. Strategies include transferring the risk to other party, avoiding the risk, reducing the negative effect of the risk and accepting some or all of the consequences of a particular risk*”.

Risk management is the art and science of planning, assessing (identifying and analyzing), handling, and monitoring future events to ensure favorable outcomes. Thus, a good risk management process is proactive in nature, and is fundamentally different than crisis management (or problem solving), which is reactive (Edmund H. Conrow 2003).

In the words of **Roehrig, P (2006)** *“objective of risk management is to reduce risks related to a preselected domain to the level accepted by society. It may refer to numerous types of threats caused by environment, technology, humans, organizations and politics. On the other hand it involves all means available for humans, or in particular, for a risk management entity (person, staff, and organization)”*.

Therefore, we could define risk management as a process whereby organizations methodically address the risks attaching to their activities with the goal of achieving sustained benefit within each activity and across the range of all activities. The focus of good risk management is the identification and treatment of these risks as well as adding maximum sustainable value to all the activities of the organization. However, *“the risks facing an organization and its operations can result from factors both external and internal to the organization” (IRM, AIRMIC, ALARM, 2002)*. Thus, managers’ failure to identify these

factors could straightforwardly outcome into breakdowns coupled with financial losses.

INTERNAL AND EXTERNAL RISK FACTORS

Actually, in the absence of timely and adequate risk managerial skills, business entities result into management problems that could easily lead to financial losses. This is due mostly to the fact that managers do not often seize certain information associated with risk probability within business environment. The major business risks can be categorized further into 4 types of risks such as strategic, financial, operational and hazard. The following table gives examples of the key risks and shows that some specific risks can have both internal and external drivers:

Table of internally and external driven risks

<i>RISK CATEGORIES</i>	<i>EXTERNALLY DRIVEN</i>	<i>INTERNALLY DRIVEN</i>
FINANCIAL RISKS	Interest rates Foreign Exchange Credit	Liquidity Cash flow
STRATEGIC RISKS	Competition Customer changes Industry changes Customer demand	Research and development Intellectual capital
OPERATIONAL RISKS	Regulations Culture Board composition	Recruitment Supply chain
HAZARD RISKS	Contracts Natural events Suppliers Environment	Public access Employees Properties Product and services

(Source: Gorrod, M. 2003).

Financial risks are risks that a company will not have adequate cash flow to meet its financial obligations (***The Wall Street Journal***). Companies that issue more debt instruments would have higher financial risk than

companies financed mostly on entirely by equity. Financial risks also result from high rate of interest by financial institutions as well as high foreign exchange rates. Internally financial risks are related with company liquidity and cash flow. In other words, if they are not taken care of they could simply lead to problems such as failure to honor bills, to pay employees salary and to meet all other financial obligations within an organization.

Externally, competition, customer changes, industry changes and customer demand are identified as factors that could bring about strategic risks. Sometimes they can result from internal factors like, the lack of intellectual capital, research and development skills (**Aswath Damodaran, 2007**). All these strategic risk factors are linked with poor strategic risk management, since managers fail to seize the competition impacts or to adapt strategies to the changing customers' requirements. According to **Charles A. Holloway, Joshua Spitzer (2006)**: *"Companies face strategic risk: the chance that disruptive technologies, fickle customers, radical competitor moves, and new government policies will upend--even destroy--your business. Managers need to craft strategies that defend their company against sudden-death threats and seize the golden opportunities uncertainty can provide"*. The major outcome problem is often the loss of a significant number of customers along with collapse in the sales.

"Today's vision of Operational Risk Management is to optimize the performance of a business by understanding the effects of adverse operational losses on business activities and assets so as insure against them by preparing for that rainy day." (**Kristin Gallina Lovejoy, 2005**). Operational risk involves breakdowns in internal controls and

corporate governance. Such breakdowns can lead to financial losses through error, fraud, or failure to perform in a timely manner.

The last risk factors are those associated with hazard. According to above table, both internal and external factors are said to bring about hazard risks, only if they appear absolutely strange to the managers, with no correlation to operational, strategic or financial gap or aspects.

Generally, it is extremely important for managers to ascertain risk associated factors within their business entity so that they can elaborate plans to adequately address them. Nevertheless, for those problems that are beyond the vision of the project team, such as an unanticipated budget cut (often termed "unknown unknowns"), a good, properly implemented risk management process can help to rapidly quantify the problem's impact and develop sound plans for alleviating its affect **(Charles, Tapiero, 2004)**.

Given the above global view on risk associated factors facing business entities, we are going to identify major risk factors in the case of Rwandan business entities.

Major Risk factors in Rwandan business entities

Taking a look at the background, Rwandan small-scale business entities evolved after 1994 genocide, which vandalized the whole nation by reducing demand and halting business. Today, business sector plays a big role in development of the country. This is associated with the current government policy which calls for people to create their own jobs rather than being job seekers from government institutions. However, the business sector achieved a significant growth; some companies are hold back due to the challenges connected with this

growth. The major risk factors that small-scale business entities face in Rwanda include:

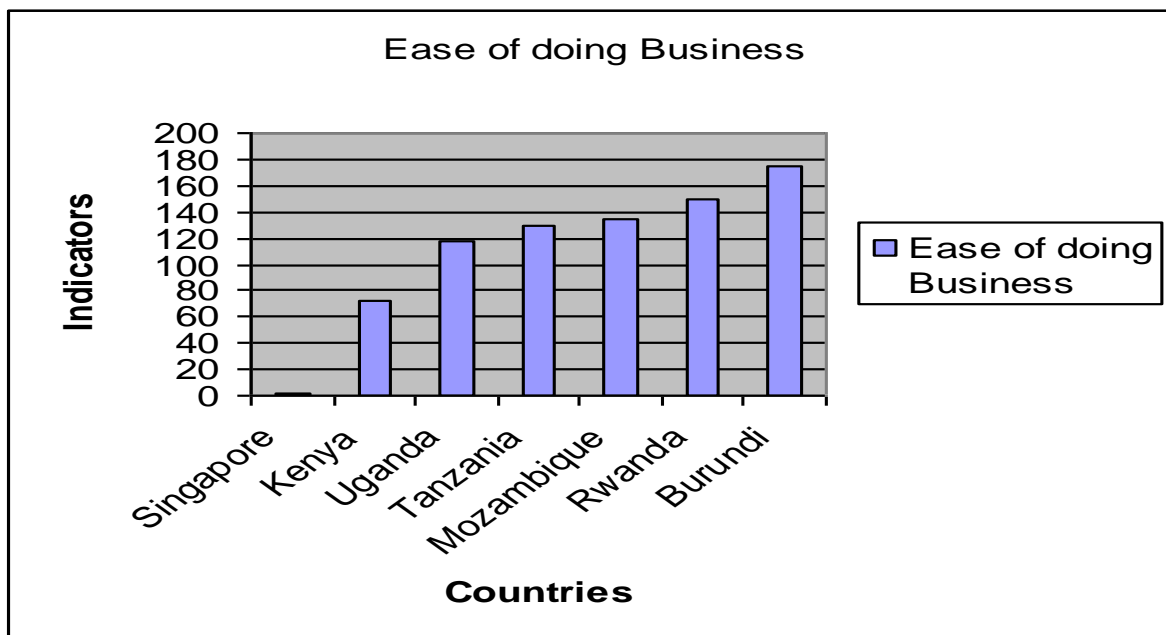
Competitive markets

Businesses entities in Africa operate in conditions prevailing in the informal sector (**Suresh Munbodh, 2003**). In Rwanda, every one can be a businessperson or start a business entity and enter into the economy without any requirement from the government. This has increased their numbers in cities, but with much exposure to strategic risks. It is not evident for all small-scale business entities to cope with high competition. Consequently, some of them stagnate at the bottom and do not show any sign of growing, while others fail. However, it is associated with managers' failure to seize and control risk factors facing their business.

Regulations

Rwanda is ranked 150 out of 178 economies in the ease of doing business (**World Bank and International Finance Corporation, 2008**). The following chart shows the comparison of Rwanda to other countries in the ease of doing business:

Rwanda-Compared to Global Best/Selected Economies:



(Source: Doing Business in 2008 Rwanda)

Over the last 13 years after genocide up to date, Rwandan has made a lot of changes in the regulations not only in business sector, but also in other sectors and at the constitutional level, so as to restore and boost up its economy. These changing regulations sometimes go along with supplement taxes or changes in tax rates, rebuilding and reorganization of business centers, etc..., which could easily generate operational and strategic risks to small-scale business entities.

Managerial skills -Internal risk factors

Most small-scale African entrepreneurs lack a strong formal educational background and thus prefer a practical interactive form of business education. According to **Van Scheers L. and Radipere S (2007)**: "It is evident from the conducted research that small business owners lack certain managerial skill such as financial management, marketing and human managerial skills to operate their businesses successfully". All

the internal risk factors are mainly associated with lack of adequate competence on the part of managers. This poor and/or lack of managerial skills is the major source of risks facing small-scale business entities. Obviously, business entities are exposed to risks if managers lack appropriate skills and competences to ascertain potential risks within and outside the organization.

Therefore, in Rwanda, it is equally evident that most of the external risk factors have roots from the internal ones, in that lack of adequate financial, marketing, control and human managerial skills seem to worsen changing environment, competition, regulations and other external related risks. Small-scale business managers play a limited ability to manage financial resources, with exhibiting too much informal, fragmented and subjective managerial control which expose their businesses to all kind of management risks both internally and externally.

In order to effectively deal with uncertainties facing business environment, which sometimes lead to breakdowns or result into financial losses, there is a need for managers to develop strategies to address them.

Measures to address risk within business entities

Given that risks could easily endanger business performance, Business or Project managers should consider the following major steps to effectively respond to risks facing business entities: risk identification, assessment and treatment measures.

Risk Identification

Risk identification is continuous activity. The job of identifying risks does not end when the business or project plan is written. New risk can develop at any stage of the project or the business. Thus, good risk identification is essential because risks can only be managed if they are identified. The process of identifying risks involves source analysis which deal with determining risk sources or factors. When either source or factor is known, the events that a source may trigger or the events that can lead to a problem can be investigated. For example: stakeholders withdrawing during a project may endanger funding of the project; privacy information may be stolen by employees even within a closed network.

Risk assessment

Once risks have been identified, they should be assessed as to their potential severity of loss and to the probability of occurrence. Risk assessment should base on the two major factors: probability and impact. If the probability is high and impact is low, it is a medium risk. On the other hand if impact is high and probability low, it is high priority risk; **(Neville Turbit, 2005)**. It is therefore critical for managers to make the best educated guesses possible in order to properly prioritize the implementation of the risk management plan.

Potential risk treatments

Once risks have been identified and assessed, all techniques to manage the risk fall into one or more of these four major categories: risk avoidance, reduction, retention and transfer **(Flyvbjerg, August 2006)**.

Risk avoidance includes not performing an activity that could carry risk. Avoidance may seem the answer to all risks, but avoiding risks also means losing out on the potential gain that accepting the risk may have allowed. Hence, not entering a business to avoid the risk of loss, also avoids the possibility of earning profits.

Risk reduction involves methods that reduce the severity of the loss or the risk of the loss from occurring. Examples include sprinklers designed to put out a fire to reduce the risk of loss by fire. However, this method may mitigate the risk, but the cost may also be prohibitive as a strategy.

Risk retention involves accepting the loss when it occurs. Risk retention is a viable strategy for small risks where the cost of insuring against the risk would be greater over time than the total losses sustained. All risks that are not avoided or transferred are retained by default. This method may be suitable if the chance of a very large loss is small. If the cost to insure for greater coverage amounts is so great it would hinder the goals of the organization too much.

Risk transfer means causing another party to accept the risk, typically by contract or by hedging. Insurance is one type of risk transfer that uses contracts.

Therefore, based on the above methods, management need to select an appropriate strategy to deal with the specific risks. In doing so, managers should purchase insurance policies for the risks that have been decided to be transferred to an insurer, avoid all risks that can be avoided without sacrificing the entity's goals, reduce others and retain the rest.

However if risks are inappropriately managed, time can be wasted in dealing with risk of losses that are not likely to occur. Spending too much time assessing and managing unlikely risks can divert resources

that could be used more profitably. If the risk is unlikely enough to occur, it may be better to simply retain the risk and deal with the result if the loss does in fact occur.

CONCLUSION

Risk management is essential for a wide variety of projects and business entities because certain information about key business environment, performance, and schedule attributes are often unknown until late in the business. Potential risk issues that can be identified early in the business may potentially impact the business later, and can be alleviated with a good risk management process. In doing so Business managers should ascertain risk associated factors or sources both internally and externally in order to produce an efficient risk management plan. For those problems that are beyond the control of the manager(s), such as customer changes, bank rate, regulations, exchange rate... (Often termed "external factors"), and those within manager's control (Often termed "internal factors"), a good and properly implemented risk management process can help to rapidly quantify the problem's impact and develop sound plans for alleviating its affect as well as increasing the chance of success. Nevertheless, the absence of adequate managerial and competence abilities on the part of managers would not only prevent satisfactory handling of internal risk factor, but would also tend to aggravate potential external risk factors.

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