Risk Management and Financial Planning in Entrepreneurship

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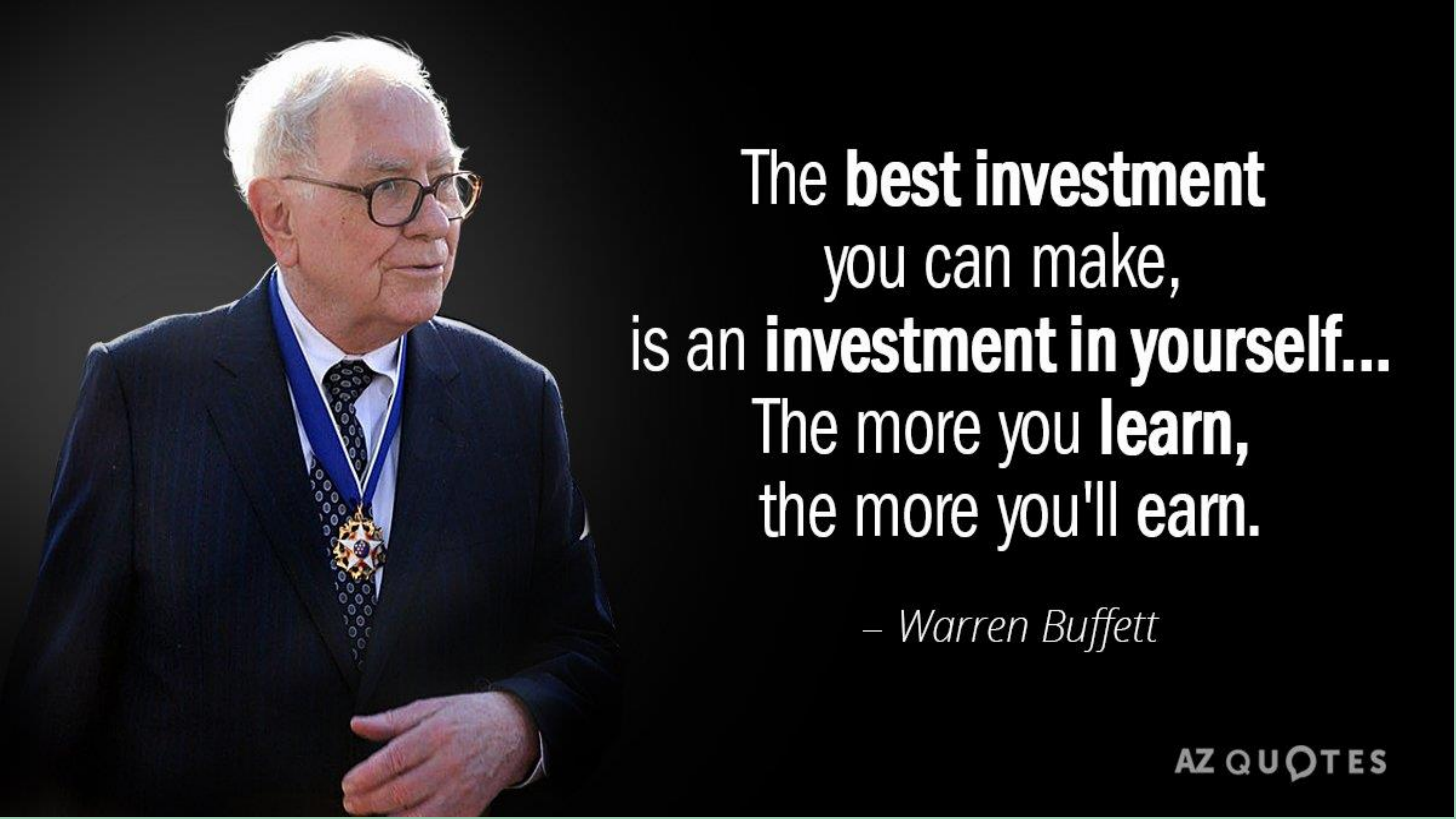

The **best investment**
you can make,
is an **investment in yourself...**
The more you **learn,**
the more you'll **earn.**
– Warren Buffett
AZ QUOTES

Entrepreneurship

- Oxford dictionary, an entrepreneur is “A person who sets up a business or businesses, taking on financial risks in the hope of profit”.

- “Entrepreneur is an employer, master, merchant but explicitly considered as a capitalist” (Adam Smith, 1776).

- In words of A. H. Cole (1959), “Entrepreneurship is the purposeful activity of an individual or a group of associated individuals, undertaken to initiate, maintain or organise a profit-oriented business unit for the production or distribution of economic goods and services”

- “Entrepreneurship is neither a science nor an art. It is a practice. It has a knowledge base. Knowledge in entrepreneurship is a means to an end. Indeed, what constitutes knowledge practice is largely defined by the ends, that is, by the practice.”

‘nothing is certain, but death and taxes’ ‘nothing is certain but death, taxes and the risk in their businesses’

- (Longenecker et al., 2000)

Risk

The possibility that the actual return may be less than the expected return.

The risk is a situation that would cause smaller profits than expected, or a situation that may result with loss of the company's financial and/or material resources.

The risk means facing with market changes, new competitors and technological changes (Carsrud and Brännback, 2007).

TYPES OF RISKS

1. ***Pure risk.***

- The risk is considered as pure, when it cause a sure loss, or a situation that it is in break-even point and it is always unpredictable. As examples of this type of risk are counted: fire, death of the owner, loss of any significant customer, traffic accident, theft etc.

2. ***Speculative risk.***

- When the risk is pure, the entrepreneur faces with those situations in which can only lose, while in a speculative risk, he can lose or can win. An entrepreneur can buy a parcel (land) hoping that its value will increase in the future; another entrepreneur will sell his current business to buy another one with hope that the second one will be more profitable than the first; someone else can buy shares of a certain company and hope for their greater value in the future. As profits can be expected from these investments, there also can occur unpredictable and plot situations, where the new purchased business, land or shares lose their previous value and all this will end up with losses for the entrepreneur.

TYPES OF RISKS

3. *Fundamental (unavoidable) risk.*

This type of risk is different from the previous types, because when it occurs, includes all companies which operate in a respective country or community. As possible sources of this type of risk can be the natural forces, political factors, economic factors, social factors, etc. For example, floods, earthquakes, wars, inflation, etc. are fundamental risks.

4. ***Financial risk.***

Due to a certain investment, the entrepreneur puts at risk an important part of its capital, which usually comes from the savings made as a result of any activity in the past. This capital will be lost if the business fails. Besides the invested capital in a business, if the business debts exceed the invested capital, the entrepreneur should cover them with his personal wealth – outside the business.

TYPES OF RISKS

5. *Career risk.*

A topic that is often discussed is that how an entrepreneur will be able to find a job or to return to their old jobs, if his business will fail?! How he will tear from himself the epithet of ‘a loser’?

6. *Family and social risk.*

Starting an own business, besides the financial/material investment, also requires more energy and time to be spent by the entrepreneurs. Constantly, his business commitments can cause problems of various natures. Those who are married and especially entrepreneurs with children expose their families to the possibility of a permanent emotional scars.

TYPES OF RISKS

7. ***Psychic risk.***

The greatest risk may be the one that has to do with the psychological wellbeing of entrepreneurs.

Ranking by Entrepreneurs

Types of risks	Ranking	Percentage
Fire	2	14,06
Death of the main person	8	5,73
Bankruptcy of any significant customer	5	10,42
Thefts by unknown persons (customers)	1	19,27
Thefts by employees	6	9,38
Traffic accidents	7	7,81
Decrease of the value of real estate	10	3,13
Floods	11	1,04
Earthquakes	9	4,69
Inflation	4	11,46
Wars (armed conflicts)	3	13,02

RISK MANAGEMENT

Risk management represents an integral and very important part of the overall management of the company. Risk management itself includes all activities that are related to the treatment of risks, such as planning, identification, analysis, compilation of proactive and reactive strategies, monitoring and control of risks.

Types of Risk Management

	Traditional Risk Management	Business Risk Management	Enterprise Risk Management
Focus	Financial and operational risk; internal controls	Business risk and internal control; risk-by-risk approach	Business risk and internal control; entity-level portfolio view of risk
Objective	To protect the value of the company	To protect the value of the company	To protect and to increase the value of company
Scope	Treasure, security and operations are the primary responsible	Business managers accountable	Across the company
Emphasis	Finance and operations	Management	Strategy
Application	Selected risk areas, sectors and processes	Selected risk areas, sectors and processes	All sources of value

Benefits of Risk Management

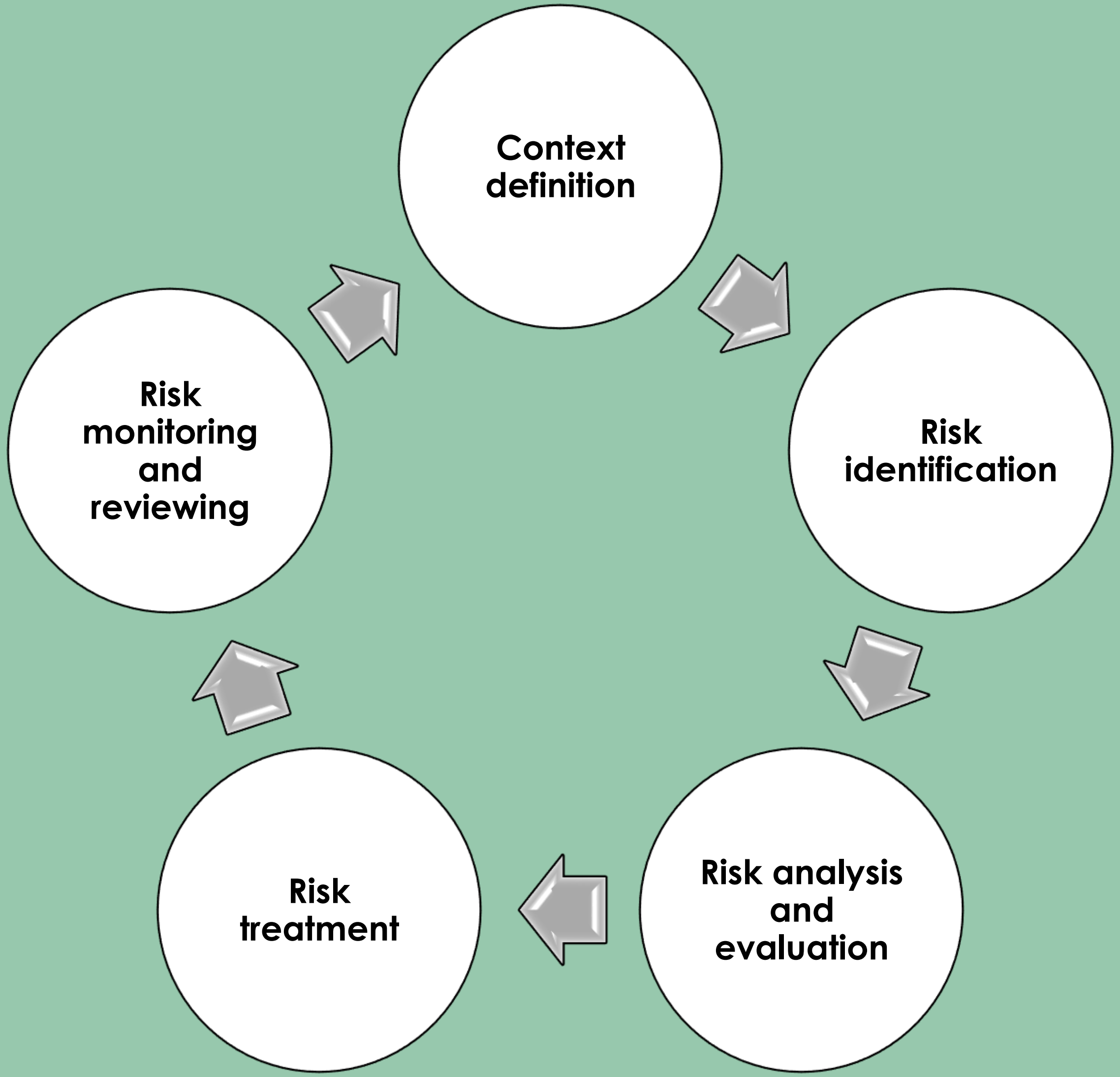
- Treatment of negative situations enables companies to reduce the probability they to be occurred, and if they occur, it will greatly reduce negative consequences.

- Risk management enables to accumulate large amounts of data and information from the external and internal environment, which contribute for a better decision-making process in a company.

- Risk management contributes to improve the reputation of the company. Stakeholders, as employees, suppliers, bankers, governmental and nongovernmental institutions, other companies, etc., are interested to be part of such a company or cooperate with it.

- Risk management enables the company to better identify and exploit opportunities in the market.

Risk Management Process



1 Context definition

- *Safety* - Safety must be upheld constantly. No injury or fatality is allowable;
- *Financial impact* - Costs for an activity/project must be within the approved budget;
- *Media exposure* - An activity/project should not undermine the reputation of the company and it should be protected from negative media exposure;
- *Timing* - An activity/project must be implemented within a defined timeframe
- *Staff management* -The necessary knowledge, skills and abilities for proper implementation of a certain activity/project must be ensured. If the necessary knowledge, skills and abilities are not available within the company, the outsourcing opportunities should be considered;
- *Environment* - An activity/project should be implemented within the existing environmental legislation and the company should be committed in creating of a clean and healthy environment.

2 Risk identification

- *Source* - something that has the potential to change, divert or destroy a certain activity or project or to help that change, deviation or destruction, such as competition or government.
- *Event* - something that happens as a result of the risk's source, such as the expansion of a competitor to the entrepreneur's operating area, or bringing a new law by the government that affects the entrepreneur's business.
- *Consequences* - the result or the impact on the company, stakeholders and assets, such as the loss of market share as a result of competition or the decrease of the profit as a result of a new law that runs tax increases.
- *Reason (what and why)* – why a change, deviation or destruction is occurred, such as the failure to forecast the actions of competition or government decisions.
- *Control and his level of efficiency* - undertaking of activities such as training, market research and market surveillance.

3 Risk analysis and evaluation

Risk = consequences x likelihood

Consequences from a specific risk can be characterized as:

1. *Irrelevant* – the risk doesn't impact changes in the company's goals and objectives
2. *Minor* – the risk can be treated with existing resources
3. *Moderate* – the impact of risk can be treated, but additional resources are required
4. *Major* – treatment of the risk will require significant additional resources from other sectors or sources
5. *Significant* – the risk might cause the company to fail achieving its goals and in some cases can prove to be fatal to the company

3 Risk analysis and evaluation

Risk = consequences x likelihood

Likelihood a risk to occur can be characterized as:

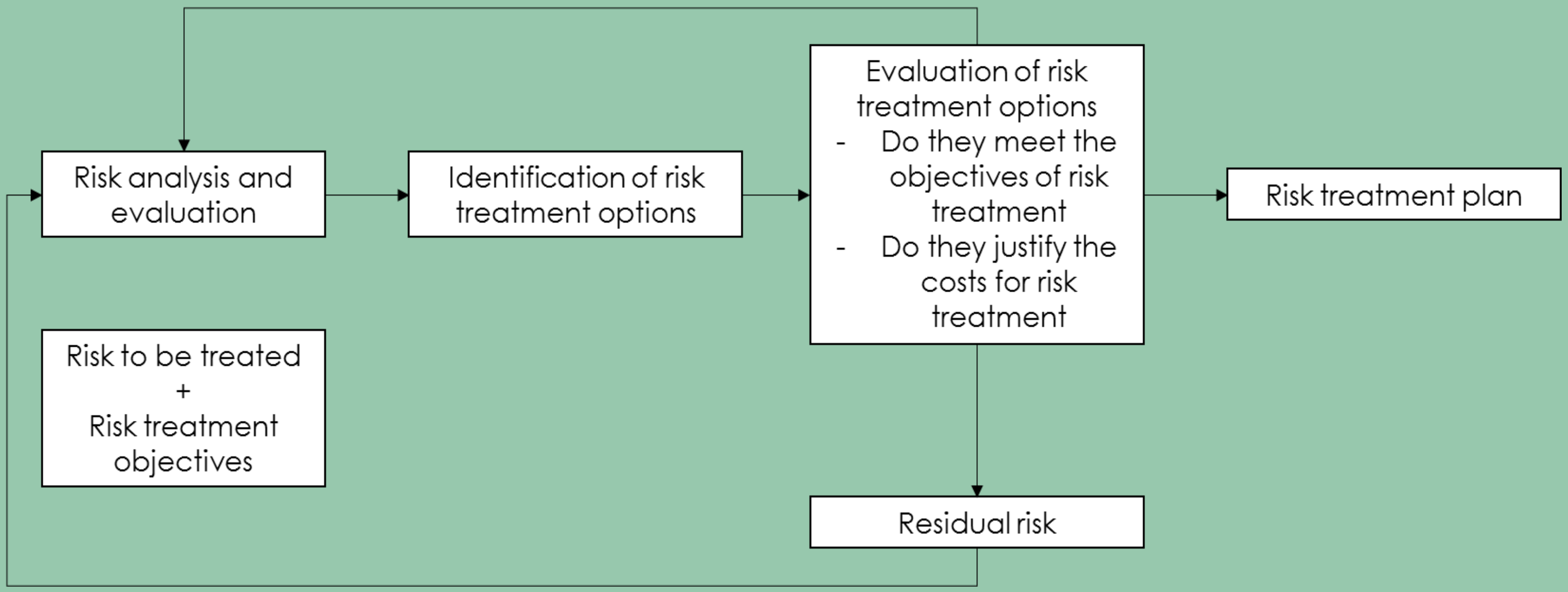
5. *Almost certain* – the risk is expected to occur in the majority of cases, occurs often during the relevant year. Probability of occurrence is 95-100%.
4. *Likely* – the risk might occur, at least once during the year. Probability of occurrence is 70-95%.
3. *Possible* – the risk might occur at some point, for example, once in 3 years. Probability of occurrence is 30-70%.
2. *Unlikely* – the risk might occur at some point, for example, once in 5 years. Probability of occurrence is 5-30%.
1. *Rare* – the risk might occur only in extraordinary circumstances. Such a risk has occurred somewhere else and might occur once in every 5+ years. Probability of occurrence is lower than 5%.

3 *Risk analysis and evaluation*

5	10	15	20	25
4	8	12	16	20
3	6	9	12	15
2	4	6	8	10
1	2	3	4	5

Critical High Moderate Low

4 Risk treatment options



4 Risk treatment options

a) *Risk avoidance* includes taking proactive measures, such as requiring clients to cover purchased goods with credit through a collateral, or not undertaking any activities at all, which is expected to be damaging;

b) *Risk reduction* includes taking concrete measures to minimize the consequences of a specific risk, such as installing alarms to secure assets from eventual thefts, or installing fire alarms;

c) *Risk anticipation*, in literature, also known as the self-insurance strategy, where entrepreneurs leave aside some amount of money in order to cover damages if a risk occur;

d) *Risk transfer* means transferring responsibility to a third party, such as insurance companies, for example insuring a factory from fire by transferring risk to an insurance company.

e) *Risk acceptance* means tolerating risk, in case it is not significantly consequential to the business, or when the treatment is costlier than the damages that would eventually occur, for example, a small flowers' salesman, the value of his products do not exceed 2.500$, cannot afford to install sophisticated alarm systems that cost 4.500$ just to be ensured against thefts.

5 Monitoring and reviewing

Risk management plan	Part I – Context Information
Brief description of the activity	Installing an online system for ordering and buying from Divine Flowers for You. It's expected that online ordering and buying contribute with 10-20% in revenue in the first 12 months.
Reasons for this particular activity	A new initiative for business growth and expansion
Goals	1. Installing a secure system of online ordering and buying 2. Minimizing exposure to deceits and other risks to security 3. Maximizing customer trust and readiness for using the online system
The importance of the activity	Medium to high – currently unable to counter consumer demands
Required references (legislative, policies etc.)	1. Country legislation: - Copyright - Privacy - Commercial practices and consumer protection - Spam - Cyber crimes 1. IT security guide
Assumptions	All information is accurate and in real time
Restrictions	1. Budget 2. Available expertise

5 Monitoring and reviewing

Risk management plan		Part II - risk register	
	Risk dimension: security	Risk dimension: financial	Risk dimension: legal
Serial number	1	2	3
Risk description	Cyber-crimes, including virus damages, identity theft, spyware, general deceits	Expenditures regarding online transactions may exceed the benefits from the new initiative	Legislative breach regarding e-business
Impact	Direct financial losses, reputation damages, equipment damages, unavailable system	Direct financial losses as a result of compensation increase, loss of customers as a result of additional spending	Possible fines and legal prosecution
Consequences	Significant	Medium	Medium
Likelihood	Expected	Expected	Possible
Level of risk	Extreme	High	Medium
Risk priority	1	2	3
Treatment options	1. Updating anti-virus software and checking firewall stability 2. Reviewing requirements for online banking security 3. Developing and testing security policies 4. Developing recovery plans in case of a disaster	1. Developing a case study to identify the impact of compensation increase	1. Reviewing every law 2. Consulting with lawyers 3. Developing and testing appeal policies and procedures

5 Monitoring and reviewing

Risk management plan		Part III – Risk treatment	
Serial number	1	2	3
Treatment strategy	1. Updating anti-virus software and checking firewall viability 2. Reviewing requirements for online banking security 3. Developing and testing security policies 4. Developing recovery plans in case of a disaster	1. Developing a case study to identify the impact of fee increase	1. Reviewing every law 2. Consulting with lawyers 3. Developing and testing appeal policies and procedures
Required resources	Security guidelines: 5 days available for completion	3 days available for completion	5 days available for completion
Priority	1	2	3
Person liable	Owner	Owner	Owner
Deadline	Data X	Data X	Data X
Review strategy	Testing security policies Hire a IT security specialist	Survey customers Review the impact on revenue every week for three months	Consult with a lawyer for reviewing policies and procedures Review the legislation every three months
RMP developed by	Owner		
Methodology	Brainstorming with staff	Discussions with software developers	Consulting with experienced users
Tools for risk analysis	Developing a risk matrix		
Signature			

What are the best statistical analysis techniques for improving risk management?

1. Descriptive statistics
2. Inferential statistics
3. Regression analysis
4. Simulation analysis
5. Machine learning

Financial Planning in Entrepreneurship

Financial Plan

A financial plan is a comprehensive strategy outlining how a business intends to manage its finances to achieve its goals and objectives.

The primary purpose of a financial plan is to ensure that the business has adequate financial resources to operate efficiently, pursue growth opportunities, and remain sustainable in the long term.

It serves as a roadmap for making informed financial decisions and helps entrepreneurs track their progress toward financial targets.

Components of the Financial Plan

1. Proforma Investment Decisions
2. Proforma Financing Decisions
3. Proforma Income Statements
4. Proforma Cash Flow
5. Proforma Balance Sheet
6. Break-even Analysis
7. Economic and Social Variables

The Importance of Financial Forecasting and How to Start

Financial forecasting is the process of using past financial data and current market trends to make educated assumptions for future periods. It is an important part of the business planning process and helps inform decision-making.

Effective forecasting relies on pairing quantitative insight with creative evaluation. Taking what you know and what you believe could happen near term, you can plan for what comes next.

Forecasting factors in expected events such as predictable economic changes or business expansions. It also attempts to establish contingency plans for unforeseen events such as stock market corrections, natural disasters, or long- or short-term business disruptions.

While forecasting cannot predict or avoid every pitfall — for instance, a global pandemic — it can ease the impact of outlier events and create opportunities for growth during advantageous periods.

Five areas to review in financial modeling

•**Historical data:** Past financial performance is the cornerstone of forecasting. Examining your financials through previous forecasting periods will surface growth opportunities. This data is your most accurate starting point for making future projections.

•**Forward-looking projections:** Depending on your business and reporting method, your time horizon may vary from a year to two years. These projections should attempt to predict future revenue goals, new business opportunities, and other positive impacts.

•**Expense and cash flow forecasting:** Your forecast should attempt to evaluate expected expenses based on current company objectives, adjusted for consequences like inflation and increased goods and services costs. The better your procurement data, the more accurately you can forecast these expenses.

Five areas to review in financial modeling

•**Best/worst-case scenario planning:** Financial modeling is not just about statistical analysis, but creative thinking. Therefore, thorough forecasting should explore different scenarios and outlier events. This includes adverse events — such as fires, location closures, cyber attacks, and natural disasters — and positive events such as higher-than-expected revenue, investment returns, etc.

•**Risk analysis:** Part of your contingency planning should consider liability caused by internal and external forces. While contingency planning for outside risk sources is essential, it’s also necessary to plan for internal risk factors such as employee malfeasance, lawsuits, and crisis events.

Reference

- Robert D. Hisrich and Veland Ramadani (2017), **Entrepreneurial Risk Management,** In book: Effective Entrepreneurial Management. DOI: 10.1007/978-3-319-50467-4_4.