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The Risk–Managing Entrepreneur

by Thomas Nightingale

To be successful, entrepreneurs cannot just assume the risk of a business venture, they must actively manage risk. However, the business plans of many entrepreneurs indicate they have given relatively little thought to the various operational risks their new enterprises will encounter. As these flaws are readily apparent to prospective investors, the entrepreneur may not get necessary financial backing to move forward. By incorporating risk management into the planning process, the entrepreneur gains a better understanding of the business system and has a tool for analyzing and managing operational risk. Further, the rigor this process adds to a business plan has real value to potential investors.

The Entrepreneur as a Risk Taker

Entrepreneurs start new business ventures because they have an idea for a new service or product. They have a vision of an unfilled niche in the marketplace that they believe they can capitalize on. Because of this vision, and the creative impulse that drives it, entrepreneurs have a belief in their own uniqueness. The fact that many new business ventures will not get off the ground or will fail within the first year or two is immaterial to entrepreneurs—they are different. So while the very nature of an entrepreneur implies taking on risk, their *perception* of risk is often much different than the actual risk assumed.

The New Business Plan

It is this disconnect between actual and perceived risk that can undermine the entrepreneur's vision and become the cause of future failure. Risk that is not perceived cannot be managed and the entrepreneur who wears "rose–colored glasses" will not plan for contingencies they do not see. If a business plan requires ideal circumstances to succeed then it will undoubtedly fail, because nothing ever goes exactly as planned.

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Of course, even getting to this point often requires significant financial support. Banks and venture capitalists that an entrepreneur may appeal to for funding will likely take a much harder view of the prospects for success of the new business, and a poorly conceived business plan will stop the train before it leaves the station. As discussed in a recent *Wall Street Journal* article:

> "Truth be told, most business plans fail to make much impression on potential investors. Most aren't even read in full. Their shortcomings tend to be obvious even in a two–page executive summary, largely because they are written before enough real work has been done to create a solid foundation."[1]

The above problem is not limited to small business start–ups. It can and does apply to new business opportunities within a large organization. The champion of a new opportunity acts like an entrepreneur that must get the necessary support from senior management and funding to move it forward.

But whether it is a small business or a large corporation, the solid foundation that is missing from these business plans can often be traced to various implied assumptions the plan makes regarding the future. These assumptions, or underlying premises, are unstated and difficult to detect, but can be critical to the plan's success.

Unfortunately, entrepreneurs may not even realize their business plans contain these unstated premises. Most people view the future with a filter that is heavily influenced by present circumstances. Their perception of future trends is based on recent past experience. They paint the future picture with broad strokes, ignoring many of the details. Important factors are glossed over or simply not addressed. In our personal lives, these tendencies lead to dissatisfaction and unhappiness because the future, when it arrives, is not what we had expected and hoped for.[2] In business, these tendencies not only ignore risk that is inherent in an uncertain future, but may create additional risk. Not only are entrepreneurs unprepared to manage as conditions change, their actions may be counterproductive.

Thus, to add a solid foundation to their business plans, entrepreneurs must identify and challenge the underlying assumptions. They must also include recognition that the future has many possible outcomes and show how the business can be managed through each of these possibilities. A successful entrepreneur does not just "assume the risk for a business venture," they also *manage the risk of a business venture*. Viewed in this way, risk management is an opportunity for the entrepreneur, as opposed to a mundane task that distracts from, and imposes limitations on, the core business function. Risk–managing entrepreneurs will improve their likelihood of survival and produce more nimble organizations that can quickly respond to changes in the business environment.

The Risk–Managing Entrepreneur

What does it mean to be a risk–managing entrepreneur? For that matter, what does it mean to be a risk–managing enterprise? As noted previously, the human tendencies to project from the past and to gloss over details are not just found in the new business plan of an entrepreneur. They can also be found in the business plans of large organizations. In fact, these same tendencies can be found in the day–to–day management of large and small businesses alike. A key factor in precipitating the recent financial crisis was an implied assumption that future trends (e.g., housing prices) would continue on their historic (upward) course. Also, it appears that management in many financial institutions did not understand the complexities and interrelationships of various components of their business.

Were these institutions managing risk? From the outside, it would appear they were not, even though many of these same banks and insurance companies have an enterprise risk management (ERM) program in place. Therein, perhaps, lies the problem; ERM is not a "program," it is a process, an algorithm. Just as the scientific method is an algorithm for testing a hypothesis, ERM is *a process for managing risk*. Organizations may build an ERM program in order to implement the process, but the two should not be confused.

The lesson for the entrepreneur is that ERM, as a process, is scalable; it can provide a useful risk management approach for businesses of any size. ERM as a process does not need to be based on a large and expensive program with its own department and chief risk officer. The risk–managing entrepreneur, then, is one who incorporates an ERM process into day–to–day management, beginning with the development of a business plan. The risk–managing enterprise also incorporates ERM into the day–to–day management of the business. It is not simply a narrowly focused risk control program that sits outside of the management process.

Understanding Your Business

The entrepreneur who incorporates ERM into business planning will discover that ERM is not simply about controlling risk to the organization, although that is a primary focus. At a broader level, ERM means *understanding your business*. This statement may be difficult for an entrepreneur to accept, since it would seem axiomatic that entrepreneurs understand their own business. And they are very knowledgeable, perhaps expert, in the product or service they propose to bring to market. But understanding your business goes beyond this knowledge. The lack of a "solid foundation" in business plans, as noted above, demonstrates that many entrepreneurs have a poor understanding of the entire business *system*.

ERM provides this understanding by forcing systems thinking into the planning process. Before you can control risks, you need to analyze them. Before you can analyze risks, you need to know what risks exist. Before you can identify risks to the enterprise, you need to understand, at a detailed level, how the business will operate and the competitive and economic environment surrounding it. Understanding the business system means understanding all of the complexities, interrelationships, and feedback mechanisms, both internal and external, inherent in any business organization.

Understanding the system then leads to risk identification, risk analysis, and, ultimately, risk control or management. But again, this process should not be viewed narrowly. The ERM process adds flexibility to the business plan and the entrepreneur is better prepared to respond as business conditions change. All of this will be viewed favorably by potential investors. Clearly it makes their investment more secure, which has value. In addition, as key decision points in the start–up process are identified, various options to respond (expansion, contraction, etc.) can be prepared in advance. As with financial options, these real options have value.[3]

A Solution Looking for a Problem

Some have called ERM "a solution looking for a problem." This is like saying the scientific method is an algorithm looking for a hypothesis. ERM does not need to look very far to find a problem that it can solve. Normal management practices have been shown time and again to be insufficient in controlling operational and other types of risk within an organization. They are insufficient because of the human tendencies described above. ERM exposes the unsupported assumptions these tendencies hide in a business plan and subjects them to analysis and testing. This leads to development of strategies for managing the new enterprise in an uncertain future. An entrepreneur's business plan can only improve when applying this solution.

[1]Why Business Plans Don't Deliver. *Wall Street Journal*, June 22, 2009.

[2]Gilbert. Stumbling on Happiness. 2006.

[3]Copeland et.al. Financial Theory and Corporate Policy. Ch. 9, "Multiperiod Capital Budgeting Under Uncertainty: Real Option Analysis."

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