Creating growth from effective opportunity risk management

By focusing on the downside of risk, companies can overlook opportunities that provide significant possibilities for organizational innovation and new competitive advantage.

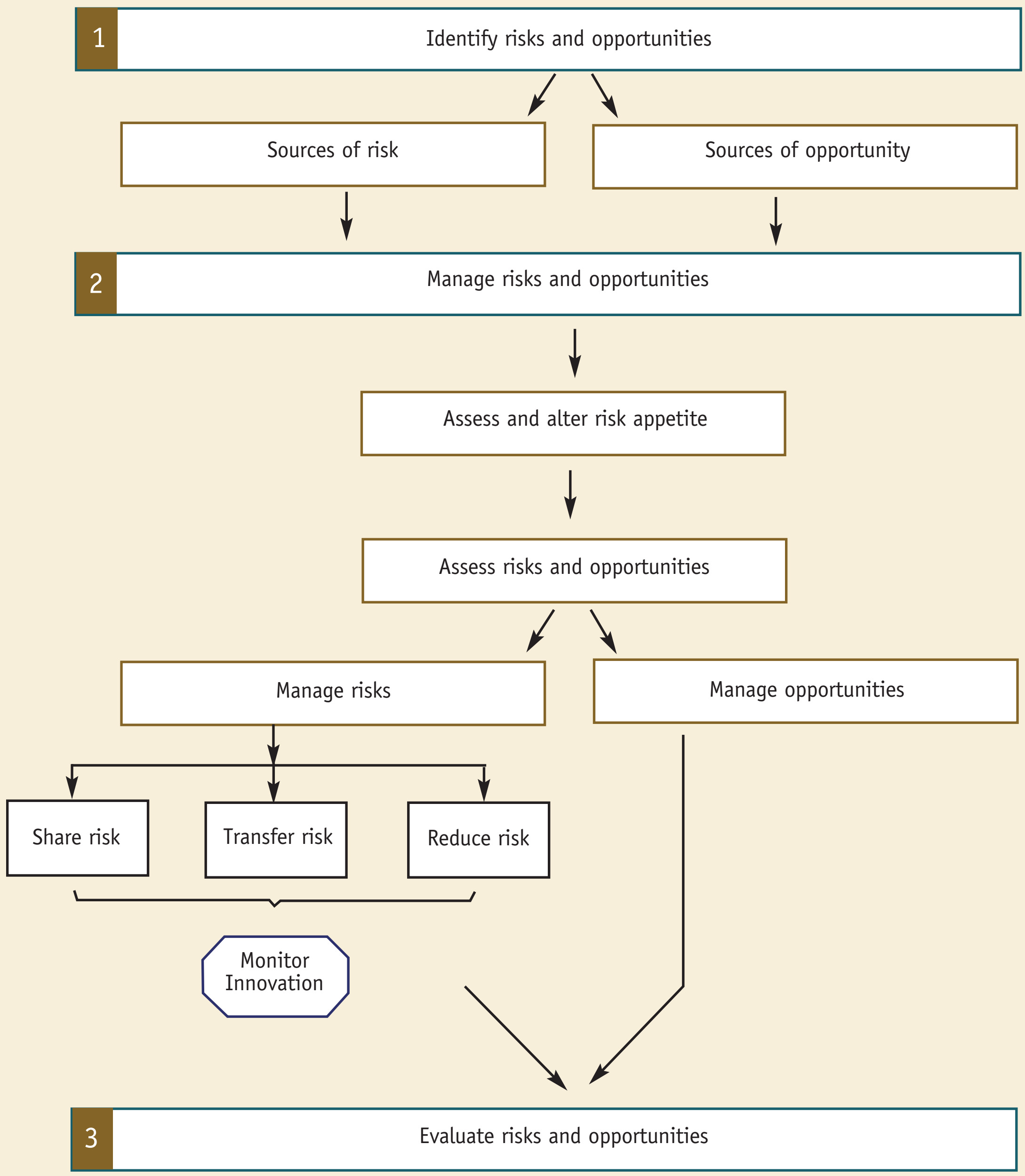
By Tamara Bekefi, Marc J. Epstein and Kristi Yuthas

When General Electric (GE) launched Ecomagination, its commitment to addressing environmental challenges, it recognized an opportunity where many others only saw risk. While others were litigating and lobbying to avoid liability, GE captured opportunities from concerns about the environment by developing products ranging from energy efficient compact fluorescent light bulbs to hybrid locomotives. Ecomagination is a business strategy driving growth — current revenues from this program already exceed $12 billion annually, and GE is not alone — many companies are discovering opportunities in, and making money from, issues traditionally seen as too risky.

By focusing on the downside of risk, companies can overlook opportunities that provide significant possibilities for organizational innovation and new competitive advantage. The reality is, risk and opportunity are two sides to the same coin — and both require attention by those who want to survive and thrive in the current business climate. By knowing how to recognize, manage and innovate around risk, a world of opportunity is available to companies.

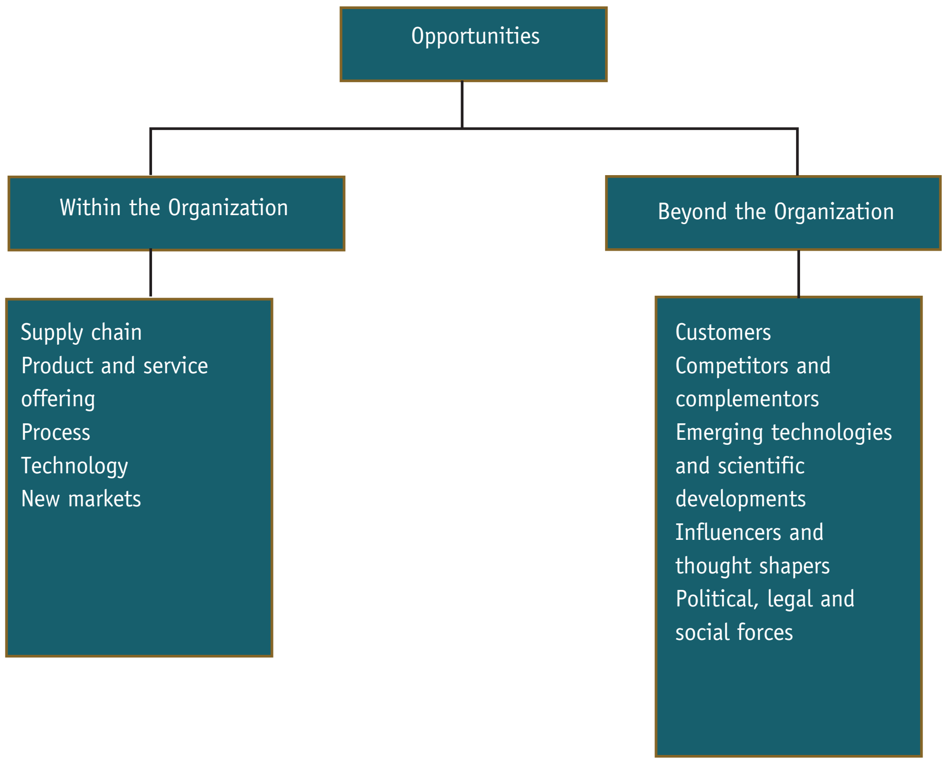
Consider Kinepolis, a Belgian movie-theatre operator that entered the market in 1997 when cinema audience numbers were in decline

Exhibit 1: Risk & Opportunity Management Process[1]



and cinema operators across Belgium were closing down. The first Kinepolis theatre opened on the ring road outside of Brussels — a location challenging the conventional wisdom that movie theatres needed to be centrally located to capture foot traffic and spontaneous movie watchers. Kinepolis also entered the market when most observers believed that a movie theatre could not be a successful business proposition. The world's first megaplex, with 25 movie screens and 7,600 seats, provided superior screens, sound, and seats, the latest movies, and free parking in a city notorious for its high parking cost and scarce parking in the downtown area. Kinepolis achieved spectacular growth, capturing 50 per cent of the market in Brussels in the first year, expanding to France, Spain, Poland, and Switzerland, and posting a 14.6 million Euro profit in 2006. It created a profitable business opportunity where others only saw certain risk of failure.

Exhibit 2: Sources of Opportunity[2]



Central to opportunity management are financial professionals who create and design systems to measure and achieve key performance indicators. The risk and opportunity management process (Exhibit 1) provides a model with tools and techniques to foster and manage innovation within the risk management context for improved decision making. This model builds on the knowledge and systems already employed from using COSO and other risk management tools to focus on risks and opportunities to create growth and innovation.

1. Identifying opportunities

Opportunities can arise from areas within the organization, and externally as illustrated in Exhibit 2. Internal sources of opportunity include supply chains, how a company structures itself, partners with other entities, and operates to deliver its products and services. Technological innovation around new products and services, or changes to existing products and services, such as mobile phones and software is another source. Identifying ways to source products differently from new markets, serve new geographies or new consumer groups can be another supply of opportunities. Procter and Gamble offers its high-end Pantene shampoo products in two-cent single serve packets for sale in India and China targeted at a low-income population, seeing this new market as a huge growth potential and revenue base.

Beyond the organization, sensitivity to customer needs or trends can open a fountain of opportunity. Companies that focus on shifts in customer behavior and their needs can sometimes anticipate changes and innovate to meet needs before the competition. Coach, the designer bag company, realized this. Coach began designing small wrist wallets that appealed to young women who wanted to go clubbing, which broadened the company's customer base beyond its traditional target of mature women.

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Developing a sensitivity to what competitors avoid because of perceived insurmountable risk can also yield opportunity. Identifying the ways in which your organization is better equipped to deal with these issues than the competition can unlock opportunities. Opportunities can be found in the political, legal and social landscape in which business is conducted. For example, concerns over climate change have led many companies to develop "green" products or processes to meet consumer demand and respond to regulatory pressures in Europe, Canada, and the United States.

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The giant retailer, Wal-Mart, which has the second largest truck fleet in the U.S., has barred drivers from idling while loading and unloading their cargo. As a result, the company is reducing greenhouse gases by 100,000 tons a year and saving itself $25 million in the fuel that it took to keep those trucks idling. Each organization should establish its own list of opportunity sources that are most relevant to its businesses and operating environment.

Strategies for identifying opportunities

A number of strategies exist to help identify new opportunities and to give consideration to those that have been neglected because of perceived, but unexamined, risk. Some of these strategies include:

Learning from the past: While past experience cannot necessarily be a predictor of future performance, signals that were ignored, missed opportunities, and business surprises can provide insight into organizational blind spots.

Customer sensitivity: Trying to understand customers in a way that the competition does not, and creating systems to exploit this information, can lead to great gains.

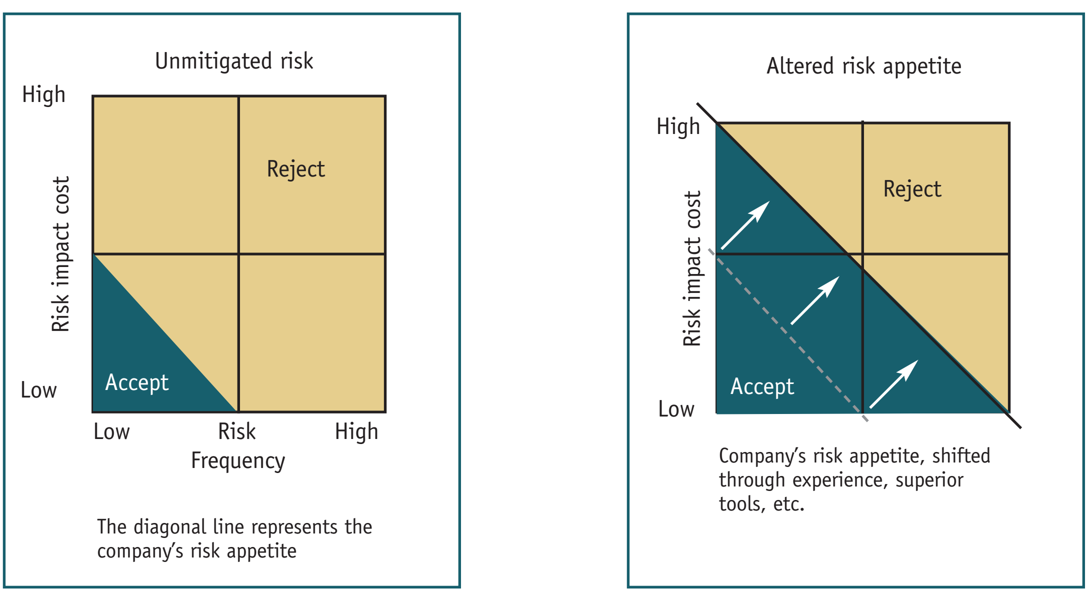
Learning from others: The adage, "A wise person learns from experience, but a wiser person learns from the experience of others," holds as true in business as it does in life.

Scanning: Active scanning of the business environment, potential competitors, or rival technologies is critical to successfully seizing opportunities and combating risk.

Scenario planning: Once mainly the domain of crisis management teams, scenario planning is a powerful tool for generating new ideas.

Identifying the market gaps and change the game: Instead of continuously trying to compete with other

Exhibit 3: Risk Appetite Tolerance[3]



businesses in one's category, identify where there are gaps in the current industry model, different customers to serve, or a complimentary products or services that holds value can spur innovation.

Idealized design and competing in advance: As in chess, business strategizing by projecting to an imaginary future and moving back to the present allows for free thinking without constructing impediments to potential breakthrough ideas.

Market sensitivity: Recognizing where and how the market is changing and moving quickly to adapt can hold a key to innovation.

Financial professionals play a critical role in risk and opportunity identification because they are responsible for developing a process for identifying and categorizing these factors within a framework that includes financial evaluation. To ensure rigour from the outset, financial professionals should be involved at the strategic planning stage to ensure that major changes are being considered within such a framework.

2. Managing opportunities

Assessing, and potentially altering, the organization's risk appetite is a first step in managing opportunities related to risk. A company's risk appetite is heavily influenced by its culture and changes over time. Risk appetite should be defined and agreed upon at least annually, and ahead of assessing individual risks and opportunities.

Sometimes shifting risk appetite is necessary to capturing opportunities. This shift can be accomplished by developing the capacity to accept more risk, thereby shifting the risk appetite boundary in Exhibit 3. There are a variety of ways to alter risk appetite including improving organizational learning, using networks for increased learning, expanding the time horizon, and expanding the breadth of stakeholders considered in the analysis.

Improving organizational learning: Developing the ability to learn from effective and ineffective risk experiences, and incorporating this learning into control system policies and procedures, can help organizations increase their risk appetite. This can be done through building a corporate knowledge base and regularly improving business processes.

Using networks for increased learning: Incorporating stakeholder knowledge and management strategies into learning systems leads to a larger pool of knowledge to tap, both for risk mitigation and for innovation design. Gathering this information can also foster more support and trust from a wider network. For instance, the advisors who can give insight into socio-political risk can also be a good resource for testing ideas about innovations in less stable markets.

Financial professionals — including risk officers, financial officers, and internal auditors — play a key role in supporting the organization's risk management philosophy by promoting compliance with risk appetite, managing risks within their areas of responsibility, and analyzing and reporting risks. Once the risk appetite is determined, the organization must assess the risks and opportunities that have been identified and decide on a response to capitalize on opportunities and identify countermeasures to mitigate the risk.

Innovation's role in managing opportunities and risk

Companies that can identify and seize opportunities, often where others only see risk, often do so through innovation. Innovation can include a break-through idea that leads to a winning product, like the iPod. Product innovation catapulted Apple from a boutique computer maker into a multi-platform company that changed the rules of the game for three industries: PCs, consumer electronics and music. Innovation can also be a new model of doing business in a seemingly saturated market, like the theatrical circus Cirque du soleil.

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While Ringling Bros., Barnum & Bailey and other smaller circuses were busy competing with one another for an ever-shrinking market, Guy Laliberté and Daniel Gauthier recognized that audience taste was shifting away from the traditional big top shows.The two street performers innovated to create a hybrid circus/theater that has been viewed by over 60 million people in 90 cities globally with an annual revenue topping well over half a billion U.S. dollars. Laliberté and Gauthier changed the very definition of the circus and with it, the market.

Innovation is a key component of capturing opportunity from taking or managing risk as depicted in Exhibit 1, the "Risk and Opportunity Management Process." Once an opportunity has been identified, the process of moving the idea to market requires an innovation system. Contrary to popular belief, innovation is not just having a good idea at the right time, it is a system to improve the likelihood that these ideas will flourish within the organization and will lead to market success. Innovation systems are aided by established policies, procedures, and information mechanisms that facilitate the innovation process within and across the organization.

Financial professionals play a critical role in the creation, implementation, and smooth operations of an innovation system. They are charged with creating structures, measures, and incentives and rewards systems that keep the innovation system streamlined and goal-oriented rather than diverging into innovation for the sake of innovation. Financial professionals are also in the unique position of including both risks and opportunities in financial calculations for more rigorous project planning and corporate strategy.

3. Evaluating opportunity through ROI and other methods

Evaluating is the final step in the process of managing opportunities that have been identified as both aligned with corporate strategy and viable within the organization's structure. Some evaluation methods can be more informal than others, yet it is critical to evaluate opportunities for inclusion in financial calculations for more effective appraisals. This can be done in a variety of ways, including expected profits, expected value added (profits minus the cost of capital involved in developing and running the opportunity project), or common measures such as ROI.

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ROI, including NPV calculations modified to include real options theory, is our recommended method of evaluation. This allows for both flexibility in investment appraisal options and for the inclusion of the costs of risk mitigation actions that can be central to capitalizing on opportunities. Real options are a complement to, and an extension of, traditional NPV calculations and should be included as a step in the application of the ROI method. A modified ROI calculation that includes real options is a seven-step process that includes:

1) Generating options using real options thinking;
2) Estimating the opportunity benefit;
3) Evaluating the costs inherent in capturing the opportunity (including required risk mitigation activities);
4) Estimating the probability that the risks needing mitigation will actually emerge;
5) Calculating the expected impact/value of the risk;
6) Calculating NPV of the opportunity and the risk;
7) Calculating the expected value of the ROI.

Like other estimates used in financial analysis, these estimates do have limitations. However, through proper estimating and disclosure, they certainly aid managerial decision making. Assumptions made in quantifying risks and opportunities should be included as a footnote or appendix to the modified ROI analysis.

In today's business world, risk poses threats, but also provides opportunities to create new competitive advantage and ways to satisfy customers. In order to realize these benefits, risks and opportunities must be evaluated and handled within a system that adequately identifies, quantifies, and mitigates them. Financial professionals play a critical role in this process, lending their expertise at every stage. Such a robust treatment of risk and opportunity enables organizations to capitalize on their risk and innovation management expertise to identify and capture opportunities that can help them to beat the competition. ■

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This article is based on "Managing Opportunities and Risks," a management accounting guideline written by Tamara Bekefi, Marc Epstein and Kristi Yuthas and published by CIMA, the American Institute of Certified Public Accountants and The Society of Management Accountants of Canada.

1 Bekefi, Tamara, M. J. Epstein, K. Yuthas. 2007. "Managing Opportunities and Risk." Jointly published by Chartered Institute of Management Accountants, Society of Management Accountants of Canada and American Institute of Certified Public Accountants.

2 Bekefi, Tamara, M. J. Epstein, K. Yuthas. 2007. "Managing Opportunities and Risk." Jointly published by Chartered Institute of Management Accountants, Society of Management Accountants of Canada and American Institute of Certified Public Accountants.

3 Basic diagram sourced from: Ballou, Brian and Dan Heitger. (Winter 2005). A building block approach for implementing COSO's enterprise risk management – integrated framework. Management Accounting Quarterly. 6:2, p. 9.