Risk Management: Focus on These Three Areas

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Risk is involved in every aspect of life, but business leaders and entrepreneurs usually deal with a higher degree of risk than most people. Starting and managing a business is inherently risky, of course, and most business executives try to take prudent steps to reduce the risks inherent in running their enterprises.

There are many different types of risk involved in running a business. Following is a look at three of these risks and some suggestions for how to manage them.

1. Interest Rate Risk

Companies with variable rate debt (including senior corporate debt) face the risk of potentially volatile interest rates. While the U.S. has been in a historically low interest rate environment for the past several years, this can't (and won't) last forever. This makes now a good time to devise hedging strategies to manage your interest rate risk and lock in the current low rates for the long term.

Interest rate derivatives are a common tool used by many companies to help mitigate the risk of rising interest rates. Sometimes perceived as complex, derivatives at their core are relatively simple hedging tools that allow businesses and banks to exchange different forms of interest payments through a maturity date. There are three main types of derivatives:

Swaps — A swap converts a variable interest rate to a fixed rate, enabling you to possibly decrease your future interest costs and protect your margins. Swaps are the most common derivative used by middle-market companies.

Caps — A cap is basically an insurance policy against rising rates. It limits interest rate exposure by setting a maximum rate level (or cap) through a predetermined date.

Collars — Usually used in higher interest rate environments, a collar adds a floor to a cap by establishing a range in which variable rates can float.

2. Investing Risk

When investing corporate funds, business executives must strive to balance the competing interests of risk, liquidity and return. Maximizing return is important, of course, but this must be weighed against the need to maintain adequate liquidity so that funds are available to meet working capital needs. And both of these objectives must be considered within the context of managing risk.

The first step is to define your company's level of risk tolerance. Then you can make investment decisions that will result in the highest possible return within your defined risk parameters to protect capital, while also ensuring that you maintain adequate liquidity.

One way to achieve this balance is to create an investment policy statement that provides a framework for all of your investment decisions. It should include a statement of purpose, specific investment objectives,

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definitions of responsibilities and prudence, investment policy details, and guidelines for portfolio review and benchmarking.

3. Embezzlement and Online Fraud

During tough economic times like we've been facing in recent years, incidences of embezzlement and fraud tend to rise. Some employees who normally wouldn't consider stealing or embezzling funds engage in fraudulent activity when faced with dire personal financial circumstances. Internal fraud can take many different forms, including check tampering; skimming; cash larceny; and expense reimbursement, billing and payroll schemes.

The best way to guard against internal fraud is to make sure that you have implemented solid internal controls. These include segregating financial duties among several different employees, ensuring proper oversight of all business financial activities, using bank anti-fraud services like Positive Pay, and establishing a fraud hotline so employees can report their fraud suspicions anonymously.

Online fraud and cybercrime is another growing risk faced by business executives today. In fact, cyber-thieves are increasingly targeting business computers, since the potential rewards are often greater than they can reap by targeting individual computers. Two types of business cybercrime have emerged as particular threats: Man-in-the-Browser and Man-in-the-Middle attacks, in which cyber-thieves intercept and modify information sent between parties (including businesses and their banks) while it is in transit. Using this information, they create fake transactions, manipulate transactions in process, and hide these activities by altering users' computer screens.

The best way to guard against cybercrime is often simply to use some common sense. For example, don't click on email links or open attachments from unknown senders. Be especially careful about emails that appear to be from your bank, as cyber-thieves have become adept at "phishing" schemes that send fake bank emails to employees asking for sensitive corporate information. And diligently guard all corporate passwords, user names and security tokens.

Concluding Thoughts

Now is the time for Los Angeles and Southern California business leaders and financial executives to take a close look at their risk exposure in each of these areas and formulate concrete strategies like those discussed here to mitigate their risks. An outsourced CFO services provider can offer invaluable assistance in this area by helping you pinpoint your specific areas of risk and then devise strategies to manage them.

About CFO Edge

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