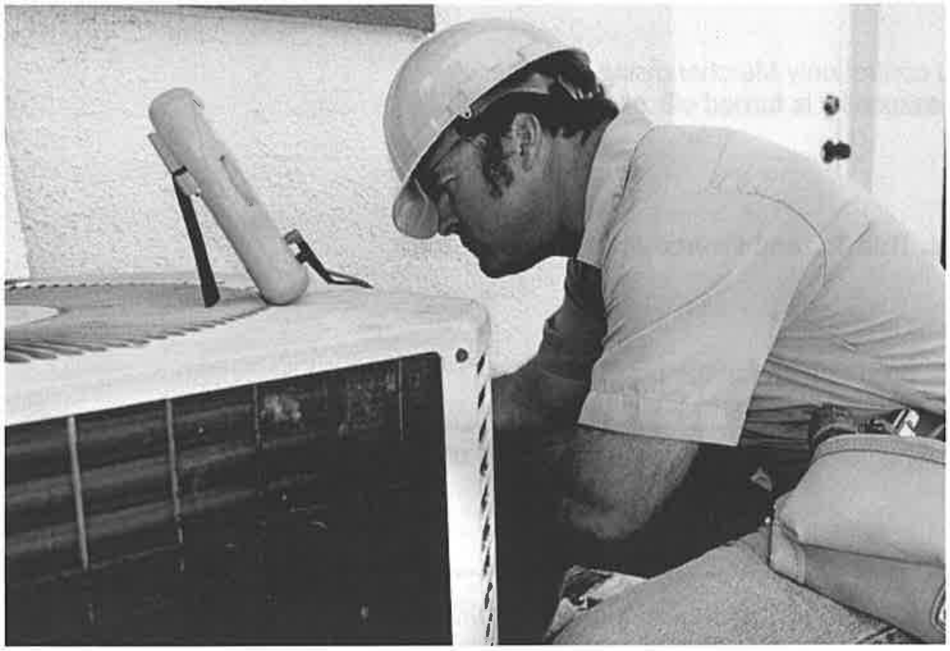
Risks and Surprises

LESSON 13



What is a Business Risk?

There are risks associated with most activities that people engage in, and running a business is no exception. A business risk involves circumstances that can threaten financial loss or failure. It is important to recognize potential risks and to handle them in a way that has the least negative impact on the business.

Risk Management

Business risks cannot be eliminated entirely, but there are actions retailers can take to help decrease risks to a business. Risk management is the process of dealing with risks that minimizes financial loss for a business.

Types of Business Risks

Most business risks fall into one of three categories: economic risks, human risks, and natural risks.

Economic Risks

Economic risks are caused by changes in the business climate. One economic risk can be a downtrend in the national economy. This can make it more difficult to obtain loans. Economic downtrends can also cause customers to cut back on their spending. Retailers must be watchful of changes in customer buying patterns. During these times it may become necessary to fine-tune inventory levels and trim expenses.

Main Idea

The material in this unit deals with the subject of business risks and how to manage them. We will study the types of risks a business faces and review some of the ways a retailer can handle these risks. We will then review some mathematics associated with business risks.

After completing this lesson you will be able to:

- Give examples of the three main types of business risk - economic, human, and natural
- Describe the elements of an effective risk prevention plan
- Explain the different types of insurance and calculate the cost of premiums
- Compute merchandise losses based on book value, inventory value, and sales over time
- Weigh each of the following in terms of financial impact: on-demand repair calls, extended product warranties, and service contracts

Key Terms

- Business Risk
- Risk Management
- Economic Risks
- Human Risks
- Natural Risks
- Insurance
- Property Insurance
- Liability Insurance
- Warranty

COMPUTER EXERCISE **LESSON 12**

Advanced Merchandising

GOAL: Your goal is to design a store that generates the maximum profits. You have complete control of what type of fixtures you lease, where you locate them, and how you place goods on them.

YOUR SITUATION: In this lesson, you control only Merchandising. All other Actions are controlled for you. Note: Seasonality is turned off; all products sell evenly throughout the year.

Part A

1. Run the **Merchandising**, **Products**, **Run To**, and **Financials** sections of the **Tutorial**.
2. Open the **Advanced Merchandising** lesson.
3. Open the **Products** report. Uncheck **Total** and check the boxes next to **Generic Cola**, **Primo Cola**, and **Bolt Cola**. Click **Table** under **Show As**.

QUESTION 1: Which is your worst selling cola? What are the weekly sales of that cola?

4. You've been visited by a slushy rep. He says you'll increase sales and profits by adding a slushy machine. You agree to give it a 3 week trial.
5. Replace the fixture containing your worst selling soda with a slushy machine. Using **Options->Run To**, run the simulation to February 5th.
6. Use the **Products** and **Financials** reports to fill in **Worksheet 1**, use the date from the most recent week. To find the COGS for slushies open the **Products** report, click **Table** under **Show As**, uncheck **Total** and check **Slushies**, then click **COGS: Actual Sales** under **Data**. To find the cost of the slushy machine open the **Financials** report, click **More Detail**, and look under **Equipment Costs/Fixtures**.

QUESTION 2: Was the slushy machine more profitable than the soda that it replaced? By how much? Should you keep the slushy machine?

Part B

1. Continuing with your simulation, try to layout your store to make a weekly profit of $8,000 or more. The customer base of your store is mostly students, with a few business people and almost no seniors. Consider customer demand, cost of fixtures, and buying patterns in your decision.

2. Print out the store layout that achieves your highest weekly profit.

WORKSHEET 1

Slushy Sales	Slushy COGS: Actual Sales	Slushy Gross Margin	Cost of Slushy Machine	Slushy Contribution to Profit in Dollars

Another economic risk retailers should avoid is holding onto merchandise that is outdated or obsolete. Once merchandise is no longer relevant or useful, customers will not want to buy it. Thus retailers must remain knowledgeable about trends and new products in their industry in order to keep their inventory updated and desirable. Other economic risks can include changes in competition, customer demographics, or customer lifestyle, which can have a profound influence on marketing.

Human Risks

Human risks include people who are dishonest, careless, or responsible for human error. These risks can be categorized as security risks or safety risks.

Some security risks are:

- Customer Risks—Theft by customers includes shoplifting merchandise, merchandise return fraud, writing bad checks, and credit card fraud.
- Employee Risks—Employee theft includes stealing merchandise or cash or taking advantage of discounts. Employees also pose risks to businesses through carelessness and error. Errors made while checking in new merchandise, recording inventory records, or improperly recording markdown information are all sources of potential loss for retailers.
- Vendor Risks—Vendor risks include vendor errors in shipments like sending the wrong merchandise or the wrong quantities of merchandise and are another source of potential loss for retailers.
- Computer Risks—Computers are vital to retailers, but can also pose risks. Computer viruses can destroy business records in a very short amount of time. Computer hackers, who breech security to make unauthorized entry into business data, are another risk for retailers.

Safety risks can threaten both customers and employees and can cause accidents. Accidents can result from poor maintenance both inside and outside a store. Merchandise displays should be constructed so that they are stable and unlikely to collapse. If a store sells perishable items, proper care should be taken to ensure their proper handling and storage.

Natural Risks

Natural risks include those caused by acts of nature. Natural risks many businesses often face are earthquakes, fires, floods, hurricanes, landslides, and tornadoes. Events such as these have devastating consequences that affect many people. They can cause a business to be closed for days or weeks and can also ruin a store's entire inventory.

There are other risks classified as natural risks even though they may be caused by people. Some of these include power outages, riots, terrorism, and arson. These events can have some of the same consequences as other natural risks.

Handling Risks

There are steps retailers can take to help protect a business from the various types of business risks. Risk prevention and risk transfer are two ways of handling risk exposure.

Risk Prevention

Business risks can be decreased greatly by pre-employment screening of job applicants and training of employees once they are hired. Pre-employment screening includes checking an applicant's prior employment and references. This screening can also include background checks. Employee training consists of employee orientation and periodic training. These measures are especially effective in helping reduce the risks of shoplifting, employee theft, bookkeeping errors, and errors from vendors.

Computer risks can be reduced by the installation of virus detecting software, the use of passwords, and training employees about the proper use of company computers.

Safety risks can be decreased greatly by providing a safe workplace and by training employees in job safety. Teach your employees about accident prevention and the safe handling of potentially dangerous products or materials. All employees are guaranteed a healthy and safe work environment through the Occupational Safety and Health Administration (OSHA), which is a federal agency that sets the standards for workplace health and safety. OSHA has the authority to enforce its guidelines through worksite inspections and can issue fines to businesses that do not comply with its safety standards.

Risk Transfer

Risk transfer describes the process of giving the responsibility of dealing with certain business risks to another business. This is generally accomplished through the purchase of insurance or warranties.

Insurance is an agreement between an insurance company and a business for coverage of a particular business risk in exchange for a specified amount of money. Businesses usually purchase at minimum property and liability insurance. Property insurance is purchased to protect a business from losses and damage to buildings, equipment, fixtures, and merchandise. The extent of the insurance protection depends on the type of policy purchased. Liability insurance is purchased to protect a business from risk exposure due to injuries or property damage sustained while on business property. Insurance can be purchased for many types of protection. Before purchasing insurance, retailers should comparison shop for different types of coverage and note any exclusions from coverage between policies.

A warranty is a guarantee by a manufacturer that a product will provide certain levels of quality and performance. Manufacturers normally provide warranties for a specific period of time that contain limitations and exclusions. Extended warranties are sometimes available for a small cost at the time of purchase of fixtures or equipment. They should be evaluated considering the cost and likelihood of service calls.

Many retailers purchase service contracts for their equipment. A service contract is an agreement between the retailer and the equipment dealer that covers routine, preventive maintenance and specific repairs to equipment. Some service contracts will also provide coverage for certain replacement parts. Service contracts offer the retailer assurance that store equipment is operating properly. Service contracts are usually a good buy, but the retailer should evaluate the cost by considering the price of routine maintenance, repair costs, and the cost of business lost due to equipment failure.

Summary

In this unit we have learned about business risks and how to manage them. We have also learned about the types of risks faced by businesses—economic, human, and natural. We discussed some of the ways a business can handle risks. Lastly, we reviewed some of the mathematics dealing with business risks.

Key Math Concepts

COMPUTE THE COST OF PREMIUMS PER MONTH

Insurance premiums are generally stated in cost per year.
To compute the cost of premiums per month, use this formula:

Annual Premium ÷ 12 = Monthly Premium

COMPUTE MERCHANDISE LOSSES

Merchandise losses are stated in a percentage of sales. To compute merchandise losses, use this formula:

Merchandise Loss as a Percentage of Sales = (Merchandise Book Value − Physical Inventory Value) ÷ Sales During a Given Time Period

Key Terms

Business Risk
A risk that involves circumstances that can threaten financial loss or failure.

Risk Management
The process of dealing with risks that minimizes financial loss for a business.

Economic Risks
Business risks caused by changes in the business climate.

Human Risks
Business risks that include people who are dishonest, careless, or responsible for human error.

Natural Risks
Business risks that include those caused by acts of nature.

Insurance
An agreement between an insurance company and a business for coverage of a particular business risk in exchange for a specified amount of money.

Property Insurance
Insurance purchased to protect a business from losses and damage to buildings, equipment, fixtures, and merchandise.

Liability Insurance
Insurance purchased to protect a business from risk exposure due to injuries or property damage sustained while on business property.

Warranty
A guarantee by a manufacturer that a product will provide certain levels of quality and performance.

Risks and Surprises

1. A furniture store has the following types of insurance coverage with the annual premiums noted: Inventory – $1,500, Building – $2,500, Auto – $3,000, and Overall Liability – $1,100. What is the total annual premium and the monthly premium for business insurance for the furniture store?

2. You have just purchased a large refrigeration unit for your convenience store at a cost of $25,000. The extended warranty on the unit, payable at the time of installation, is $1,000 for 10 years and covers service calls plus parts and labor. A local service call in your area averages $150. Assume you will need five service calls over the next 10 years. Is the investment in the extended warranty a good use of your money?

3. A local business wants to calculate merchandise loss as a percentage of sales. The business would like your assistance and has sent you the following information: the book value of the merchandise is $315,000 and the physical inventory value is $291,000. Both of these values are stated in terms of what the retailer paid (cost) for the merchandise. The average markup for the store is 42%. Retail sales for this period were $850,991. Compute the merchandise loss as a percentage of sales on the retail basis.

4. A local sporting goods store has calculated shrinkage of $18,000 on $750,000 in sales for the last quarter. An analysis has identified the following losses: inaccurate paperwork – $3,200: damaged or misplaced merchandise – $4,100. Calculate the total amount of shrinkage attributable to shoplifting or employee theft. Then compute shrinkage as a percentage of sales and what percentage of sales each area of loss accounts for.

WRITTEN EXERCISES **LESSON 13**

Risks and Surprises

1. Read the main news and business sections of your local newspaper. Make notes about what you have read that could pose potential business risks to local businesses.

2. New styles and trends forecasted for the future often influence the risk a business may have with its existing inventory. Research a retail category of your choice and identify a new consumer trend. Then identify the source of your information, the potential business risk exposure, and recommendations to affected retailers to minimize the risk.

3. Visit two types of local retail stores and identify potential safety risks both inside and outside each store. Describe your findings and recommendations you would make to each of the local retailers to reduce the safety risks.

4. Select a recent natural disaster that occurred in your local community or on the state or national level. Prepare a brief report that explains how the event affected business owners by placing their businesses at risk. Document your findings and any risk prevention measures that should have been in place to assist business owners in the recovery process.

COMPUTER EXERCISE

Risks and Surprises

LESSON 13

GOAL: Your goal is to learn to deal effectively with the inevitable surprises that occur in business.

YOUR SITUATION: In this lesson, you control all aspects of your store.

Part A

1. Run the **Purchasing**, **Service and Repairs**, and **Financials** sections of the **Tutorial**.
2. Open the **Risks and Surprises** lesson, choose **Sim 1**.
3. Run the simulation forward. Watch your messages. Stop the sim when you get a message.

QUESTION A1: What message did you get?

4. Continue to run the simulation foward.

QUESTION A2: What happened? How might you have been able to capitalize on this event to improve profits?

5. Reopen the simulation, and try different stategies to improve profits. Repeat this process trying to boost your revenue to $50,000 for the week ending January 28th.

QUESTION A3: What did you do to get your revenue up to $50,000?

Part B

1. Reopen the **Risks and Surprises** lesson, choose **Sim 2**.
2. Run the simulation forward. Watch your messages. Stop the sim when you get a message.

QUESTION B1: What major surprise has just occurred in your business? What are the possible consequences?