



## CRISIS AS A CONSEQUENCE OF THREATS IN THE HOLISTIC CONCEPTS OF RISK MANAGEMENT

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**ABSTRACT.** Critical situations seem to be a kind of a "natural" potential consequence of risks taken in business activities. Nevertheless, this issue rarely appears in contemporary concepts of risk management. The paper includes a review of various risk management ideas and standards, considering the way how the problem is taken into account within proposed frame structures of the risk management process. The legitimacy of reference to critical risk impact at the stage of risk analysis and assessment of the risk management process is also discussed.

**Key words:** risk, risk management, crisis, crisis management.

Both risk and critical situations jeopardising the continuity of business activity and maintaining the ability to achieve business goals are normal elements of the business game. The operating conditions of contemporary enterprises, both giant corporations and SMEs, demonstrate a distinctive growing tendency in terms of threats they need to face up to. At the same time, managers consciously take decisions which are laden with risk, striving to achieve a greater competitive advantage over their competitors or perceiving risks in the category of business opportunities. If a certain risk type materialises, it may set off a crisis, i.e. a situation where the achievement of the company's goals becomes seriously compromised or even impossible. Consequently, the importance of risk management and crisis management, two relatively new areas within the business management strategy, has been growing steadily. Their task is to lessen the likelihood of risk occurrence and reduce the scale of possible consequences of risk. Furthermore, they are supposed to prepare the company for confronting the crisis and pull it out of a critical situation as quickly and safely as possible. The aim of this study is to analyse selected standards of risk management not only from the viewpoint of striving to minimise existing threats but also taking into account a longer-term perspective which might involve a critical situation requiring direct and smooth transition from risk management to crisis management procedures. The section below outlines the concept of critical effects produced by threats and its application in risk estimation and assessment.

The relatively extensive literature dealing with causes and results of various disruptions affecting the operation of enterprises and supply chains, as well as business practice in this area, falls under one of two basic approaches to the problem of threats inherent in business activity. One of the approaches can be essentially equalled with concepts based on risk management (in all its versions and types), i.e. focused on analysing causes of disturbances. The fundamental feature of this approach, especially in a holistic framework, comes down to the philosophy of proactive influence on sources of

potential threats (referred to as risk factors) and preventive actions aimed at reducing the likelihood of unfavourable events and/or limiting their potential consequences. The other general trend, which can be loosely defined as crisis management (again with its broad array of types and variants), concentrates on potential consequences of business disruptions, preparing enterprises to face critical situations, sustaining business existence and restoring the capability to pursue business goals. By its very nature, the other approach is mostly reactive, as it prepares companies for taking appropriate actions when a critical situation arises.

Naturally, the two trends enumerated above are not contradictory (i.e. they cannot be considered as mutually exclusive alternatives), while sets of standard actions which both of them propose can in fact (depending on a particular concept) contain solutions that overlap and are, in a sense, mutually complementary. Having said all that, it needs to be noted that - in the general perspective - risk management and crisis management exist and develop independently of each other, almost without any shared conceptual, functional (not to mention procedural) elements. This state of affairs can be bewildering, especially that both intuitively and on the basis of the logic of these phenomena a critical situation experienced by a company is without doubt a simple, nearly immediate consequence of risks that the company takes. Meanwhile, literature devoted to risk management includes very scarce studies [e.g. Sadgrove K., 2005] dealing with aspects of crisis management. The single chapter (out of nineteen) of the work referred to above, focused on crisis management, emergency planning and restoration of business continuity, does not rest on any conceptual links with other chapters dedicated specifically to risk management. Discussing sources of critical situations, K. Sadgrove fails to relate them to the remaining sections of his study, such as the thoroughly discussed taxonomy of risk, using empirical data published by the Institute of Crisis Management that are completely unrelated to risk management processes. Problems associated with crisis management are in fact treated in a similar manner, as an autonomous issue [Zakrzewska-Bielawska A., 2008]. The majority of other authors essentially do not take up the problem of a causal relationship between risk and crisis within their proposed frameworks, procedures, methods and techniques of risk management.

General principles of organisation and risk management procedures are described most comprehensively in documents typically referred to as risk management standards. In this context, the term "standard" is to be understood as representing a set of principles and procedures which help to give structure to a certain issue, a type of a guidebook, not a technical norm that imposes any mandatory solutions. Chronologically, the first regulation of this type (with several amendments), still regarded by a number of practitioners as one of the best, is the Australian risk management standard [Australian/New Zealand Standard 4360, 2004]. The document, just like the majority of comparable standards, is limited to activities relating to risk management. The topic of organisations facing a potential crisis as a result of risk materialisation is not dealt with. The only reference to the possible jeopardisation of the organisation's goals is Note 4 to the definition of risk effects which contains the claim that they should be related to the problem of goal accomplishment. This, however, is not followed by an in-depth analysis of risks that might potentially produce a crisis or a formulation of criteria for the assessment of such threats.

A similar account of these problems is contained in the following standards: Canadian [CAN/CSA-Q850, 2002], British [BS 25999, 2006/2007] and the newest ISO standard due to be published in 2009 [ISO 31 000 (draft), 2007]. In the latter draft regulation, despite the general statement that "it is necessary to understand the internal context, in terms of, for example (...) policies, objectives and the strategies that are in place to achieve them", there are no references to any assessment of possible effects of risk in the context of the potential occurrence of a critical situation. These standards also fail to go beyond preventative actions and do not offer any functional references to a possible crisis.

The same holds true for other documents of this type. The Risk Management Standard [FERMA, 2002] contains a section devoted to risk estimation and assessment of potential consequences of risk including a simple classification into high, medium or low threats. Even though

their impact on the organisation's strategy and operating activities is accounted for, the standard only distinguishes between major, medium or minor consequences.

Finally, the most developed proposal of a risk management standard, COSO Enterprise Risk Management - Integrated Framework [COSO 2004], also fails to analyse the concept of a critical situation, even though its own definition of corporate risk management mentions "potential events that may affect the entity" and providing "reasonable assurance regarding the achievement of entity objectives". Presenting a sample description of potential consequences of risks, COSO focuses on their literal "technical" aspects only. Furthermore, while enumerating severity levels of risk effects referred to as "serious" or "catastrophic", the document fails to define any detailed criteria. The understanding of these categories is taken to mean current consequences, without being related to the underlying strategic goals (e.g. a serious decrease of production output - more than two days' production downtime).

Some works on the subject point slightly more specifically to the need to analyse reasonably precarious levels of risk consequences, without being limited to risks entailing the most potentially severe effects [Lam J., 2003]. Discussing a scenario analysis method in reference to an assessment of financial consequences of the October 1997 global stock market mini-crash, Lam points out that investigations of extreme events typically disregard the fact that there may be adverse events which do not trigger nearly as extreme consequences but are nevertheless much more likely to occur. Lam, however, does not explore this aspect in any greater detail and fails to define critical situations in this context. Similarly, Kaczmarek [2004] claims that "the basic problem in critical situation management is not risk as such, but a specific degree of risk. But does that mean a degree of risk that takes account of nothing or must fulfil certain conditions in a specific situation and circumstances?" Kaczmarek leaves the resolution of this problem to further research and analyses. Hopkin [2002] enters slightly deeper into the core of the problem by using the notion of "significant risk" which is defined as a risk potentially producing effects above the reference level and, as such, jeopardising the existence of the organisation affected by them. Machowiak [2008] explores the problem in a more organised manner by introducing the concept of critical consequence and standardisation of risk effects, and formulating threshold criteria based on the identifiable threat of a critical situation. Kaczmarek [2008] advocates the need of "early identification of threats, their monitoring and elimination to prevent the organisation from falling into a critical situation", however the claim (put forth in the context of feedback between risk management and corporate management) is very general. The topic is never explored in any greater detail. A very interesting account of issues discussed in this study is presented by J. Zawła-Niedźwiecki [2008]. For example, Zawła-Niedźwiecki asserts that safety and business continuity should be handled together. The claim, however, is rooted in a slightly different conceptual framework and uses different instruments than risk and crisis management.

All the documents and publications enumerated above share one fundamental feature. Across the entire spectrum of analysed threats, they do not give any preference to crisis-inducing risks (those with a potential to put an organisation into a critical situation). Likewise, in their proposed procedures and models of risk estimation and assessment, they fail to distinguish a critical level of consequences (potentially triggering a crisis) as an important threshold value requiring special treatment. The quality usually adopted to describe the consequences of possible threat materialisation, used for the purpose of estimating the measure of risk and defining its scope, is related to maximum possible risk consequences together with the corresponding likelihood of occurrence of such an event - cf. e.g. R. Rudnicki [2004]. The approach can be regarded as useful for analysing the potential scale of threats, however from the viewpoint of the possibility of an organisation falling into a critical situation and taking into account the risk of ignoring or underestimating possible consequences of a particular risk type, this framework seems inadequate, as it fails to reflect the actual extent of threat. A crisis within an enterprise is not necessarily an outcome of risks entailing maximum adverse consequences. In fact, companies often face critical situations at a much earlier stage, in response to risks that are markedly lower than the maximum possible levels. Risk estimation procedures based exclusively on maximum risk effects simply do not take such possibilities into account.

Assuming that the defining feature of crisis is the company's incapacity or substantial limitation of possibilities to achieve its goals, the critical level of risk consequences should be taken to mean an extent of risk effects above which a company plunges into a critical situation. If so, and if the level is assessed as being lower than the maximum, the stage of risk estimation and assessment should not only take into account the maximum extent of consequences caused by the risk (the parameter remains important and provides significant information about the risk) but it should also, or above all, consider the critical threshold level of risk effects. This approach is further supported by the fact that critical situations may be much more likely to occur than events resulting in maximum adverse effects (an observation made e.g. by J. Lam and also other authors, e.g. Machowiak [2007]). In this way, risk analysis can be enhanced and complemented with a very important element of threat evaluation, namely the following question: what is the probability for specific risks to become materialised and produce critical effects for the organisation (i.e. trigger a crisis)? This modified approach seems justified both from the viewpoint of the main objective of risk management, i.e. ensuring the safety of business activity, but also as an element of another function of the process, i.e. optimisation of decisions. An additional factor speaking in favour of the proposed approach is the fact that, as the arguments outlined above show, establishing hierarchies of threats and prioritising actions on the sole basis of the assessed extreme scope of potential threats might turn out to be faulty and incommensurate with the actual risk spectrum.

Complementing the risk estimation and analysis process with critical levels of effects caused by particular threats may prove beneficial from yet another standpoint. Within the framework of the risk management process, many sources suggest that, in addition to defining potential effects and the likelihood of occurrence of particular risk types, general quantities comprehensively accounting for the spectrum of risk and the extent of threat to the organisation should also be determined. The most frequently proposed parameter which makes it possible to specify a general risk level is the concept of "risk appetite", sometimes accompanied by other conceptually related notions of "risk exposure", "risk capacity", "risk tolerance" or, in Polish sources, "combined risk" and "total risk". Each of the concepts listed above refers to a slightly different aspect of the comprehensively understood state of threat faced by an organisation. However, what they all share is that they seek a certain "synthesis", or rather superposition, of different risks which make up a complete framework for analysing the problem on a scale of the entire organisation. For example, COSO [2004] defines risk appetite as "the amount of risk - on a broad level - an entity is willing to accept in pursuit of value". Hopkin [2002] defines "risk exposure" as the "sum total of risks in relation to values assigned to particular risk types". However, as Hopkin underscores, the problem is that most organisations fail to determine the value of acceptable risk. Likewise, they do not perform ongoing assessments of values affected by risk. The reasons for that are simple, Hopkin claims. There are no available tools that would make it possible to perform such tasks in the holistic risk management environment. The trend is most visible within the holistic approach to risk management where the "summing up" of risks is difficult or plain impossible (e.g. due to different measures of expression of risk effects). Having taken into consideration all aspects discussed above, it seems apt to propose a thesis claiming that the interpretation of concepts given above on the basis of critical levels of "individual" risks is a much better representation of actual risks than an analysis of maximum levels of risk consequences. A simultaneous standardisation of risk effects will enable a marked reduction of technical difficulties involved in their practical application.

Summing up, despite suggestions and references contained in some published sources, the process of risk management in its current form imposed by existing risk management standards is very poorly related to the prospect of occurrence of critical situations stemming from risks taken by an organisation. There are a number of possible consequences of ignoring this aspect. On the one hand, it results in imperfect and potentially erroneous outcomes of risk estimation and analysis. On the other, it produces a certain conceptual and procedural incoherence coupled with qualitatively inferior results of the entire process (which in turn translates into being worse prepared to face the crisis). Accordingly, it seems desirable to expand the programme of actions at the stage of risk estimation and analysis with elements of in-depth analysis of critical threats that would make it possible to isolate those risks which, if they occur, might induce a crisis, and determine their potential effects: not only extreme but also critical (along with corresponding probability levels). This category of risks would require

a special course of action at further stages of the risk management process, e.g. development of variant-based situational scenarios, more precise monitoring (together with early warning signals), special methods of risk limitation etc. and development of procedures for smooth transition into crisis management.

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## KRYZYS JAKO KONSEKWENCJA ZAGROZEŃ W HOLISTYCZNYCH KONCEPCJACH ZARZĄDZANIA RYZYKIEM

**STRESZCZENIE.** Sytuacje kryzysowe wydają się być naturalną potencjalną konsekwencją ryzyka podejmowanego w działalności gospodarczej. Pomimo to problematyka kryzysu rzadko występuje w ramach współczesnych koncepcji zarządzania ryzykiem. Przedmiotem pracy jest analiza różnych standardów i koncepcji zarządzania ryzykiem pod kątem uwzględniania w proponowanych przez nie ramowych strukturach procesu zarządzania ryzykiem kryzysu, jako możliwego następstwa zrealizowania się ryzyka. Omówiono także zasadność odniesienia się do krytycznego skutku zagrożeń na etapie analizy i oceny ryzyka.

**Słowa kluczowe:** ryzyko, zarządzanie ryzykiem, kryzys, zarządzanie kryzysem.

## **KRISE ALS KONSEQUENZ VON GEFAHREN IN HOLISTISCHEN RISIKOMANAGEMENTKONZEPTEN**

**ZUSAMMENFASSUNG.** Krisensituationen scheinen natürliche Konsequenz des Geschäftsrisikos zu sein. Trotzdem tritt diese Problematik in den gegenwärtigen Konzeptionen des Krisenmanagement selten auf. Der Gegenstand des Artikels ist die Analyse verschiedener Standards und Risikomanagementkonzepte in Hinblick auf die Berücksichtigung der Krise in den Rahmenstrukturen des Risikomanagement-Prozesses als mögliche Folge des Risikoauftritts. Es wird auch die Stichhaltigkeit des Bezuges auf die kritische der Gefahren auf der Etappe der Analyse und Risikoabschätzung erörtert.

**Codewörter:** Risiko, Risikomanagement, Krise, Krisenmanagement.

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