



# Risky business

While business might accept that the value of their intellectual capital far outweighs the value of their physical assets, all too often they don't have a plan in place to manage the loss of key people, says Cecilia Farrow.

In January this year, Apple CEO Steve Jobs announced he was taking leave due to poor health. The analysts predicted that the market would crucify Apple's share price—within a month it had dived a punishing 10 percent.

About the same time, New Zealanders awoke to the news that Infratil boss Lloyd Morrison was stepping down from the helm of some of his key boards to focus on his battle with leukaemia. It left the market wondering who was going to fill the void.

And just last month, Kiwis were shocked to hear of the deaths of Te Papa chief executive Seddon Bennington, who was caught in severe weather while on a weekend tramping trip, and Tim Mackay, president director of Holcim Indonesia cement company, who was killed in a bomb blast at the Marriott Hotel in Jakarta. Two organisations, one here and the other in Indonesia, are now dealing with the repercussions of the sudden loss of a key person.

## Organisational 'glue'

A 2007 survey of 282 CEOs of international companies, published by the Economist Intelligence Unit, found that human capital risk was the risk of second greatest concern reported by respondents, next to reputational risk. Interestingly, the CEOs also reported difficulties in measuring and managing this risk.

Businesses of any size can be exposed to human capital risk. The key impacts can be the loss of organisational 'glue', the loss of intellectual capital, and a reduction in profit as costs increase and revenue falls.

Although many of us would accept the statement from the Ministry of Economic Development that the value of a firm's intellectual capital far outweighs the value of its physical assets—such as its buildings or equipment—very few have a structured plan in place to manage the loss of the key people in the business. Almost all businesses, however, have risk management for fire or plant failure.

### Case study

The issues that arise from human capital risk are often best explained by looking at real situations and then applying that learning to other organisations.

Let's take Company A as an example. It's a well-established, privately owned enterprise in the high tech sector. It employs 120 people with offices in two main cities. Turnover exceeds \$20 million pa. The founder is the majority shareholder and, until recently, he was the CEO. The company has a formal board with independent directors.

As part of Company A's succession strategy, an external CEO was appointed. It took six months to locate an appropriate person. The founder, however, still has a substantial role in the company, especially in the development of the international growth strategy. He has also funded much of the capital needs of the business so there is a substantial debt owing to him.

The board sought professional advice on the risks related to the demise of the founder and the obligations the company may have to pay the debt owed to the estate on his demise. The risk analysis process highlighted a number of issues for the company:

- The founder was still quite material to the achievement of the company's growth strategy, and disablement of longer than three months was going to affect the momentum that was being made on the international front;
- The new CEO was still 'bedding-in' and therefore the loss of the founder was likely to lead to uncertainty among employees which could affect morale and, as a consequence, productivity;
- On his death or catastrophic disablement, the founder's estate would expect a sizeable sum of cash immediately to enable his family to maintain their lifestyle as he was the key source of income.

The risk assessment also considered the impact if anything were to happen to the new CEO. It found the following:

- The executive determined that the loss of that individual could affect total productivity by five percent which would result in eliminating almost all the profit the company was forecast to make;
- The founder would need to step back into the role, thereby slowing down the international growth;
- Based on the past experience of recruiting, the risk planning assumed at least six months before a new CEO could be found.

The potential financial effects ran into the millions, taking into account the reduction in profitability and the estate's need for repayment of some of the debt owed to it.

### Typical scenario

This case study is not a rare example. Rather it is typical of the organisations seen daily by professional risk consultants throughout New Zealand, where 99 percent of all enterprises are privately owned.

While 97 percent of all businesses in New Zealand employ fewer than 19 people, it is common to find that even in relatively large businesses there is substantial financial risk to the business due to its reliance on key people and the interdependence that the founders have at a personal level.

Human resource managers can assist the executive and boards of companies to ensure that the assessment and implementation of human capital risk strategies are just as important to the business as the assessment and implementation of risks related to fire, public liability and loss of profits.

The first step that needs to be undertaken to assess the businesses exposure to human capital risk involves determining the likely financial effect that the loss of a key person may have on the business, arising from the potential change to revenue, costs and profit.

The second step is then to develop a 'response' plan to minimise the financial risk. This will require assessing the ways in which the business can retain the risk through strategies such as transferring functions and responsibilities to other team members, documenting business processes, client retention programmes, recruiting replacement labour, and reducing costs.

Financial modelling of the predicted reduction in revenue, changes to productivity, and increase in costs will enable the board or executives to anticipate the effect on the business in terms of the total potential change to profit. If the company faces any risks related to insolvency or exposure to creditors it will become evident.

The analysis process will clarify the level of financial risk the business can retain, and the level it should transfer to insurance to avoid the business being forced into liquidation.

People are the life blood of any organisation. Human capital risk planning helps a business build resilience and, over time, assists in making it more robust and better able to deal with the loss of intellectual capital that comes with the loss of key people.



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