Coping with Risk and Uncertainty

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As markets, events and businesses become more interconnected; scientific, social, political, environmental and technological developments occur; and entrepreneurs create new possibilities more companies may become exposed to greater uncertainty and new areas of risk. Periodic reviews of risks by specialists need to be replaced by continuing vigilance across corporate networks, greater flexibility and quicker reactions. The imminent National Convention on Risk Management and presentation of Golden Peacock Risk Management Awards will provide directors with an update and status check on how leading companies are coping with risk and uncertainty.

Enterprise and entrepreneurship involves risks. Risk management itself also involves risk. A balance needs to be struck between managing known risks and being alert in order to identify new sources of risk. Simply existing as a business involves exposure to commercial risks faced by all enterprises and the possibility of being the target of malevolent activity, whether internal fraud or the attentions of external hackers. Coping with risk and uncertainty can involve both the protection of areas ranging from reputation to intellectual property and enabling responsible innovation.

Traditionally risk and return have been related. The search for competitive advantage, breakthroughs and higher margins can create exposure to new and enhanced risks. Change and activities such as restructuring and cost-cutting can also generate additional risks. In periods of uncertainty and insecurity this reality creates challenges for those seeking to meet expectations for maintaining or increasing returns while at the same time containing or reducing risks.

Risk Tolerance

As a business grows it may encounter new forms of risk, such as the currency risk that accompanies exporting as overseas sales are made. Some strategies, courses of action and projects may be inherently more risky than others. Decisions on which to adopt should take account of the risks involved, possible returns and the probability of success or other outcomes occurring. A board needs to be clear about the level of risk it is prepared to tolerate and ensure that it and those who prepare proposals are both aware of risks, dependencies and contingencies and take them into account.

The UK Corporate Governance Code states that “the board is responsible for determining the nature and extent of the principal risks it is willing to take in achieving its strategic objectives” and that “the board should maintain sound risk management and internal control systems”. Risk tolerance can vary according to sector, activity and aspiration. In transportation and healthcare companies may go to great lengths to ensure passenger and patient safety, while in retailing or clothing a company might regularly launch new products and designs in the expectation that across a portfolio of offerings some may succeed while others might fail to meet expectations.

A board should take account of the interests of shareholders and other stakeholders when considering the degree of risk that would be appropriate for different areas and activities. Account also needs to be taken of the scale, nature and reach of consequences. A failed local design can be replaced, but an incident and attendant publicity that damages a reputation might have a widespread and international impact. Reduced sales and a lower share price may quickly follow.

Innovation and Insurance

Like military leaders and the best football teams, effective

directors need to both attack and defend. In competitive markets they must seek competitive advantage and new business while retaining existing customers and maintaining valued relationships. They need to both innovate and insure, and these activities can require different but overlapping perspectives. Innovation can require ambition and courage where insurance may demand caution and prudence, but with both one needs to consider future possibilities, make choices and determine how far to go.

Innovation and discovery may be required to achieve product and market leadership. Those seeking to pioneer and go out in front sometimes encounter new areas of risk when moving beyond what is already known. Some people are inherently cautious. They instinctively draw back from uncertainty and are often laggards in adopting new ideas. While challenging impetuosity and thinking through possible consequences are desirable, so too is the courage to initiate and try alternatives. On occasion, trying to preserve the *status quo* against a background of changing aspirations, demands and priorities can be the most risky strategy. Sometimes an existing position can rapidly erode and capabilities can quickly become obsolete. It is possible to be left behind as others move on.

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Providing direction is often about achieving a balance. Being risk averse and insuring against every eventuality can be expensive. Insurance needs to be appropriate to one's risk appetite, assessments of probabilities and consequences, and the context. In some fields progress is so rapid and the lifespan of a generation of technology is so short that when an item is damaged and subject to an insurance claim it may be out of date and no longer required if replaced on a like-for-like basis. The relentless march of innovation may impact far more upon the value of assets than fire and fraud.

Diversification versus Focus

Individual investors have traditionally spread their risks by holding a portfolio of investments of different types. The mix of each investment category typically depends upon risk tolerance which is often related to investment objectives and age. A younger investor might put a higher proportion into equities, which while more volatile may generate a higher return. In contrast, an older retired person may have a greater proportion invested in bonds that will yield a predictable income stream.

The boards of what became known as conglomerates spread risks by developing a diversified portfolio of different business units in the hope that at any one time the results of poor performers would be counter balanced by those that were doing well. For a period investor sentiment moved away from diversification in favour of focus upon a core business. Boards have released value by hiving off any businesses that were not a close fit or obviously complementary, returning proceeds to shareholders who can invest directly in a portfolio of more focused businesses to their liking. Boards should consider where they stand on this issue given the greater risks of concentration.

Smart directors consider the risks inherent in different business strategies when deciding which to adopt and make sure an appropriate risk management strategy is adopted. The spreading of risks is easier in some sectors than in others. A publisher may commission a variety of titles on the basis that some will do better than others and historically the proceeds of those that succeed will compensate for those which disappoint. In other fields, such as aviation where once a number of military projects may have been initiated, produced and subsequently compared, development costs are now so high that much earlier choices have to be made. All eggs may now be put into one basket, with cancellation and ceasing to be a prime contractor a possible consequence of failure.

Uncertainty and Increasing Flexibility

If risks cannot be spread or otherwise avoided and increasing uncertainty is a fact of life, one needs to limit the possible consequences. One way of doing this is through greater flexibility, whether of contracts, working arrangements and processes, or organisation and governance arrangements. A lack of flexibility could turn out to be an enterprise's greatest risk. Take the people that so many annual reports refer to as an "asset". They can represent a significant cost. Their skills can quickly become out of date, and in an era of automated on-line transactions, expert systems and robots far fewer of them may be required. People can quickly become a burden for both companies and countries. In some arenas such as the film industry or seasonal agriculture traditional full-time contracts of employment have only been used for relatively few of the people

involved.

In certain developed economies such as the UK, if recent trends continue more flexible arrangements such as part-time, independent or zero-hours contracts may soon account for over a half of those in work. Office and support costs can be reduced in various ways from hot-desking to teleworking. Greater connectivity, the widespread adoption of mobile devices, and the movement of resources to the cloud is freeing ever more people from dependence upon particular places. Taking work to people rather than people to work can free up time and reduce congestion and pollution costs. Increasingly, people require support as and when requirements arise, wherever they are including when on the move. 24/7 personalised performance support may be an affordable option.

Organisational type and flexibility should be appropriate for a board's aspirations and priorities. Bureaucratic forms of organisation have lasted far longer than many might have expected. Back in 1992 in my book *Transforming the Company* I put the case for flexible network forms of organisation embracing multi-locational project groups, customers and business partners that could adapt and evolve to meet changing requirements. Continuing adaptation and greater flexibility can reduce the need for costly, disruptive and high risk re-organisation and restructuring.

Better Management and Governance

Simply putting an item on a risk register may not always be sufficient nor even desirable. Weak and undemanding managers sometimes assume risks and seek to mitigate them or insure against them rather than role up their sleeves and avoid them by devising an alternative, safer and more certain way of achieving sought after outcomes. If a project is going off the rails, rather than increase one's insurance cover a better answer might be improved project management or a new project manager.

For many directors, especially independent directors who do not have executive responsibilities, the directorial equivalent of improved and more energetic management is better decision making. Do board papers and board decisions highlight, address and take into account risks and dependencies?

Some boards select the first available option that achieves an objective when less costly and risky options might be uncovered by further investigation. Where time allows, it may be worth holding off a final decision until other approaches and possibilities have been considered that might yield a better option when both risk and return are considered.

Entrepreneurs need to reflect upon the risk consequences of business growth. Rapid expansion can lead to over-trading that stretches resources and finances. As a company's activities, capabilities, footprint and profile expand and develop it may encounter a succession of new challenges, opportunities and risks. Governance arrangements, particularly in areas such as risk and information governance, should be periodically reviewed if governance itself is not to become a major area of risk. The rapidly evolving confidence and techniques of a community of hackers sharing their insights can exploit identified windows of vulnerability, including at weekends and holidays.

Planning Approaches and Arrangements

Directors need to ensure that contingency plans and arrangements are in place to deal with crystallised risks, uncertain events, and crises, emergencies and disasters as and when they occur. Unless they are vigilant, up-to-date and able to quickly react at any time of the day or night, including in out-of-office hours, the members of the IT team of an established company may find its security arrangements breached, either by lone teenage hackers in their bedrooms or organised criminal gangs. Speed of reaction is critical as sensitive and valuable information can be downloaded in seconds. As news gets out, customers and other groups that could be at risk can become alarmed as awareness of a breach of security is spread by both social and traditional media.

Plans of any form need to be regularly reviewed. In an era of uncertainty and change a corporate plan that is inflexible and cannot be quickly revised can soon be overtaken by events and become out of date. In turbulent and fast moving contexts traditional annual planning processes may need to be replaced by real time intelligent steering. Risks should be revised along with likely or expected outcomes as and when new information becomes available or situations change. A range of possible outcomes may give a board greater understanding than a single figure that is liable to

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change.

Like planning, traditional accounting and the use of single values for balance sheet items that are judgement calls is increasingly problematic in situations of significant uncertainty. Values may depend upon prices and other factors that are in a state of continual flux. Confidence accounting recognises uncertainty and finds ways of presenting it, for example giving a distribution curve of possible outcomes rather than a single value. The shape of a curve provides the users of accounts prepared on this basis with a visual representation of risk and possible outcomes.

Limiting Adverse Consequences

One can increase margin and profit by raising revenues and/or reducing costs. In relation to risk, one can increase expenditure upon avoiding or mitigating unwelcome occurrences and/or reduce their cost and impact by means of damage limitation strategies, policies and practices; avoiding dead ends and minimising crawl-out costs. Providing corporate direction sometimes feels like swimming against a current or running against a headwind. While effort is devoted to moving ahead there may be counter forces to confront and downside as well as upside potential. Prudent directors look for ways of limiting the costs and consequences of when things go wrong.

Where innovation and progress is relentless, even the best of solutions may have a limited life. In the long run the least commercially risky options may be those with the lowest crawl-out costs. In certain fields such as nuclear power or off-shore drilling the costs of decommissioning can be both substantial and a problem that will be faced by future decision makers. Self-interested boards can make themselves look good by selecting options that benefit current stakeholders at the cost of future generations. Insecure directors postpone much needed but costly investments because of concerns about negative reactions from those who would need to pay for them, whether customers facing higher prices or investors receiving lower dividends.

Some courses of action while seemingly promising in their early stages lead to dead ends. An example would be a technology at the limit of its potential, or which is no longer compatible with other developments. The risks of obsolescence can be reduced by selecting options that can be built upon, upgraded or more easily replaced. Some directors think through the consequences of different courses of action before taking an important decision, and try to avoid options that might trap, lock them in or limit them and so reduce their flexibility and future room for manoeuvre. To cope with risk and uncertainty one needs to feel them and learn how to live with them. ■

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