

MANAGING RISK AND UNCERTAINTY*

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Risk management can involve both short and long term thinking. As markets, events and businesses become more inter-connected; scientific, social, political, environmental and technological developments occur; and entrepreneurs create new options, more companies may become exposed to greater uncertainty and new areas of risk. Periodic risk reviews by a small number of technical experts and professionals need to be supplemented by continuing vigilance across an organisation and its network, greater flexibility and quicker reactions. At the same time, directors need to read the road ahead and reflect. Responsible boards also consider the longer-term implications of current practices and trends, for example in relation to the planet's capacity to cope (Higgs, 2014).

Enterprise and entrepreneurship involve risks. Risk management 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 and proactive risk management can involve compliance and the protection of areas ranging from reputation to intellectual property and creative exploration and the enabling of responsible innovation.

Traditionally risk and return have been related (Modigliani and Miller, 1958) and governance arrangements should embrace both risk and performance (ACCA, 2014). In both areas there may be limits to what is acceptable. Maintaining balance between them can be important. 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 involve risk. 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.

THE BOARD AND 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 the proposals it considers are both aware of risks, dependencies and contingencies, make them explicit, assess them and take them into account. It also needs to ensure that all relevant categories of risk are addressed and that appropriate risk management processes are in place (IOD, 2015).

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” (FRC, 2014). 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 fail to meet expectations. The risk profile of the portfolio might be a board's main consideration. Care may need to be taken to ensure that setting tight risk and downside limits for individual products does not inhibit innovation.

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 its attendant publicity that damages a reputation might have a widespread and international impact. Volkswagen found that publicity resulting from exposure of the programming of its engines to pass emissions tests in the USA reduced both its sales and its share price. It also led to the resignation of Martin Winterkorn the company's chief executive.

INNOVATION, INSURANCE AND BALANCE

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. These activities can require different but overlapping perspectives. Innovation can require ambition and courage whereas insurance may demand caution and prudence, but with both one needs to consider future possibilities, make choices and determine how far to go, given budgetary limits.

Innovation and discovery may be required to achieve product and market leadership. Where innovation and progress is relentless even the best of solutions may have a limited life. Sometimes entrepreneurs have to consciously put existing activities and capabilities at risk in order to innovate and replace them with better and more competitive alternatives (Schumpeter, 1975).

Those seeking to pioneer and go out in front sometimes encounter new areas of risk when they move beyond what is already known. Some people are inherently cautious. They instinctively draw back from uncertainty and are often laggards in terms of 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 current capabilities can become obsolete. It is possible to be left behind as others move ahead.

Providing direction is often about achieving a balance. Being risk averse and insuring against every eventuality can be expensive. Insurance cover needs to be appropriate to a board'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. A sense of realism and an awareness of trends is required when arranging insurance.

RISK AND STRATEGIES OF DIVERSIFICATION OR 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 and retired person may decide to have a greater proportion invested in bonds that will yield a more predictable income stream and perhaps with a lower risk of sudden swings in capital value.

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, and have returned the proceeds to shareholders so that they can then invest directly in a portfolio of more focused businesses to their liking. As boards and those controlling family businesses consider where they stand on this issue they should reflect upon the risks involved in concentration (Hartung, 2010). If there is to be focus, perhaps it should be upon critical success factors for quickly succeeding in whatever business opportunities come and go (Coulson-Thomas, 2007).

Smart directors consider the risks inherent in different business strategies when they decide which to adopt and they 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, today development costs are so high that much earlier choices have to be made. All eggs may now need to be put into one basket, with cancellation and ceasing to be a prime contractor a possible consequence of failure.

INCREASING FLEXIBILITY TO COPE WITH UNCERTAINTY

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 (Ford, 2015). 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 all 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 can be an affordable option for both private and public sector organisations (Coulson-Thomas, 2012a & b; 2013).

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. In my book *Transforming the Company* I put the case for flexible network forms of organisation that can embrace multi-locational project groups, customers and business partners, and which can adapt and evolve to meet changing requirements (Coulson-Thomas, 1992 and 2002). Continuing adaptation and greater flexibility can reduce the need for costly, disruptive and risky re-organisation and restructuring. Care needs to be taken to ensure that laws, regulations, rules, controls and governance codes are proportionate, balanced and do not inhibit flexibility (KPMG and ACCA, 2014).

MANAGEMENT AND GOVERNANCE

The review of management and governance arrangements and practices can be a key element of coping with risk and uncertainty. 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 roll 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 should 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 (Mainelli, 2014). As Talk Talk recently found, the rapidly evolving confidence and techniques of a community of hackers sharing their

insights can exploit identified windows of vulnerability. This can occur at any time, including in out-of-office hours and at weekends.

PERIODIC PLANNING VERSUS INTELLIGENT STEERING

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, the members of the IT team of an established company can find its security arrangements breached, whether 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, and as news gets out customers and other groups that could be at risk may become alarmed as awareness of a breach of security is spread by both social and traditional media.

A board should agree a policy covering how and when to respond as and when hacking and data breaches occur. When considering what action to take, and in particular how open to be about what has happened, responsible boards give priority to protecting their customers from financial loss and unnecessary anxiety. Establishing a time horizon and/or the length of a life cycle or window of opportunity or vulnerability can be of considerable significance when considering mitigating actions to deal with identified risks. For example, where time allows it may be possible to use incentives to change behaviours in ways that reduce exposure to risk (Thaler and Sunstein, 2008).

Plans of any form should be regularly reviewed. In an era of uncertainty and change a corporate plan that is inflexible and which cannot be quickly revised can be soon overtaken by events and thus 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 estimated figure that may be liable to 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 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 distribution or bell curve can provide the users of accounts that are prepared on this basis with a visual representation of risk and possible outcomes. Such information may be easier to match against a risk tolerance schedule.

LIMITING DOWNSIDE RISKS AND 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.

Boards should ensure that compliance and efforts to avoid and/or minimise risk does not inhibit the innovation required to remain competitive. There is some evidence that entrepreneurs take better decisions as opposed to riskier ones (Brockhaus, 1980). Performance support can share more effective approaches and the incorporation of pointers and blockers can enable more calculated and responsible risk taking. It can also enable the results of innovation to be rapidly disseminated and its benefits to be more quickly secured (Coulson-Thomas, 2012a & b; 2013).

In the long run the least commercially risky options may be those with the lowest crawl out costs. Reference has already been made to the cost of employing people. The variability of their ambition, health, performance, motivation and resistance to temptation, not to mention their proclivity to make mistakes, means they are the source of many risks. It may be possible to reduce these by making greater use of automation and intelligent systems (Kaplan, 2015).

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 decision makers 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 be required to fund them, whether customers paying higher prices, staff forgoing remuneration or investors receiving lower dividends.

Some courses of action while they may seem 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 they try to avoid options that might trap, lock them in or otherwise 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 to live with them. In an era of greater uncertainty risk management might need to involve more people than has hitherto been the case and may require more innovative solutions if it is not itself to become an item on risk registers.

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