# Directors' views of strategic risks

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The current debate on the role of corporate boards is starting to focus on the value that boards add in the strategic process and in assessing the environment for risks and opportunities. Commentators bemoan the amount of time spent on 'mere' compliance and exhort boards to spend more time on performance.

Unfortunately there are few practical examples of how modern boards add value to the strategy and risk processes. While most companies have developed robust processes for developing strategic and risk management plans, few companies claim to have found a way of aligning the perspectives of board and management to give a better outcome. It is almost as if boards and managers are speaking different languages.

What do board members worry about?

A common complaint from executives who frequent the boardroom is that, although the board is responsible for ensuring there is an appropriate risk management system, when risk is presented and discussed in the boardroom it is difficult to generate the right level of engagement. Experienced company secretaries can share many horror stories of directors, or whole boards, that shirk the question, refute the risks, or simply doze off.

A simple solution to this problem is to start the discussion with a question rather than a presentation. Start from the strategic plan and ask the board:

- what are the key deliverables in the plan, and
- what are the risks that would threaten attainment of the plan objectives?

This will create an interactive discussion with high engagement. These questions also reveal a possible cause of the symptoms of a disengaged board: when risk is considered by the board in the absence of a management-developed framework, the key risks that emerge from the discussion are frequently not those that management expect!

This occurs regardless of how rigorously executives or consultants have analysed the issues. It is not that either board or management are *wrong* in their assessment. It is just that they assess the issues from their own unique perspective.

What are the key risks as perceived by the board?

From research with 241 company directors, undertaken from 2004 until 2006, the key risks as perceived by the directors were:

- finance
- government
- resources
- reputation
- strategy
- leadership
- competitors, and
- mergers and acquisitions.

Of themselves, the risks in this list are unremarkable; however, in discussion about how risk will manifest, the directors' perception differs from the way in which risks are portrayed in a traditional risk management system.

## Focus on the cash flow

Financial risk is rarely considered in terms of fraud or of financial statement inaccuracy. These things can be embarrassing and annoying, but they are rarely 'company killers'. The key issue raised by directors is cash flow and the need to have sufficient money when it is needed. Financial performance was also mentioned, but usually only insofar as it affected reputation and hence the cost of raising equity or debt.

## Get to grips with government

Government is seen as the second most likely factor to prevent a company from achieving its strategy. In discussion, this risk is characterised as a risk of change in the legislative and regulatory environment. Government action is, clearly, outside the control of most companies. However, that is no excuse for failing to develop systems for monitoring likely developments or for briefing politicians and their advisers on the implications of change.

## It's the people that make a difference

When discussing the risk of inadequate or misapplied resources, most directors go straight to the *human* resources of the organisation. The most common risk is a lack of appropriately skilled resources at an affordable price. Another resource risk, which is frequently mentioned, is loss of intellectual property with departing staff. This tends to be more of an issue for directors in organisations where the HR plan is only weakly linked to the strategic and business plans.

## Reputation is built on action

The risk of reputation damage is usually discussed in terms of failure to manage the reputation rather than in terms of avoiding activities which are not acceptable to modern day society.

## Is this the right strategy?

Many directors voice concern that they may have simply endorsed the wrong strategy. In particular they fear that the organisation may not have the skills required for implementation. Lack of decision-making skills at other levels in the organisation is also cited as likely to exacerbate this risk, as are poor communication of the strategy and a lack of the leadership required to drive it.

## The issue of leadership

Many directors, while claiming a lack of confidence in the leadership ability of management, raise lack of skill in change management, and also lack of real management support for the endorsed strategy. Board members are unanimous that, if management does not really support the strategy, no board can expect it to be delivered. Another frequently raised leadership issue is board failure. This is frequently characterised as a failure to reach consensus, which leads boards to pursue small 'no regrets' actions, rather than make bold progress.

## Where boards and management agree

When discussing competitor activity, boards tend to mention issues and risks in a way which would normally be covered by a traditional risk management system. These include customers switching, lack of a pipeline of development products, blockage of suppliers by a more powerful competitor and unexpected competitor actions.

As with the competition risks, the risks of mergers and acquisitions tend to be those which a normal well-managed risk management system would contain. Integration risk tends to be the key internal weakness, while adverse publicity for failure of an expected deal is the most common external weakness.

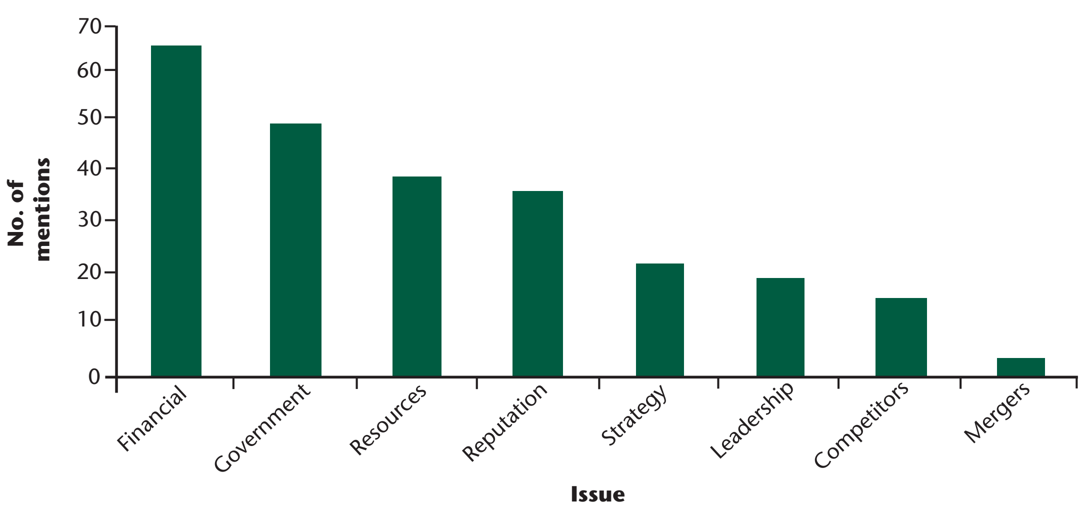
## How are companies managing these risks?

Companies manage the risks of competition and of failed merger and acquisition activity quite well. A possible hypothesis would be that when board and management concur about what the biggest risks are, and share a common vocabulary for discussing these risks, the company is better able to effectively address and manage the risks. Unfortunately, as shown by the responses depicted in Figure 1, the risks board and management tend to agree upon are the two least common risks perceived by board members.

The risks that more commonly worry the board of directors tend not to be discussed. They also don't reside in the risk management system and are therefore not managed explicitly.

The simple observation is that companies cannot manage risks for which no management plan has been developed, implemented or monitored. The issue for the governance professional is how best to raise the issue of what may be an unpalatable source of failure, without becoming personally associated with the issue and risking personal opprobrium. It can be hard to raise contentious issues, especially when the board wishes to support management in implementing

**Figure 1**



its strategic plan and do not wish to be seen as unduly critical. Bringing in an external facilitator, conducting an anonymous process or engaging the chairman in a series of one-on-one discussions with individual board members are all legitimate ways to raise these issues. It is important to create an environment where directors feel safe to voice their concerns even though these concerns are not palatable to management.

Once the issue is on the table it is much easier to develop a suitable management response. Many companies, however, do not yet seem to have developed a robust mechanism for getting these issues openly discussed.

## Emerging new risks or popular furphies?

When discussing the risks that are most likely to occasion strategic failure the directors in the research made no mention of:

- ethics or morality
- sustainability, environment or CSR
- fraud or accounts misstatement
- terrorism or acts of war
- diversity or 'groupthink'
- tax (or equivalent regime)
- lack of people willing to be directors.

It could well be, that like the risk of financial statements misstating reality, these risks are simply not serious enough to lead to strategic failure, either on their own or in association with one of the other risks. However, it is equally possible that the lack of reference to these risks is caused by a failure to recognise the devastating potential they entail. Certainly, each of these risks has at some stage been the subject of considerable publicity. Only time will tell which of the risks falls into each of those two categories.

## Starting strategic risk conversation

As I suggested at the start of this article, the current practice of presenting the risk management system to boards, or to audit committees, is not gaining the traction and input that boards, management and their professional advisers are hoping to generate. It is difficult for a board member, even a qualified, skilled and experienced board member, to do much more than just reflect on how risks are portrayed or query why certain risks have been characterised in certain ways. What is needed is a whole new approach.

To garner valuable board input, it should be sought at an early stage to give the board some ownership of the basis for monitoring and reporting risk at the board level. Ideally the board input will be first gathered in a forum where the board members feel able to be candid about the issues that cause them greatest concern. This is not always in the presence of management, other than, perhaps, the CEO.

Establishing a forum where board members feel empowered to speak on taboo subjects, such as lack of consensus or lack of management support for the endorsed strategy is difficult. A board retreat or a special meeting may provide an appropriate forum. To get the most from the board input, the forum needs to be an information gathering exercise. It is also an arena for the development of a shared vocabulary for discussion of the risks that threaten strategic attainment.

## Two bites at the cherry

Having discovered the key risks (as perceived by the board), possible mitigation strategies can be suggested. It is expecting too much for these to be quantified or assessed in any great detail at the same meeting in which they are initially identified. A second meeting is required to inform the board of the results of a detailed evaluation of their concerns and the resultant portfolio of risks and reporting mechanisms.

This is immediately an issue, as access to the board is rarely granted twice in any process. Given a single point of access to the board, most professionals opt to present rather than to inquire. It is safer for them and lessens the risk of discussions going in unexpected directions or exceeding their allotted time. However, it is the process of inquiry that opens up the possibility of discussing some of the new risks, especially when there is a difference in perception between the board and the management team. Taking the courageous step of using scarce and valuable board time for a process of inquiry is the only way to gain this insight.

## Building on progress

Once the process has been started through an open inquiry, the board can be kept informed by means of written reports or graphic KPIs. Most boards, having had a strategic conversation, will make the time for follow-up sessions. Engagement breeds engagement.

Over time, as management and the board become accustomed to discussing the key risks to performance and developing processes for building a robust response, the value added by the board will enhance performance and create a demonstrable point of strategic differentiation.

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