# ENGAGING WITH THE BOARD ON STRATEGIC RISK

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This paper is based on a three year research study for Julie Garland McLellan's soon to be published second book **All Under Control: Great Governance of Strategy and Risk.**

## Background

At the IIAA/CPA 2007 conferences in Sydney and Melbourne there was widespread agreement from delegates that something is going awry when finance and audit professionals attempt to engage the board on risk management. Few in the audience were surprised to hear that company directors are also concerned by the difficulty of getting risk management to become a key element of the board's toolkit. This paper looks at common views of risk and posits a possible solution to the problem of generating engagement.

Company directors are responsible for corporate performance. They set and monitor strategies and ensure management is appropriately managing risks. But directors struggle to know which are the key risks and what is an appropriate role for the board in ensuring that management has effective identification, control and mitigation strategies in place.

Finance and audit professionals have insights that can assist a board with developing and maintaining a correct focus on the right set of high level strategic risks. However, when called upon to discuss risk with the board these professionals often report that they struggled to generate meaningful and useful engagement or, in extreme cases, even basic agreement on the key risks. It occasionally appears that no matter how much work has been done to identify risks and develop a management plan the board will never be satisfied. So how can the finance and audit professional broach the topic in a constructive and useful manner that will elicit a better response?

This paper is based on conversations about strategy and risk with over 200 professional board members and senior executives. The conversations start by identifying the key risks that would prevent attainment of strategic objectives and then proceed to what the board does about them. Insights are classified by organisation type and commonality of occurrence. Leading company directors have provided additional commentary to extend the reach of the research and provide practical examples of effective boardroom behaviour. The material is accurate, relevant, timely and interesting.

The focus of this paper is on how audit professionals can initiate a conversation that will lead to identification of the risks that are of concern to the directors of the board that they are serving. Having obtained agreement on the highest priority risks there is a simple transition to developing systems for monitoring and managing these risks to allow the directors to discharge their duties in a diligent and informed fashion.

The key to this paper is the rigour with which the data from unrestricted conversations has been codified and subjected to statistical analysis. This analysis was conducted by an appropriate professional statistician.

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## What do Board members worry about?

A frequent complaint from executives and finance and audit professionals is that, although the board are responsible for ensuring that the organisation has an appropriate risk management system and that it is implemented, when risk is presented and discussed in the boardroom it is difficult to generate the right level of engagement.

A simple solution to this problem is to initiate the discussion with a question rather than a presentation. Starting from the strategic plan and asking the board, firstly, what are the key deliverables and, secondly, what are the risks that would threaten attainment of the plan objectives, it is possible to create an interactive discussion with a high degree of engagement.

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 would be typically encountered in a risk management system, regardless of how well it had been developed. This is not to say 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 or acquisitions

Of themselves, the risks in this list seem unremarkable; however, in discussion about how the key risk will manifest itself the perception differs markedly from the way in which risks of a similar name might be portrayed in a traditional risk management system.

Financial risk is rarely considered in terms of fraud or of financial statement inaccuracy. These things are embarrassing and annoying, but they are rarely ‘company killers’. The key issue raised was cash flow and the need to have sufficient money at the times when it was needed. Financial performance was also mentioned, but usually only in so far as it affected the other issues. The smaller the company the more likely there would be a need to raise capital and the greater the chance that failing to do so would prevent strategic success.

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

of change. This risk is more likely to be voiced by the more experienced directors than by the younger, less experienced directors, as being the most likely cause of strategic failure.

When discussing the risk of inadequate or misapplied resources most directors went straight to the human resources of the organisation. The most common risk was a lack of human resources or lack of appropriately skilled resources at an affordable price. Another resource risk, which was frequently mentioned, was the loss of intellectual property with departing staff.

The risk of reputation damage was nearly always discussed in terms of failure to manage the reputation rather than in terms of being found to have undertaken activities, which were not acceptable to modern day society.

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

On the issue of leadership, many directors, whilst declaiming a lack of confidence in the leadership ability of management, raised the issues of change management, and also of a lack of real management support for the strategy which had been endorsed. Board members were unanimous in agreeing that if management did not really support the strategy no board could expect it to be delivered. Another frequently raised the leadership issue was that of board failure. This was frequently characterised as a failure to reach consensus, which led boards to pursue small "no regrets" actions, rather than make the bold progress which the strategy required.

When discussing the risks associated with competitor activity board is tended to mention issues and risks which would normally be expected to be covered within a traditional risk management system. These included customers switching, lack of 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 tended to be those which a normal well-managed risk management system would contain. Integration risk tended to be the key source of internal weakness, whilst adverse publicity board failure of a large publicly expected deal were the most common sources of external weakness.

### How are companies managing these risks?

The short answer is that companies are managing quite well the risks of competition and of failed merger and acquisition activity. These are not the most common risks, however. The risks that more commonly worry the board of directors tend not to be discussed and are therefore not managed at all.

The risk of failure to attract sufficient financial resources to enable the company to implement its chosen strategy is usually managed by diligent cash flow, production productivity and cash management controls. However, it is not uncommon, the staff who are not aware of the underlying strategic imperative to view these controls as an intrusive imposition, rather than as a necessary element of strategic success. Raising awareness of the underlying risk factors that are being managed can lead to greater understanding and better performance.

Many companies, and even those companies whose boards cite government as the largest source of strategic risk, do not have robust systems for monitoring political sentiment, or for ensuring that the policymakers, regulators and legislators are adequately briefed on the potential impact of their actions on the company. A related issue is the reputation of the organisation and the support (or lack thereof) for the company's continued existence and success in its sphere of activities. The public sector, with its strong emphasis on probity and transparency is easily moved to close banks against corporate organisations, whose reputations are tainted, regardless of whether the taint is justified.

The human resources, including intellectual capacity, of an organisation are not easily subjected to quantifiable analyses. This can lead to their treatment in the risk management system, being superficial and prone to motherhood statements, or, alternatively, to be reduced to the numerical 'productivity side' of the equation, without taking account of the human factors behind it.

The simple observation is that companies do not manage well risks, which are outside of the risk management system, and for which no management plan has been developed, implemented or is being monitored. The issue for the finance and audit 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. Once the issue is on the table it is much easier to develop a suitable management response.

### Emerging new risks.

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/group-think
- Tax (or equivalent regime)
- Lack of people willing to be directors

It could well be, but 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 and cause of board is to take on new members who have the skills required to deal with the risk. Only time will tell, which of the risks falls into each of those two categories.

## Starting strategic risk conversation.

As was suggested at the start of this document, 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 advisors are hoping 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 really garner board input, it should be sought at an early enough stage to allow the board to have some ownership of the key risks that will form the basis for monitoring and reporting 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. Gaining access to a board retreat or a special meeting may assist the finance and audit professional in developing an appropriate forum. To get the most from the board input the forum needs to be firstly and information gathering exercise and also an arena for the development of a shared vocabulary for discussion of the largest risks that threaten strategic attainment.

Having discovered the key risks as perceived by the board the possible mitigation strategies can be postulated but it is expecting too much for these to be quantified or assessed in any great detail. A second meeting is thus required to apprise the board of the results of the detailed evaluation 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 professional opt to present rather than to inquire. However, it is the process of inquiry that opens up the possibility of discussing some of the new risks, especially if 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.

Once the process has been started through an open inquiry the board can be kept informed by means of written reports or graphic kpis. There is less need for a repeat meeting although, having had a strategic conversation, most boards will find the time for follow on sessions.

## Summation

Many risk management systems fail to identify the risks as perceived by the board, particularly in the case of risks that arise from the board itself, from the senior management team and from government or regulatory actions. These risks are often believed by the board to be the risks most likely to underlie a strategic failure. By relinquishing the position of an expert presenter and adopting, instead, the position of an inquisitive researcher, the internal auditor and alert finance executives may gain insights into additional risks that the board believe to be germane to the organisation given its current strategy. Developing management responses to these risks is not difficult once they are in the system but is impossible when the risks are not openly acknowledged and remain tacit.

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