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Corporate Governance Framework

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GRAPPLING WITH RISK: A BOARDROOM CHALLENGE

For centuries mankind has had to deal with various risks. In prehistoric times these risks may have been characterised to be a caveman defending himself against a fearsome beast, or even safeguarding his cave and its inhabitants from an uncontrolled fire. It was only in times much later where humans -- with more applied intelligence -- began to understand their vulnerability against these risks, and were able to apply some form of defence in perhaps a more daring manner to survive the very risk that previously, and most certainly in prehistoric times, would have ended disastrously. Perhaps it is from these early beginnings that the ancient Italians drew their meaning from the word *risicare*, which literally means to dare. It is widely known that the early Romans and Greeks did not believe in uncertainty. Instead, they believed everything in life was predestined and this was in spite of having access to the most advanced mathematical skills of their time, some of which are still variously applied to risk management by modern-day actuaries and treasurers.

In the book, Against the Gods, its late author Peter L. Bernstein argues that the "notion of bringing risk under control is one of the control ideas that distinguishes modern times from the distant past." Today of course, the discussion surrounding *risk* permeates all sectors of society and as a topic; it is not a new concept for the people who lead business and set their strategic path for success. Similar to the book's theme, business leaders are challenged in an ever-increasing and complex environment to understand the risks to which their businesses are exposed on a daily basis, and then knowing how to deal with them.

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Business complexities: past, present and future

Whilst the complexity of business has increased through the years, the basic principles of understanding and managing risks -- arguably -- have remained the same since the 14th century. If you knew in 2009 what you know today, what would you as a director within your organisation have done differently? It is clear that the challenges were, and continue to be, around *knowing how* to predict future risks as though it was a matter in the past -- today, this is what we would commonly refer to as hindsight.

In all circumstances, leaders who are willing to endure the dare of the risk, will in most instances want to have an understanding of the known risks that lie ahead, with the calculated knowledge of whether or not the odds of survival are in or out of their favour. Conversely, others who lack the risk appetite, skill, experience and knowledge may indeed not view the actions of the business risk-takers in the same manner. In this sense, risk and its permeations in a modern day world is an *option exercised by those leaders who have an appetite for the risk*; it is *not a fate,* which is quite different to our cavemen who lacked the experience of dealing with risk.

Moreover, the actions taken (or not taken as the case may be) to manage the risk, for a successful outcome, will be directly and proportionally related to the actions we take. In determining which factors are within your control and which are without; it is vital for organisational leadership to avoid committing more resources to risk management than the value of the exposed assets.

We could ask ourselves if today's business world is more uncertain than it was before (or if it only seems that way) due to the greater access to information in our environment today?

This approach is nothing new, however many business leaders may still not appreciate its origins whilst they continue to 'fly the risk by the seat of their pants'. Interestingly, Daniel Bernoulli -- a Dutch-Swiss mathematician, born in 1700 -- proposed that most people make choices and reach conclusions on the basis where satisfaction originated from a *slight increase in richness*, and that this was inversely proportional to the amount of goods a person would have possessed previously. Bernoulli went on to explain why King Midas, remembered in Greek mythology for everything he touched turning into gold, was unhappy and why people are *usually risk averse*. In the same century, an Englishman and non-conformist, Thomas Bayes, introduced the idea of mixing new information with old information and showed statistically how decisions on probability could be made through the Bayes' Theorem which focussed on intuitive and safe judgements.

Board responsibilities for Risk Management

Undoubtedly, the business of risk management has been undergoing a fundamental change over the past decade resulting in a far greater convergence of the discipline at the pinnacle of the organisation -- in the Boardroom.

Applying the knowledge of risk and risk management drawn through the ages has now become more critical than ever and business leaders have to ensure that the topic, which is inextricably linked with organisational strategy and stakeholders, remains a permanent item on their agendas.

Supporting the notion that directors have a critical role to play when dealing with risk and its management, the recently launched King III Report on Governance for South Africa is quite clear regarding the governance of risk, more specifically pointing out the risk management principles in Chapter 4, namely that the "board should;

• be responsible for the governance of risk,
• determine the levels of risk tolerance,
• delegate to management the responsibility to design, implement and monitor the risk management plan,
• ensure that risk assessments are performed on a continual basis,
• ensure that frameworks and methodologies are implemented to increase the probability of anticipating unpredictable risks,
• ensure that management considers and implements appropriate risk responses,
• ensure continual risk monitoring by management,
• receive assurance regarding the effectiveness of the risk management process,
• ensure that there are processes in place enabling complete, timely, relevant, accurate and accessible risk disclosure to stakeholders, and
• the risk committee or audit committee should assist the board in carrying out its risk responsibilities."

Clearly, the rules attached to risk and the management thereof have had a drastic change in recent years and undoubtedly this has been as a direct result of numerous -- and in some cases catastrophic -- company collapses where risk and risk management procedures where not applied. The failure of these companies can in almost all cases be attributed to gross mismanagement, and sadly this can only be pinned on the board and its lack of accountability to perform its basic duties to protect the company and its stakeholders.

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Adding to the seriousness of this topic, the common law duties impressed upon the directors -- who are also known as fiduciaries -- compels them to pay serious attention to the affairs of the company they serve, and this means that they have a duty to ensure that they exercise a degree of care, skill and diligence and act always in good faith and in the best interests of the companies to which they are appointed. Unfortunately, many directors do not realize the implications when they fail this duty and this could inevitably result in a director being held personally liable to pay monetary damages and in other cases, being held criminally responsible when certain statutory duties, which are regulated by various Acts, are not performed.

Of course, this message may come as a surprise to many business leaders -- and even instill their greatest fear -- as they begin to understand the gravity of not applying their mind and business judgment to managing their risks. To others, it may be a case of business as usual, where forward thinking businesses have actively applied risk management methodologies within their strategic charters, with sound governance principles supporting their business decisions, practices and behaviors.

"What can bring our business down?"

Understandably, risk savvy business leaders know to a greater extent where their risks lie and have put into place mitigation strategies and plans to avoid potential disasters. In many instances, these leaders may in fact purposefully 'run toward' some of their risks, realizing full well that risk and reward are inexplicably connected. Where companies have excelled in traditionally high risk areas, and these would include industries such as financial services and mining, their leadership has ensured that a robust risk management framework and processes are in place to anticipate, understand, assess and mitigate those areas within their business which are likely to, or may, expose them to the threat of direct and or indirect risks. Whilst the appetite for risk will vary from country to country, and between industries, companies and people, each of these entities will be faced with similar challenges when addressing their associated risks. The initial areas that require understanding to determine risk tolerance levels involve four basic areas, these being;

1. the need to understand the company's risk philosophy and appetite for risk,
2. knowing the extent to which the company has established effective risk management processes and how the risks will be prioritized and dealt with,
3. reviewing the company's portfolio of risks and matching them against the company's risk appetite, and
4. knowing which are the most significant risks and whether these have been adequately dealt with.

"How could the BP oil spill off the coast of Louisiana possibly affect my company's operations?"

Whilst some will argue that good risk management is a business science, the reality may indeed suggest that sometimes not even the most 'obvious' disasters can be predicted and that there are no easy formulae for anticipating the path of risk as it filters through a company and its supply chain, which may affect customers, suppliers, the distribution channel and even the competition.

Experts have shown that businesses who systematically examine the way in which risks spread throughout the supply chain, generally have a far better ability to foresee and prepare for the varying nature of risks, and that they are far more successful than those businesses who don't deal with risks in this manner.

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Being guided by the recommendations of King III, it becomes quite clear that the company's board of directors will need to quickly become familiar with the magnitude of their risks, and generally one can categorize those which have a direct bearing on the company to be those which are found in the company's distribution channels, the supply chain, the competition and of course the company's customers.

There are those indirect risks which a company may not have entire control over, however the company may be in a position to set in place certain protection mechanisms or buffers, which may include; foreign exchange rates, geopolitical events, inflation, changes in technology, public policy, legislation and commodity prices.

"I can't possibly mitigate for every risk under the sun."

Whilst the thought of trying to contain multiple levels of risk may spark widespread panic within the boardroom -- sometimes the risk may be entirely out of a person's control -- it is imperative that companies maintain composure as it sets a path of action in motion. Such action may be formulated within an enterprise wide, integrated risk strategy which may include;

1. a risk management policy, encompassing the tone of the company's risk appetite and setting the basis for how risk will be viewed and dealt with,
2. the establishment and implementation of risk management structures, processes and monitoring which are set against the company's risk appetite objectives,
3. executive and senior management jointly identifying strategic and operational business risks, distinguishing between risks and opportunities,
4. evaluating the likelihood and impact of the identified risks to determine how they should be managed with the associated response priorities,
5. developing risk management strategies,
6. implementing the appropriate controls, actions and monitoring to mitigate against the likely and / or unlikely risks, and
7. promoting risk management awareness within the organisation so that a risk awareness culture begins to permeate through the company by means of relevant information and effective communications.

"But that's an operations and not a finance issue"

Clearly, for a company to 'win' at its risk management strategy, the risk tone and correct levels of risk appetite must be set and known by all the employees of the company (remembering of course that a company is generally established for profit and should not be stifled by over-risk management and over-prescribed regulation.) Accordingly, the company must recognise that risk management is integrally linked to sustainable shareholder value and stakeholder interest; and there should be a continuous improvement of mechanisms to identify and monitor the company's risk areas. The success of the company's risk management will be determined largely by its internal controls and policies which must be reviewed regularly, as well as it ability to detect, measure and paramitise its risks through its management and operational systems.

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When organisations decide to pigeonhole risks into mutually exclusive groupings under the assumption that the fallout of a risk will be limited to a single operational or financial area; they limit the effectiveness of their risk management strategies. Intelligent risk management takes into account any incidental and planned interdependencies and assumes the holistic view of risk to the enterprise.

"If everything seems under control, you're just not going fast enough" (Mario Andretti)

Finally, the analogy of risk and its application is to remind the Board that the fastest cars have the best brakes. To have confidence to go fast, the driver needs to know that the brakes are working well. Brakes need to be engineered into the vehicle and not considered as an afterthought. They should be applied not only in an extreme emergency, but also frequently to moderate speed and direction. At the same time, we don't want to ride the brakes, wearing out the tires (and the brakes themselves) and flashing lights that indicate we are stopping when it isn't really necessary. As the late author and economist Peter L. Bernstein once said, "if everything is a matter of luck, risk management is a meaningless exercise. Invoking luck obscures truth, because it separates an event from its cause."

Dealing with risk -- in many instances -- becomes the freedom of choice to engage the risk.

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