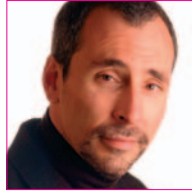




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Rethinking business risk

Anthony Mitchell and Marc Jones argue for a broader, more integrative appreciation of risk and risk management than currently prevails and examine what can be done today to avert or offset some of the disastrous consequences of what might otherwise occur tomorrow.

Our awareness of risk has changed in recent years. Back in the 70s we turned to decision science and probability theory to examine rational and irrational behaviour. When Jim Maxmin was CEO of Volvo in the 70s his main concern was whether the insurance premiums were paid. Go forward a decade or so and Jim was CEO of Thorn, a UK-based electronics business. With operating companies around the world and increased activities in a litigious USA, Thorn like others now had its own insurance company in Bermuda. During the 90s Jim had moved to the clothing retailer Laura Ashley. Now he had become *au fait* with derivatives

and concerned about terrorism and retail crime.¹

Today, any director or senior manager developing or executing a strategy needs to be clearly aware of the multiple sources and types of risk and how these might be mitigated. Failure to do so can not only undermine the potential of the strategy to be realised; it can also expose the individual to criminal prosecution. Incidents such as September 11, SARS, Enron, Parmalat, BA and Gate Gourmet clearly indicate the need for a more challenging and complex conception of risk.

Lloyds' research with the EIU in 2005 stated that whilst the amount of time spent on risk management in the boardroom had risen four fold in three years, still not enough is being done by business around the world. In a recent *FT Special Report*², Lord Levine suggested that organisations should have risk policies in place for each risk category, with fully accountable risk owners who monitor changes in likelihood and impact, communicating the key messages to those concerned. Furthermore, several high profile cases underline the personal risk that directors may face, for example when doing business in the US. Consider the recent extradition of three NatWest bankers and also events in the gaming industry.

organisation by key stakeholders, are all more intangible and thus difficult to precisely monitor and quantify. Importantly, though, they are no less significant to the health of the organisation. Scenario planning is just one popular tool for helping to identify events that could occur simultaneously and collectively conspire to create pessimistic, optimistic or most likely outcomes.

Fundamentally, each resource flow described above implicates groups of stakeholders. Thus effective stakeholder mapping, analysis and management is central to the wellbeing of the firm, and a foundation of all effective strategy development and execution⁴. The disruption of any of these vital resource flows can cause severe – even terminal – problems for the firm.

Back to basics

In light of the above, we are proposing a much broader, holistic concept of risk and approach to risk management that is founded on the resource-based theory of the firm.³ This focuses on the critical resource stocks and flows necessary to ensure the firm's survival and growth. It allows us to immediately identify vital stakeholder relationships which are linked to these critical resources.

An organisation can be conceived as being at the centre of a web of resource flows which are essential to its survival and growth. Some of these resources, such as capital from owner-investors, value-adding contribution from employees and suppliers, and the income stream from the products/services sold to customers, are very obvious, tangible, and thus measurable. Others, such as the level of legitimacy that comes from the wider stakeholder community, the continuing permission to operate as a corporate entity that emanates from government, and the stock of goodwill and reputation assets which ebb and flow according to the perception of the

Managing business risk

We suggest that the full spectrum of risks facing an organisation will fall within three categories:

1. catastrophic failure
2. strategic failure
3. operational failure.

We encourage you to think about the resource flows in each category, and identify the impact of their disruption or termination, contingencies and measures etc. Then consider how best to manage and minimise the risk factors. Several examples from differing sectors are offered to assist in identifying, analysing and managing these three categories of risk:

- outsourced engineering services / facilities management
- low cost global sourcing in the automotive industry
- complex IT projects in the public sector.

Catastrophic failure

.....can be terminal to the very survival of the firm, given its potential impact on vital resource flows from key stakeholders. Included here would be natural disasters, wars, terrorism, termination of an organisation's legal charter by government, product liability situations that bankrupt the firm, and the commitment of internal fraud at such a level as to compromise the financial integrity of the enterprise. Examples that quickly come to mind here include Enron, Union Carbide and the Bhopal disaster, and Swissair's demise. Poor organisational capabilities in areas such as governance, disaster recovery and compliance auditing can increase the potential for catastrophic failures occurring. On the other hand, the cultivation of such capabilities should have the opposite effect.

Paul Saville-King completed his Ashridge EMBA project in 2005 on the subject of Critical Engineering Risk Management (CERM), a methodology developed for applications in the health, safety and workplace/environmental areas. Paul is now Divisional Managing Director at Norland Managed Services Ltd for a newly created division that aims to offer 'peace of mind' to clients such as Merrill Lynch, Morgan Stanley, and Citicorp. These organisations 'outsource' but rely heavily on specialist providers; simply put, if they lose power, cooling etc then there is no communication, no IT, and an inevitable expensive loss of business continuity. Avoiding **catastrophic failure** of such engineering infrastructure is paramount. Norland is the first to offer a range of products and services in this new, demanding market segment. Norland's proposition is based on five key principles⁵:

1. Focus – careful monitoring of KPIs that will include 'softer' issues such as motivation, competence and delivery

2. Consistency – basis for measurement, transfer of knowledge, robust processes etc
3. Compliance – critical incidence reporting, processes, competencies
4. Visibility – management's ability to focus on the core business with 'peace of mind' about risk. Thought and investment are required, for example traffic light warning of key systems
5. Learning and improvement – use of the McKinsey 7S (or similar) framework with hard and soft issues to be addressed.

Success is more than a collection of isolated systems and processes. Behaviour and culture are also important. Aligning behaviour with robust systems will not eliminate risk, but it can mitigate it.

Norland's proposition is as relevant to an industrial activity such as meat packing (where breakdown of cooling systems can be rapidly and utterly catastrophic) as it is to the world of IT-dependent global finance. It is important to acknowledge, however, that the firm's integrated approach might need to be complemented by broader, more open-ended methodologies (such as brainstorming and scenario planning) in order to better prepare for low-probability/high-impact events which will require effective disaster recovery if avoidance efforts fail.

Strategic failure

.....is pursuing an inappropriate strategy, whether at corporate or business levels. It is due to flawed external analysis at the macro-environmental or industry levels, a misunderstanding of a firm's own competencies and how these compare to those of key competitors, and/or a poor

job of assessing alternatives and ultimately exercising poor judgment. Too often a strategy is built on 'toxic' assumptions which were once valid but over time what were once strengths can erode, ossify and become liabilities constituting weak foundations upon which to base future strategy.

Business history is rife with examples of firms pursuing the wrong strategy: Encyclopedia Britannica's decision not to work with Microsoft in the early 1990s; Marks & Spencer's resting on the laurels of its legacy throughout the 1990s; the failure in the airline industry of almost all major flag carriers to develop low-cost alternatives to compete with the likes of Southwest, Ryanair or easyJet; and the failure of Australian business schools to successfully penetrate the Asian market in recent years. The best way to prevent failures is to ensure a robust strategy development process where no stones are left unturned; the key is the planning process, not the plan itself.

Bosch is the leading independent supplier to the automotive industry. The stakes have risen over the past year since Delphi (the former No.1) has entered Chapter 11. The biggest growth trend for a number of years now in the automotive sector is the increase in demand for diesel engines. Two years ago Andreas Werner investigated where to build additional manufacturing capacity for diesel fuel sensors, in low cost countries outside of Germany. The risk for Bosch was that they would otherwise be unable to meet the growing demand, and be uncompetitive in terms of cost. The risk had to be balanced against uncertainties with currency movements, productivity, quality, control of intellectual property, cultural differences and so on. Andreas recommended a ramp up of production in four stages:

1. An existing plant in China – but with an additional line for the new product, commissioned some 18 months ago
2. Second new plant in China due to come on stream during the first half of 2007
3. Third plant in Russia
4. Fourth plant in Japan – important for supply chain reasons.

The above carefully planned steps have helped to ensure that Bosch reduced the likelihood of strategic failure.

A review of the recommendations made by Andreas has shown that capacity is now on target to meet demand. All the key risk factors were correctly identified.

Operational failure

.....is the organisation's inability to deliver its value-proposition to key stakeholders; that is, the quality and/or volume of the resource flows back to these stakeholders is significantly below their expectation, thus increasing the chances that they will lower their level of engagement with the firm in the future. Specific examples include the chronic underperformance of the major American automakers (from multiple key stakeholders' perspectives), the Playstation 3 debacle, and the pronouncement of incoming Minister John Reid that many activities within the (UK) Home Office portfolio were not 'fit for purpose'. These failures can be the result of execution gaps (poor implementation); supply chain problems; and/or pressures on a firm's business model which see it pursuing customers whose cost to serve is prohibitive, or under-investing in key value-chain activities (R&D, employee development) in order to cut costs. Poor internal execution capabilities are usually at the heart of operational failures, including a separation (formal or de facto) of the

strategy development and implementation roles in the management hierarchy.

Martin Bellamy, a former member of Ashridge faculty and now CIO at The Pension Service, is responsible for the IT that underpins £700M of 'transformational' expenditure⁶. To date the successful project management of this work at the UK's Department for Work and Pensions is a welcome relief for the Government when faced with a long list of failed projects elsewhere often with the same specialist providers. So what is different at The Pension Service?

The project is a complete re-engineering of systems in 400 Benefits Offices towards a telephone service running from ten call centres. A key dependency has been to get control of information through a parallel project to build a new Customer Information System (CIS). This complex CIS comprises 88m customer records, 30 legacy systems, and 400 enquiries a second. Bellamy chairs a steering committee managing the overall project, while day to day work is with 60 in-house IT professionals who work alongside teams from Accenture and EDS.

The difference between success and failure on such projects is often a fine line. The Pension Service has worked hard to build a culture with commitment to success, where people are encouraged to speak up early if there are concerns and / or challenges – thus identifying risk as early as possible.

Bellamy says: "...we get the best from suppliers when they know that we want them to succeed as part of the overall project team."

This is a good example of taking a carefully planned strategic approach, with substantial investment, to fundamentally

change current work operational practice. Pensions are a high profile area, and IT project management on this scale also has a reputation for high risk and the likelihood of **operational failure**. Wayne Turk further suggests that for project management Sin Number Four (out of Seven Deadly Sins) is not identifying risk and working to mitigate it.⁷ There is a danger that this becomes an exercise to just 'tick boxes'; regular reviews need to be scheduled and widely communicated.

Bringing it together

Catastrophic, strategic and operational failures, though addressed here in turn, are by no means mutually exclusive and clearly bounded in the real world. A strategic failure may result in a catastrophic termination of critical resource flows, as when Digital Equipment Corporation's failure to react to the structural shifts in the computer industry in the 1980s resulted in its eventual demise. A strategic failure can likewise trigger operational failures, as when Compaq during the 1990s pursued a strategy that entailed competing across a range of product-markets with strong global players such as Dell, HP, Sun and IBM, thus stretching the firm's resources beyond the breaking point and eventually leading to its being acquired by HP. Finally, a series of operational failures can foster strategic failure, as when continuing product quality and service support problems in the 1990s drove Alfa Romeo's UK customers to competitors' offerings, diminishing the firm's market position, which it is only now beginning to rebuild.

The examples cited above clearly demonstrate that:

- Risk is not just the preserve of actuaries and specialists in money markets; it is multi-dimensional and complex, and for an organisation it impacts upon strategy, the environment and operational factors.
- Individuals are increasingly being held more accountable for organisational decisions or malpractices.

Measuring and communicating risk

We are aware that 'Balanced Scorecards' have become popular. Risk can be tracked in a similar format with specific organisational measures. Getting the assumptions right is key. However, there are often disconnects between actual business activities and

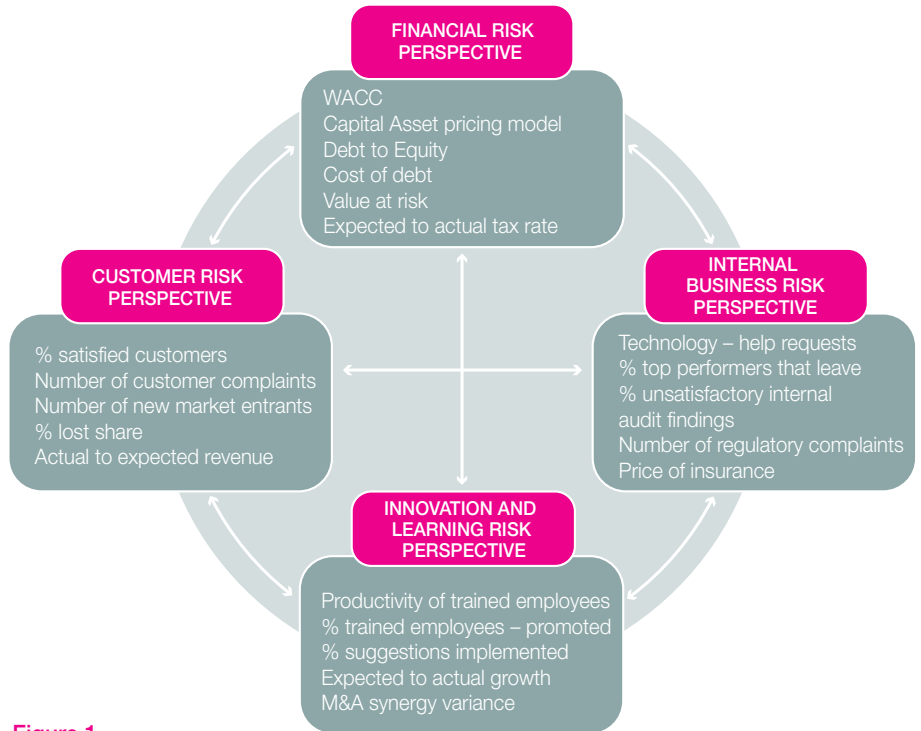


Figure 1.

Enterprise Risk Scorecard

Source: adapted from Calandro and Lane

outcomes and their valid measurement; for example, cause and effect become confused as does the indeterminate relationship between employee job satisfaction and performance. It follows that activities which are measurable become important primarily because they are easily measured, rather than for legitimate reasons. Kaplan and Norton developed a Balanced Scorecard with non-financial leading indicators to offset lagging financial measures. However, managers not only require improved performance measurement systems (such as the Balanced Scorecard) to manage activities that execute strategy, but also need to have **improved risk management systems** – to manage the possibility that certain activities will be unsuccessful. Without risk, business would be predictable and mechanical rather than value creating. So both performance and risk should be

measured and managed to ensure effective implementation and value creation.

Calandro and Lane⁸ have therefore adapted the familiar performance Balanced Scorecard to provide an 'Enterprise Risk Scorecard' – see Fig 1.

Separate scorecards for performance and risk should follow a common framework, language and methodology. This facilitates governance, robust controls and audit; and the information provided can leverage regulatory compliance. Intel, for example, has operated in such a manner for several years. Disclosure of information provided from balanced performance and risk management scorecards can help to close gaps between investor expectations and managerial capability. To effectively address catastrophic, strategic and operational

risk through a balanced scorecard methodology would entail the development of three separate scorecards, each likely incorporating differing time horizons and some distinctive elements. While some components of any risk scorecard will be generic (for example WACC), many will be industry or firm-specific. For example, the commercial aerospace industry will face significantly different risks than the cosmetic or diamond industries; within aerospace, Boeing will have to manage some different risks than Airbus due to different ownership and governance structures.

Effective risk management requires establishing a common language that enables various professionals to communicate more effectively. Factors such as the supply chain, corporate reputation, intellectual property and employee risk all now score high because failure can be directly linked to value destruction.

So, to offset disastrous consequences.....

.....we have identified the following aspects as crucial in reducing the likelihood of failure:

	to avoid:
Develop competence in governance, disaster recovery and compliance	Catastrophic failure
Install a robust strategic development process, check assumptions and shifting trends	Strategic failure
Ensure execution capability and allocation of resources for implementation	Operational failure

Developing risk management systems also has a crucial role – to complement performance management systems and reduce the risk of a measurement failure. Finally, do not rely upon a Chief Risk Officer – Enron had one. It is rather like the pursuit of quality : senior management need to be aware collectively and take responsibility. We close by noting that the this article has been premised on the assumption that

organisations will always strive to minimise the level of overall risk associated with achieving a given level of performance. Notwithstanding this point, it must also be acknowledged that first, increased acceptance of risk can create new opportunities when a firm is better prepared to manage that risk than its competitors, and second, different organisations in the same competitive set can have widely divergent notions of what constitutes high, medium and low levels of risk, as well as different risk profiles. These important topics will be the subject of future research.

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