Dilemmas, uncertainty, risks, and board performance

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This paper traces the origins of the words risk, uncertainty, governance and development and argues that a deeper understanding of each allows more effective decision taking in the boardroom. It argues that the role of the board of directors is to balance and rebalance continuously their irresolvable dilemma — 'how do we drive our enterprise forward while keeping it under prudent control?' It argues that it is the board's role to focus on uncertainty, rather than risk, and this requires a different set of intellectual skills from board members to be able to cope with monitoring a range of diverse scenarios. This is crucial for a board to develop stronger ways of both leading their organisation and of ensuring the connectedness of the learning within and between the board and the operational unit's risk taking. It advocates that to achieve this a board must develop new ways of learning — especially of thinking strategically and becoming more sensitised to the dynamics of their changing external environments. This will take them well beyond the comforts of their specialist managerial disciplines and into the true world of directing. The paper demonstrates the importance of continuous learning in reducing organisational uncertainty and risk. It uses the 'Learning Board' process and model as the central processor of both strategic and operational learning to create an annual rhythm for the board's year.

1. On being trapped by risky words

Human beings have a habit of painting themselves into corners and then wondering how they got there. What is worse is that they are the very folk who created the tools that took them there. In the tangible world of architecture Winston Churchill reminded us that first we shape our buildings and then they shape us. In the less tangible world of organisational culture Geertz [1] clarifies an otherwise fuzzy area with a helpful definition.

> An historically transmitted pattern of meaning embodied in symbols; a system of inherited conceptions expressed in symbolic forms by means of which men communicate, perpetuate and develop their knowledge about and attitudes towards life ... Man is an animal suspended in webs of signification he himself has spun. I take culture to be those webs and the analysis of it to be therefore not an experimental science in search of law, but an interpretive one in search of meaning.

It is these 'webs of signification' by which we trap ourselves which intrigues me in relation to understanding approaches to uncertainty and risk, especially because we are still spinning them. Central to these webs is the careless use of words. For example, if I mention 'the griffin' sufficient times some people will begin to believe that such a creature exists, and that it looks the same to everyone. Similarly, if I mention the word risk it is easy to assume that everyone uses the same meaning. This is not proven. Such a false assumption can trap you, your team, your organisation and your clients into the unnecessary abuse of scarce resources, especially time and money, to no useful end in the false hope of nailing 'risk'. Risk is ultimately un-nailable. It is impossible to drive it out of our lives. Both risk and uncertainty need to be coped with although their meanings and boundaries are very different. During this paper I shall use the notions of a risk hierarchy in any organisation with strategic risks as the domain of the statutory directors of an organisation and operational risk as the domain of the managers. This will upset some people as it makes new demands on their intellectual abilities and consequent behaviours at a time in their professional lives when they thought they had little more to learn.

2. Uncertainty as a strategic concept

The economist/mathematician Knight differentiates uncertainty and risk. He argues that:

> Risk is where the probabilities of different outcomes are known, but not the outcome itself.

> Uncertainty is where the probabilities themselves are unknown. It is, therefore, difficult to rationalise uncertainty even using 'bounded rationality', i.e. rational decision-making with limited information.

But I am taking the argument further here and saying that coping with uncertainty is the major role of the statutory directors of a business — the board of directors — and that their role is to identify the 'strategic risks' and use their judgement in times of high uncertainty to give direction to the whole. Ultimately these are the judgements where they 'bet the business'. Separately, assessing and managing the day-to-day risks is the major role of the managers — these are the 'operational risks'. Within both strategic and operational risks lurk personal risks, an often forgotten or excluded issue, yet one which is crucial to thoughtful decision-taking by the whole board.

3. Directors, uncertainty and strategic risk

Directors deal with policy issues in the realm of uncertainty — they must define and monitor carefully trends, if unable to define the boundaries, in such chaotic and overlapping worlds as political, physical, environmental, economic, social, technological and trade (the PPESTT analysis) [2]. Managers design, install and maintain prudent control systems which try to diminish or eliminate risk for their organisations so that projects and targets can be achieved on time, to quality and within budget. Directors supervising managers need to encourage and assess managers in their four basic choices for coping with operational risk:

- delete it,
- outsource it,
- reduce it ,
- take it.

Uncertainty and risk require distinctly different thinking, attitudes and behavioural skills. This has rarely been acknowledged or developed in organisations. But now that, for example, the UK's Combined Code of Corporate Governance 2003 makes it mandatory for UK listed companies to report annually on their director selection, induction, training and development, assessment and refreshment processes, this is beginning to change. Reporting is the easy part and usually is of the 'work still in progress' type. Little work has been done on the nature of directors coping with uncertainty and yet continuing to function. My experience shows that it is the integrative nature of the learning process — shown best in architectural education, and the philosophy, politics and economics degree at Oxford — which provide models of possible ways ahead for board development. These require the creation and tracking of multiple scenarios and consequent trends which are way beyond the experience or comfort zones of most directors. The consequence has been frequently that those charged with the highest level intellectual competences in an organisation — the formulation of policy in an uncertain world — too often fall back and try hard to micro-manage their organisation from the boardroom table using only operational risk assessments as their key tool for direction-giving and decision taking. The problem then is that they feel good about this as they are exercising their well-honed skills. But there are two dreadful effects of giving direction-givers such false comfort. Firstly, they are not doing the job for which they are paid. They are not becoming sensitised sufficiently to their changing, uncertain external world to be willing to take thoughtful strategic risk. Secondly, they are blocking the development of the managers who have the specialist jobs which they are now attempting to micro-manage. This creates even more organisational risk and a learning climate of resentment and malicious obedience.

4. The information limits of decision-taking

I argue that all directoral and managerial decision-making is by definition with limited information. It is placing often strategic bets on the company's future while relying on a mix of some hard information and much gut instinct. Many directors feel very uneasy betting their company in this way. Because they are often brought up in a world of 'strategic planning' (an oxymoronic web to trap folk if ever there was one) rather than strategic thinking, they have few tools with which to try to get to grips with the turbulent external, business environment. Yet it is what they are paid to do and for which they accept in their directoral role both legal accountability and liability. Revans pointed out in the 1960s that all organisational decision-making is an information-gathering race against time [3]. As time always wins, decisions are always risky at the operational level, but especially so at the strategic level.

5. Risk as an operational concept

Where does this currently fashionable and much abused word 'risk' originate? It enters the English language from the Old Italian *riscare* meaning 'to dare'. One can see immediately that the original meaning of the necessity of risk-taking in life sits uneasily with many current political and corporate notions of the correctness and comfort of risk-aversion. Risk in its original sense echoes the even older Chinese ideogram for 'crisis' — a dangerous opportunity. But the present doubtful enthusiasm to drive risk out of human organisations by seeking ever-greater precision in data collection is a great motivator for many bureaucrats and compliancers. Their work can be seen in the over-strict demands for compliance of some Health and Safety officers generally, and in the business world in the thoughtless application of, for example, the US's Sarbanes-Oxley (SOX) Act [4]. This latter is a wonderful irony where a piece of legislation brought in to tighten accounting procedures

against the risk of abuse by executives, auditors, lawyers, brokers, journalists and analysts has resulted in such stultifyingly risk-averse behaviours that one can only ponder on whether, left to its own devices, SOX will do more to harm US capitalism than Karl Marx could ever dream? An added irony is that it is those very auditors and lawyers against whose abuses the federal Act was created who are now making financial hay as they apply rigorously the new rules which were designed to thwart them. If such compliancers are left to their own devices (it is their job after all), then their organisations decay and die, unable to cope with the uncertainties of their changing external environments because directors and executives are unwilling to 'dare' sufficiently or to manage dangerous opportunities.

A modern interpretation of operational 'risk' can be seen in the UK's 1999 Turnbull Report [5]:

> Risk is real, or possible, events which advance the likelihood of reaching business goals and increase the probability of losses.

It concerns coping intellectually, directorally and managerially with this constant mix of chaotic events, external and internal to your organisation, plus the addition of the mathematical concept of probability, which makes taking risks so fascinating. I have written elsewhere [6] of the critical importance of accepting that '... risk assessment is not an exact science — it relies on the directors exercising their judgement.' Few are comfortable in so doing. Few will now consciously bet the business on one strategic move quoting Marconi, Equitable Life and Enron as dire examples. But, through a mixture of inaction, ignorance and uncertainty of external business environmental trends, many do just that albeit unconsciously.

6. Daring, advantage and thoughtful reward

The whole object of taking a risk is to gain an advantage. Whether this advantage is purely physical survival or financial, social, political, technological or environmental depends on the issue and the personal values of those taking the risk. An important development of the argument for coping with uncertainty and risk is that all risk-taking involves subsequent learning. All learning has a moral dimension. This is evaluated by the value set of the person or group taking the risk [7] — ultimately is it 'good' or 'bad', is it 'right' or 'wrong'? You cannot be both wimpish and successful in taking risks. But you can be thoughtful.

The key to taking a thoughtful risk to gain an advantage is that there exists a calculable risk/reward ratio. It is this concept of risk and reward which tends to be driven out by over-exuberant compliancers. Remember that life is risky. And risk is healthy. It defines the human in relation to their environment and triggers both their survival and developmental mechanisms. Without risk it is impossible to learn — to move from a less informed state to a more informed one through the acquisition of knowledge, skills and attitudes. But because risk is calculable, regardless of the complexities of the calculation, it is fundamentally an operational concept and, therefore, firmly in the realm of the executives in an organisation, rather than the board of directors. There is an expectation by many directors and managers that, once assessed, risk is containable by the organisation and that it is the executive's job to design, install and maintain the organisation's prudent control systems to do just that. The executives make the risk assessments on which the day-to-day performance of the organisation sinks or swims.

7. Corporate governance and board performance

For statutory directors things are different. Let us return to the meaning of words and the webs that they create. Corporate governance is another currently fashionable phrase. To the general public it seems to have arisen following the Maxwell pensions scandal. But it is much older than that. 'Governance' itself can be traced back some three millennia to the ancient Greek *kubernetes*. This means 'the steersman', the person who gives direction to a ship or organisation. This meaning flows through Latin and French language development and appears in Middle English in the *Canterbury Tales*. But then it virtually disappears. It is not until 1984 that Tricker writes the first book entitled Corporate Governance [8]. After the Maxwell scandal Cadbury writes a report in 1992 for the London Stock Exchange called 'The Financial Aspects of Corporate Governance' [9] which put the phrase into wider circulation in the business and governmental worlds, although it is not until the Enron scandal of 2002 that the phrase is in general use — and abuse.

This abuse is seen in the creation of a corporate mindset and culture fuelled by the growing notion of 'governance equals compliance', i.e. that, provided you have ticked all the boxes demanded by the regulator, then you can do anything else while still claiming effective corporate governance. This is dangerous and reductive nonsense. Remember that Enron was 100% compliant under the then US 'rules-based' regulations. Such a compliance-based system tends to drive out ethical enterprise. The UK and Commonwealth system is different in that, while it asks for compliance, it is 'principles-based', i.e. if your particular situation does not allow for full compliance, then you can go to your owners and explain the situation openly. If they agree, then discretion is allowed by the regulator and the market will decide the final outcome. If not, the owners have the right to sanction or sack the directors.

In a principles-based system, risk moves from a focus only on legal compliance to a focus on the quality of the judgement of the directors.

8. Cybernetics, homework and added value

But there is another, often forgotten, aspect to the word *kubernetes* which flows straight into modern English — 'cybernetics'. This concerns the connectedness and responsiveness of systems. This meaning focuses on the survival, capability and development of the whole — on total organisational performance. Originally the word concerned living organisms but now it is applied to all systems. Looking at the highest level of an organisation — the statutory directors — their role is to integrate the worlds of uncertainty (policy formulation) and risk (operational prudent control) at the strategic level of the organisation. The statutory director's primary role is to blend board compliance with board performance. This role is continuous and complex. It does not just happen around the boardroom table once a month. Directors have 'homework' because directors are 'always on', especially in terms of accountability and liability. Many directors do not appreciate that their primary role is to balance and rebalance the 'director's dilemma' — how do we drive this enterprise forward while keeping it under prudent control? This was put most elegantly by Sir Brian Pitman (the 'bankers' banker') when asked about his definition of 'added shareholder value' to which he responded that it is 'the economic value added after taking into account the reasonable short-term demands of the shareholders, the cost of capital, and ensuring the long-term health of the business' [10]. As he doubled shareholder value for Lloyds bank shareholders every three years for fifteen years this deserves serious consideration. Even a cursory glance at the issues behind 'the reasonable demands of the shareholders' and 'ensuring the long-term health of the business' show that balancing the director's dilemma is a proper job — and one that is often not addressed well with the subsequent uncertainties and risks exposing dangerously the long-term health of the business.

9. Learning and strategic risk

Among the strategic risks which directors need to address through their PPESTT analyses, and ensure that the executives have appropriate control systems for them, are such issues as:

- reputation,
- financial/funding,
- political,
- country,
- legislative,
- regulatory,
- health and safety,
- physical environmental impact,
- human rights,
- information security,
- terrorism,
- business continuity.

Most of these issues are not comfortable territory for either directors or managers. But in each it is the directors, rather than the managers, who are ultimately accountable and liable. This requires new learning for them and their organisation, and I stress a particular emphasis on strategic thinking rather than planning (a key role of managers).

10. Learning as the key to using uncertainty and risk

So let us look at another abused word — learning. It leads us into more signification traps than most, nationally and internationally, and unleashes deep passions especially about the role of power and individuals in society. The word does not have a Greek or Latin root but comes out of a more democratic Celtic tradition via northern Germany and then the Old Northumbrian language. It is very different from the Latin and French notions of the one-way transference of knowledge. You cannot 'learn' another person anything. Only they can do it for themselves. They do this by wanting to move from one state to another through that acquisition of knowledge, skills and attitudes based on personal values as I described back in 1986 [11].

In addition to learning I add the word development. This derives from the Latin *volupe* and has two related meanings:

- seeing the richness within,
- making it manifest.

So whether one is involved in property development, business development or personal development, it is both the sensitivity to spot potential richness, and then make it useful which defines the process — and the consequent learning.

Organisations are similar. It is the clarity of their ability to codify and diffuse knowledge which allows them to survive and grow, or, if unable to so do, then to wither and die. My colleague Max Boisot has written extensively about this and a quotation from his chapter in the book *Developing Strategic Thinking* [12] illustrates the point well:

> Organisations have been conceived of primarily as a device for reducing uncertainty. They achieve this by creating zones of stability — structures — that can maintain their identity over time in the face of external variations. Yet where the rate of external change increases excessively, stability can be ill-adaptive and threaten the firm's survival. Some balance has to be struck, therefore, between rates of external change

> and the rates of internal adaptation to change. This requires strategies for reducing uncertainty which must be complemented by strategies for absorbing it.
>
> In sum we can think of an organisation enhancing its survival prospects not by seeking out the unique strategy or strategic approach which fits its circumstances but by expanding its strategic repertoire to cope with a broader variety of environmental contingencies. Developing managers to handle a repertoire of strategies, however, is quite a different matter from grooming them within the framework of a single strategy. To succeed in this task people working in management development will need a much surer grip of strategy than they have displayed until now, and strategists will require a greater appreciation of what management development has to offer for the extension of their strategic repertoire.

He then continues with a very helpful anthropological analysis of organisational uses of information — moving sequentially from clans to fiefs to bureaucracies and finally to markets and the real dangers, even the impossibility, of trying to leapfrog from one to another without being aware of the necessary and sequential learning process.

11. The learning organisation

I wrote the first book on the learning organisation back in 1986 [11] and have been developing it in all sizes of organisation and on five continents ever since. The essence has been to accept that there are three levels of learning in an organisation — policy formulation, strategic thinking, and operational — and to see these not as a pyramidal structure but rather a figure-of-eight, or lemniscate, with strategy as the central processor — what I call 'the business brain' with the board at the centre but using information from managers and customer-facing staff to improve the richness of their ideas, risk-assessment and decision-taking processes. The upper loop of Fig 1 symbolises the board and the organisation's interaction with, and learning from, the outside world. The lower loop with the board's interactions with, and learning from, the internal, operational world.

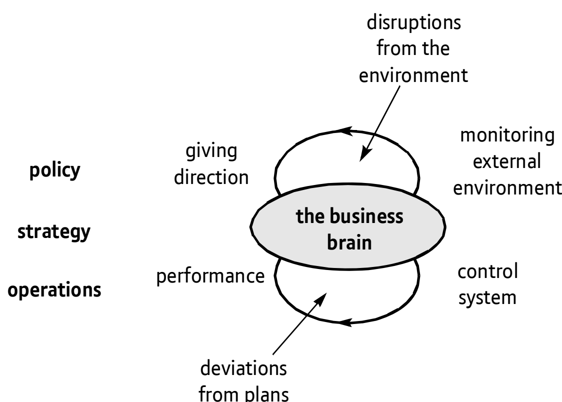

Fig 1 The learning organisation model.

A crucial differentiator here is between the board dealing with uncertainty (perceived organisational effectiveness) and the managers dealing with operational risk (organisational efficiency). Both are measurable and need to come together at the level of strategic thinking in the business so that directors can uphold their fiduciary duty as directors.

12. The Learning Board

The concept of the Learning Board [2] has been developed internationally since 1990. It starts from the assumption that director level strategic thinking, problem formulation, ideas generation, risk assessment and decision-taking are all part of that basic directoral dilemma — how do we drive our organisation forward while keeping it under prudent control?

The basic framework for the Learning Board quadrant (Fig 2) has on the vertical axis a range from internal to external perspective, and on the horizontal axis a range from long term to short term. It assumes the ability of a board, and the managers, to acquire a repertoire of thinking styles which between them cover all these aspects. No director will have all of them, but then a board is legally a collective and collegial entity and needs to ensure that it has the range among its constituent members.

Each quarter of the quadrant is focused on different aspects of a board's learning cycle:

- policy formulation,
- strategic thinking,
- supervising management,
- ensuring accountability.

13. Policy formulation and strategic thinking develop coping with uncertainty

Policy formulation (developing the 'political will' of the enterprise to deliver its purpose) is the start of each financial year and reviews its purpose, vision, and values (which should move little if at all) and then measures the movement in the emotional climate, and subsequent corporate culture, of the whole.

The primary debate for the board of directors revolves around the way they bring their views of the uncertain, external world ('monitoring the external environment' via the PPESTT analysis) into the risky process of 'positioning in the changing markets'. This is not a debate only for the

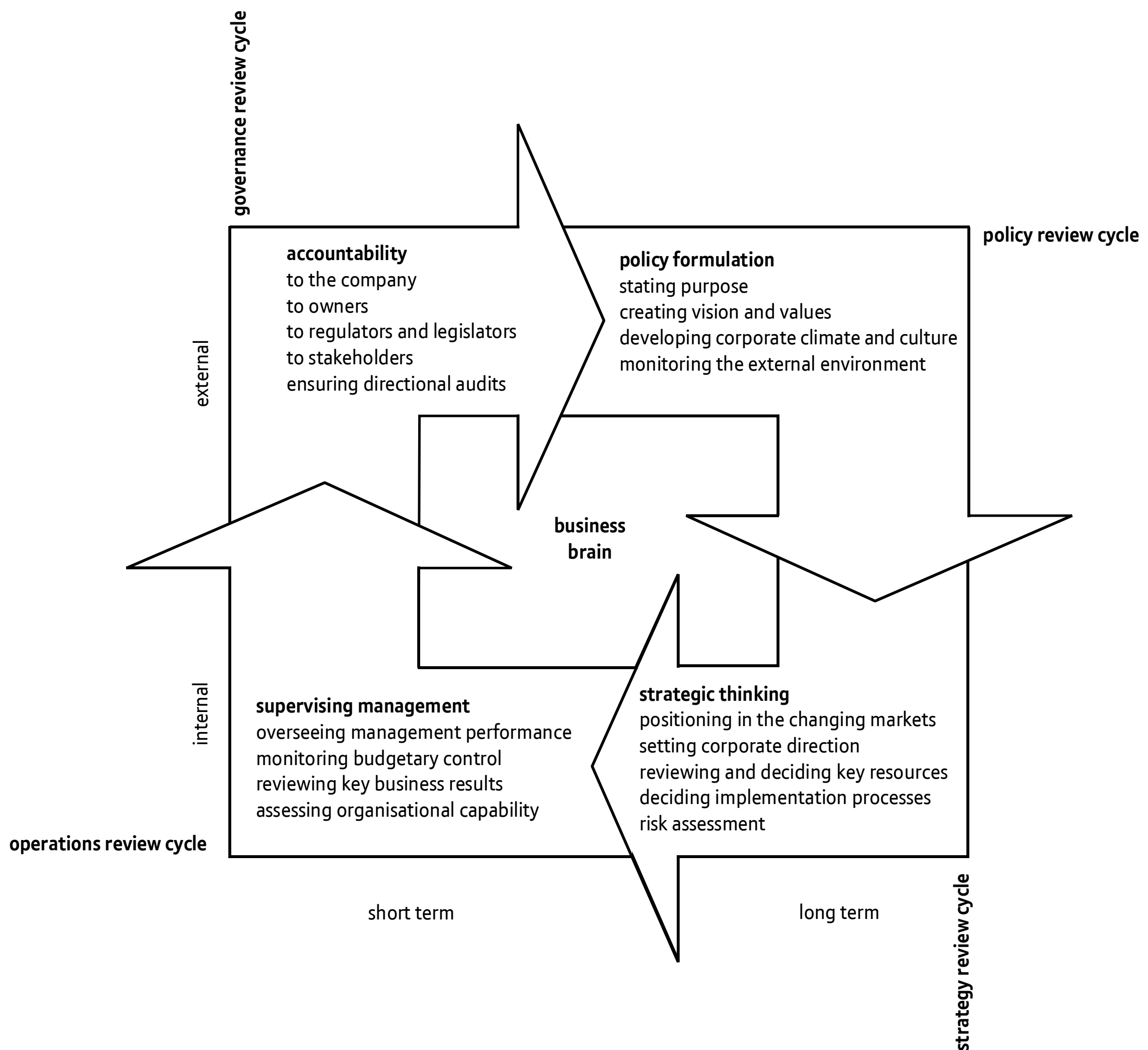

Fig 2 The Learning Board model.

board but must be informed by both managers and customer-facing staff, and have their commitment to ensure effective implementation of the subsequent strategy.

Policy formulation and strategic thinking focus on 'board performance' and the total effectiveness of the organisation as perceived by the external world. Supervising management and accountability focus on 'board conformance' (compliance) and its internal efficiencies shown by its prudent control systems.

14. Supervising management and ensuring accountability help cope with risk

The second crucial debate occurs at the interface between strategic thinking and supervising management. The key is to ensure through measurement [13] that the organisational capabilities exist to both implement the strategy effectively and to ensure fast feedback from the reality of the customer-facing staff. This necessity for 'fast learning' to refine or abandon strategy has been developed well recently in the British army [14]. This is where the cybernetics aspect of *kubernetes* comes into play. It is where operational risk is not only developed and tested but, as my colleague Ram Ramakrishnan has shown in many organisations, can be both benchmarked and then measured rigorously in real time [15] — for operational risk assessment the notion of measuring real-time organisational change and learning is the 'Holy Grail' and Ramakrishnan's work is helping us get there.

Built into the Learning Board model is the notion that there is an annual rhythm to a board's year and that this in turn drives the whole organisation forward. At its crudest the board would have a series of 'awaydays' starting with the first month of the financial year where the purpose, vision, values and culture are reviewed, and the output from the systems for monitoring the external environment form the basis of the primary strategy debate.

At least every three months the board and managers have an awayday to take the outputs from the monitoring, together with their PPESTT homework, to position themselves in the changing markets by the development of a strategy (defined here from the ancient Greek as 'the broad deployment of our scarce resources to achieve our purpose').

Even in global corporations we have been able to reduce the time per month spent on 'the numbers' to an hour. This is achieved by looking at trend lines within agreed parameters and by not trying to micro-manage the managers from the boardroom table.

In month 9 of a financial year the board needs to take a good look at delivering its accountabilities. In the old days before 'regulators rule, OK' this was often post-rationalised at month 13. Today we have to be spot on in our accountabilities to:

- the owners,
- the legislators and regulators.

The annual rhythm can be put in the board and managers' diaries a year ahead so that there is no reason why people are not following the different thinking foci needed at different quarters during the year. Consequently there is no reason for being unprepared or missing each of these key meetings because they are part of a director's contract for services. This annual rhythm is the key to opening up the continuing debate and learning needed to balance uncertainty and risk in an enterprise.

15. Personal and group risks

However good the directoral processes, there are always issues of personal and group risks which can help or diminish the achievement of policies and strategies.

At the personal level an annual appraisal of directors and managers is essential to allow them to understand the content and style of their contributions and to work on an agreed personal development plan as a crucial part of their work. But this is often derailed by a common failing of directors who fail to change their mindsets from being a manager — their obsession with just being seen to work regardless of the quality of the outcome. Many directors with whom I have worked are frightened of being found out of just sitting and thinking policy and strategic thoughts because they do not rate this as 'proper work'. This often becomes mixed with a raft of personal fears which include:

- being exposed as not knowing my specialism well enough,
- being exposed as not knowing other specialist areas,
- fear of failure,
- fear of the effects of failure on my personal circle,
- over-focus on interpersonal issues,
- fear of inability to resolve conflict.

These all allow managers and directors to lose too easily the entrepreneurial reward aspect of the risk/reward ratio and to fall into risk-aversion with the well-known phrase: 'I cannot take that risk as it is a career-threatening opportunity'.

In addition, the work group, be it the board, the executive committee, the top team, etc, are also prone to collective risk. A particularly dangerous version is to become too isolated and insulated in their thinking. Perhaps the best tested long-term study is that of Irving Janis in his book *Groupthink* [16]. In this he outlines eight causes of group malfunction and consequent risks:

- illusion of invulnerability,
- collective efforts to rationalise,
- unquestioning beliefs in the board's inherent morality,
- stereotyped views of rivals and enemies,
- direct pressure on dissident board members,
- self-censorship of deviations from apparent group consensus,
- a shared illusion of unanimity,
- the emergence of self-appointed 'mind guards'.

16. Conclusions

It is only when the hierarchy of uncertainty, strategic risk, operational risk and personal risk is identified, clarified and worked upon as a developmental learning system that 'risk' becomes a necessary and healthy aspect of organisational life. But one can never resolve the issues of uncertainty and risk totally because the fundamental directoral dilemma is by definition irresolvable because of the constantly changing dynamics of the external environment. That is why we have directors to continuously balance and rebalance the scarce resources of the organisation to cope with the changing external and internal environments — balancing organisational effectiveness externally with organisational efficiency internally. But such a balancing directoral role is frustrating for many managers and technical specialists who view directing as a voluntary, part-time role of little significance. It is not. It is vital to ensuring that shareholder value is added in the long term and the legal fiduciary duty of directors is delivered. Paradoxically these 'hard' aspects of directing are best achieved by such 'soft' areas as scenario creation, strategic thinking, collegiate behavioural develop-

ment and facing personal risks. Perhaps such soft areas are really quite hard? In my experience being on a board dealing with uncertainty and risk feels very much like F Scott Fitzgerald described in *The Crack-up*:

> The test of a first-rate intelligence is the ability to hold two opposed ideas in the mind at the same time, and still retain the ability to function.

This requires a developmental approach to directing, uncertainty and risk which few organisations have tried — yet. We have a long way to go but getting directors to think strategically is a good start.

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