Boards Face Big Challenges On Risk Oversight

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Introduction

There are few aspects of a board's functioning that are as crucial to long-term corporate success as risk management. Organisations that understand the risks they face and can articulate their risk appetite and define their risk strategy will tend to make better decisions, have greater agility and a sharper competitive edge.

Discharging the board's duties and responsibilities around risk oversight is rarely straightforward. At the heart of the challenge are two apparently conflicting desires. First is the push to improve performance – shareholders demand it and basic competition compels it. But the second sets up a tension – it is the need to understand and manage the risks involved in achieving that performance.

Potential Tension

Non-executive directors often have a less detailed awareness of the key risks within the business compared to management. The nature of the role means they have access to less information than management on which to assess the risks that the organisation takes. Addressing this imbalance of information is often a challenge.

The source of information around risks also varies significantly between organisations. Some rely on risks being identified and reported from lower levels in the organisation and aggregated company wide by someone responsible for risk management. Others rely on senior or executive management preparing a suitable summary of key risks and responses for board consumption. Such approaches are not always founded on underlying risk indicators from within the business and may be unduly influenced by executive perceptions of risks and board expectations.

Gathering Information

The key question is how much of this risk information from the business is provided to the board? Management naturally seeks to review and potentially sanitise information before presentation to the board. As a result, board members normally gain some understanding of the effectiveness of risk management, but may lack focus on key or emerging risk issues which can hamper non-executive directors' (NED) ability to oversee risk well.

It's a struggle for many companies to prepare an appropriate risk summary for board members that succinctly articulates the key risk exposures, threats and emerging issues. Often such analysis is separate from strategy and performance discussions, so there is little chance of understanding risk in the context of achieving strategic objectives and delivering shareholders returns.

Often the risks that are most material to an organisation will be those that most disrupt the business's ability to achieve its objectives. Understanding how much risk has been taken in the pursuit of strategic performance is one of the ways that the board can tell if the current risk profile is appropriate.

Understanding And Challenging

Even if the right information is given to the board, it's not always easy for NEDs to assess and challenge it, especially if they come from unrelated industries.

Directors' responsibilities are ever-increasing and NEDs commonly say that they have limited time and resource to discharge them. How much time does the board (and NEDs in particular) devote to understanding and addressing risk issues? Risk does now play more of a role in board discussions, but the growing complexity of organisations and the risk issues they face now demands more time and resource to be properly understood and addressed.

Risk Contagion

Today risks can manifest themselves suddenly and have an impact on the organisation immediately. In the past, operational failures could often be managed internally with limited impact on an organisation's reputation.

Today, any risk event is potential headline news that can result in reputation damage and have an impact on the business going forward. This 'risk contagion' demands quick and agile responses to minimise the damage to the organisation. It also requires organisations to develop strategies to deal with the growing importance of reputation risk and how it is related to financial and other risks.

Boards and risk management functions need to be prepared to respond quickly and minimise damage if risks events do occur.

Risk Thinking

Organisations operate within a variety of corporate governance structures. But whatever the framework, clear risk oversight from the board (distinct from management) is essential. Good risk management within organisations is undermined if it lacks the board's breadth of risk thinking. There is a real danger that risk management focuses only on day-to-day business activity, such as health and safety, financial or operational issues – and in doing so, completely misses the bigger picture.

The board's diversity and broad perspective on external hazards and strategic threats helps support a richer and more comprehensive risk management process.

But demonstrating the potential relevance of these external, independent views to the organisation and getting senior management and executive buy-in present another challenge for the board.

The Role Of The Audit

The board will often seek assurance from internal and external audit around the effectiveness of controls intended to manage key risks. However, many risk management frameworks fail to appreciate the true risk exposure that the controls manage. The result? The effectiveness of certain controls in reducing the impact and likelihood of risks is not always appreciated and so their importance is underestimated.

It is often the failure of one or more of these controls that leads to a previously well controlled risk having a material and unexpected impact on an organisation. So boards need to understand the reliance being placed on key controls, as well as keep a grip on the underlying risks for the business.

Consensus around the board table and confidence in management and external stakeholders is a tempting prospect. But NEDs can never lose sight of the good governance essential: challenge. And challenge around risk is no exception.

Appropriate risk information needs to be available to the whole board; the board needs sufficient risk management competency to assess this information effectively; and there needs to be an open and constructive dialogue between executive and non-executive directors around risk issues. ■