# Governance, risk and reputation

Yet again in 2018 the issues of corporate governance and its failures raised their heads, as well as related issues of risk (including terrorism) and reputation. Our blogs covered many varied aspects of all these concerns.

# Reputation damage – will they never learn?

Listening to David Davis trying to clarify what he had said on TV last month reminded me that lessons about audiences and messaging have perhaps not been learnt. It is over 25 years since Gerald Ratner's High street jewellery chain was brought down by careless talk, so for younger readers it is worth recalling the basic lessons which David Davis has clearly forgotten.

Ratner was speaking to an audience of financial journalists about his company's excellent sales figures, it was after lunch when he incautiously attributed his profitability to the fact that his products were 'crap'. While this went down well with hardened city hacks, it wound up in the tabloids where Ratner's customers naturally sensed they were being exploited. Within weeks sales plummeted and the rest is history. Ratner had failed to appreciate that sentiments aimed at one audience cannot be prevented from reaching others where interpretation is often more hostile.

Now back to David Davis at his TV interview in December, barely 48 hours after the Brexit deal had been signed in Brussels. Playing to a Sunday lunchtime domestic audience Davis was keen to point out that this agreement signed on Friday was not legally binding and was only a signal of intent. Why would he do this? He was addressing an audience not only of middle- Englanders who watch Sunday lunchtime TV, but also trying to please the Brexit ultras in his own party, many of whom like Michael Gove, had already gone on record to claim the deal could be undone if people didn't like it.

In Europe the message did not go down well, Dutch and German politicians took the message that the UK was not playing with a straight bat, and inevitably signalled that this was not going to augur well for negotiations about future trade. Davis's 'unhelpful' comments were quoted back to him by Nick Ferrari on LBC at which point Davis tried to claim that he had been misquoted. Davis then took to the Commons to clarify his position realising that in trying to appease Brexit ultras he had threatened the credibility of the UK with Brussels. One might have thought that the government had learnt a lesson from the preceding week: the UK tried to keep Belfast out of the loop preferring to work with Dublin, right up to the point where Belfast found out.

At the time of writing I have been reading an account of Luther and the impact his work had on the Catholic Church in the early sixteenth century. An attempt to reconcile the theological stance of Lutherans with the traditional Catholic Church in 1530 resulted in the Augsberg Confession. This was a statement of agreement which not only provided us with word 'protestant' but was *'the result of many compromises and was purposely inexact in many places'*. Historians have commented on the similarities between the early sixteenth and twenty-first centuries, specifically social impacts of both printing press and the Internet, but obfuscation and compromise are also common features.

The challenge in a world of 24-hour rolling news is to recognise that messages intended for one audience will inevitably reach another. The David Davis debacle shows that this lesson has still not been learnt. Sentiments for a domestic audience channelled through national media, will be relayed to an international one, especially on such a sensitive topic as Brexit. Given all the diplomacy exhibited by Davis to date his attempt to appease a domestic audience so soon after an international agreement shows how much the UK capitulated to Brussels. Politics aside, the lessons of Ratner, and Augsberg, must be learnt.

Communicating forward plans to all audiences requires careful thought, drawing on both these historic lessons and views on future strategy, in various scenarios, to guide us towards robust decisions.

*Written by Garry Honey, CEO,* ***Chiron Reputation Risk*** *and SAMI Associate, published 10 January 2018*.

# Bad Decisions

This was the title of an interactive seminar, led by Professor Paul Moxey, around the topic of how to avoid cognitive bias – or at least limit its effect on decisions.

> "A **cognitive bias** refers to a systematic pattern of deviation from norm or rationality in judgment, whereby inferences about other people and situations may be drawn in an illogical fashion. Individuals create their own "subjective social reality" from their perception of the input." (Wikipedia)

The seminar identified many types of cognitive bias, before focusing on three factors.

First, managers in organisations often are encouraged – by culture or by financial rewards – to develop an optimistic cognitive bias, leading to disaster for the organisation. Examples include Kids Company where "**The Chief Executive and Trustees relied on wishful thinking and false optimism and became inured to the precariousness of the charity's financial situation**" and HBOS where "**The FCA Final Notice found that the Corporate Division had a culture of optimism, incentivised revenue focus rather than risk and viewed risk management as a constraint on the business rather than essential to it**" . This optimism bias is often found in organisations that encourage groupthink rather than encourage challenge or diversity of thought. The Bay of Pigs invasion of Cuba is a classic example.

Second, there will be many more examples of corporate damage or failure arising from a cognitive bias among senior staff. One example discussed was when they hold the belief that all risks from IT system failure should be dealt with by the CTO and his team whereas of course senior staff also have a responsibility. Many current examples of system failure arise from human error, due to insecure handling of passwords leading to unauthorised access, so that hackers can create rogue transactions and flood systems, taking them down. And loss aversion must be responsible for some of the major cost over-runs on IT and other projects before a halt is called. We worked on an anonymised case to discuss the cognitive biases that could have caused failure of governance.

Third, a source of bad decisions, often aligned to cognitive bias, is the **use of small samples to derive or support other experimental results**, as described by Daniel Kahnemann and Amos Tversky. Many people are innumerate but even those who have many numerical skills quite often fail to spot when this is happening. It was suggested that expressing results as both a number and a percentage helps, either alone can be misleading.

How to guard against cognitive bias and make better decisions? Our list is as follows:

- Define the problem you are trying to solve and check whether other perspectives see it differently.
- Use views of the future to develop a set of possible options
- Test the options against all the stakeholders, not just the actors
- Look for counter evidence on the future and current position, what are you not seeing?
- Make a decision and explain in detail to all stakeholders – be prepared to revise if necessary

- Use a pre-mortem technique – imagine yourself in five years' time and the decision had been a disaster – why could that have been? How can you make it successful?

The list looks long but can be implemented within a week, and most decisions can wait a week!

*Written by Gill Ringland, SAMI Fellow Emeritus*, *published 24 January 2018*.

# Reporting risk

*In this blog, Garry Honey, SAMI Associate and CEO of Chiron Risk, looks at how risk is reported and examines some alternative ways of mapping risk.*

Disclosure of risk has always been a challenge for listed companies, this was recognised by the FRC when it introduced ‘materiality’ and ‘proportionality’ in previous iterations of the corporate code. The financial crash of 2008 prompted the code to improve risk reporting, so the past 10 years have seen more emphasis on this. A new FRC publication on **Risk & Viability reporting, from the Financial Reporting Lab**, acknowledges the way risk reporting has evolved of late. Apart from the ‘inherent tension’ between revealing useful information to investors and highlighting weakness for competitors to exploit, is the underlying question of confidence and competence. In disclosing risk, investors expect to see a strategy in place to handle it together with a management team capable of delivering it. Risk is finally being rehabilitated alongside strategy, something the Strategic Report was designed to encourage. Risk had initially been treated as a compliance or control function, a topic with potential to unsettle investors rather than inspire them. In talking to investors the Financial Reporting Lab has finally confirmed what has been known in the City for years: namely that investors expect companies to take risk so they look for a mature conversation about risks consciously undertaken in order to deliver an attractive return on investment. Risk is an inherent part of the investment conversation; combined with strategy it forms the vision of a profitable future for the company.

The Risk & Viability report, based on consultation with investors, sets out areas in which risk reporting can still improve. The main one is the challenge to convince investors that the management team know their own limitations, being realistic about what can and cannot be achieved. There are only four strategies for tackling risk (avoid, manage, mitigate and transfer) but how many risk reports actually match each principal risk to an appropriate handling strategy? Admittedly much risk reporting in the UK also has to take account of jurisdictions where reporting rules are different, but this comes back to the purpose of risk reporting rather than liability in foreign courts. It should not be left to a regulator to specify the types of risk to be disclosed, a company should decide what disclosures would be beneficial to investors and other key stakeholders.

Communicating risk that is both useful to investors and compliant with regulators should not be impossible. Unfortunately, much risk reporting still relies on the Heat map or risk matrix (see fig 1). This categorises risk according to probability and severity which satisfies insurers and CFOs as it relies on financial cost or loss as the key spatial determinant. Presenting top 10 principal risks on a heat map focuses attention on the urgent and important risks, and as such is a valuable tool in board meetings to determine priority tasks. Investors, however, expect more than this as it only gives a snapshot in time: it doesn’t take account of the dynamics of risk and certainly doesn’t indicate what management are going to do to combat it. This model is rather outdated and there is a better model which gives investors a more reassuring picture of response to risk.

fig 1

This advanced model has found favour among a number of corporations keen to show investors that there is some strategic thinking about risk. In short it moves the conversation away from just identifying risks as a passive statement towards an approach known as active risk management. This is shown in fig 2 which employs two different axes: ease of control and ease of prediction. In this way risks can be shown in a way that makes the response strategy self-evident: mitigate, measure, monitor and manage. The latter category naturally covers risks that are easier to control or predict. The significant difference is between the hard to control but easy to predict and their opposites the hard to predict but easy to control. This distinction helps differentiate between financial and strategic risks, some of which are shown as examples in fig 3.

fig 2

fig 3

The conversation about risk which follows the mapping thus focuses on increasing control of those risks identified as financial and increasing prediction among those identified as strategic. In this way more of the risks in the yellow boxes are migrated to the green box as they ultimately become operational and by implication manage-able. This approach allows a company to show that effective risk management is not only about increasing control but also increasing predictive skills through consideration of

alterative futures via foresight. Risk as future uncertainty deserves this approach and investors welcome it.

The Risk & Viability report from the FRC also found that investors want to know how companies are preparing to address some of the generic business risks such as Brexit impact. It will not be enough to show that the risk has been identified or that contingency has been made for a Hard Brexit or 'No deal' exit from the EU in 10 months' time. Investors want to see not only that alternative outcomes have been envisaged but that each alternative scenario is described within the context of a compensatory risk appetite adjusted to the marketplace. The dynamics of risk as a future outcome require new reporting that is not afraid of discussing alternatives. We live in uncertain times.

*Written by Garry Honey, CEO, **Chiron Reputation Risk** and SAMI Associate, published 31 January 2018.*

# Five key lessons for boards from the Carillion collapse

The sudden collapse of a business like Carillion has raised questions about financial reporting controls, auditor vigilance and exactly who should have acted sooner. The government is embarrassed by exposure to public infrastructure projects across several departments, while many smaller sub-contractors will never be paid for work they've done. The board of Carillion must bear much of the blame so what could they have done to avert this crisis?

1. **Accept collective responsibility** – Boards are made up a experienced directors selected on merit to deliver commercial success in the form of profit and shareholder dividend. The executive members operate the business on a day-to-day basis, while the non-executive members offer balance and wider perspective tasked with holding the executive to account on behalf of the shareholders. Together both groups collectively share responsibility for the business model, its strategy and risks. it is not acceptable to blame the Finance Director or auditors alone, the board is a culpable entity.

2. **Separate governance from management –** Distinction is often hazy but it is worth quoting from the British Standard for Effective Governance of Organizations (BS 13500): *'Management is about getting work done, whereas governance is about ensuring that the right purpose is pursued in the right way and that the organisation continuously develops overall.'* A board should know if suppliers are being paid late or that bill payments are being made with credit: a cash-flow problem demands attention, not as an emollient to shareholders, but to address inherent structural problems.

3. **Respond to warning signs –** Some are obvious but not all: a rapid turnover of chair or FD is pretty obvious and demands question, but so too does hedge fund activity in shorting your share price. If professional investors are betting on your share price collapsing in the future what information do they have that you don't? Boards can suffer from optimism bias and 'groupthink' and justify 'inside knowledge' for why they know better, but these viewpoints can prove to be delusional. Responsible directors ask probing questions even at the risk of making others around the table uncomfortable.

4. **Challenge experts –** Just because the Head of Risk says that risk is being managed it doesn't mean he's right. Risk is not a concept that all directors understand equally and that is a good thing. Perspective is a valuable tool in risk appreciation, especially as once recognised controls for handling it can be pretty straightforward. The same goes for assertions from the FD, Head of Internal Audit

or indeed Head of Sales. Future business is never certain until the cash is in the bank. This is something Enron learnt to its cost. Even Tesco now understands that external auditors can be wrong also.

5. **Prevent the death spiral** – This can be quite fast and consists of five stages: it starts with shares being sold in volume forcing the price down and reducing market capitalisation. Lenders get nervous and refuse further loans so the cost of borrowing increases. Ratings agencies downgrade your stock and cash flow stalls, this is the liquidity crisis often known as the Wall. Death can be averted through cash injections but white knights are scarce, the fifth and final stage is administration. Boards need to prevent this death spiral through listening to investors not just their own executive team.

There is an ominous sixth lesson for boards as well: avoid performing so poorly as to attract the attention of a Commons select committee. MPs will ask probing questions you should have had the temerity to ask, a press and wider public will be amazed at your lack of scrutiny. In order to take 'robust decisions in uncertain times' collective leadership must be competent and capable.

*Written by Garry Honey, founder of **Better Boards,** CEO, **Chiron Reputation Risk** and SAMI Associate, published 14 February 2018.*

## Why boards fail to address risk

Does your board spend as long debating risk as it does strategy? Both are estimates of opportunity and threat in an unknown future environment. Both require sound judgement and a keen appreciation of where the organisation is headed, yet there is ample evidence that many boards see risk only through the lens of business continuity, control rather than uncertainty. Those who do appreciate the concept of uncertainty, often regrettably seek certainty in the wrong places. Misplaced certainty and ignorance of risk have been evident in three recent high-profile cases of poor decision making by boards. I shall look at Carillion, Oxfam and KFC.

Carillion collapsed spectacularly because the board failed to fully understand the financial predicament it was in. Finance heads and external auditors claimed the business was technically solvent, when in reality it wasn't. Institutional investors and hedge funds knew there were problems long before the collapse on 15 January 2018 yet none of the board directors queried this. The board collectively trusted assurances that the business was fine right up to the sudden profit warning of July 2017, at which point the CEO was fired, and the ship began sinking fast. Groupthink was a factor, as was confirmation bias and over-optimism, all of which academics knew 40 years ago can cause systematic bias leading to errors of judgement.

Oxfam has suffered significantly through revelations of unethical behaviour among its field agents over seven years ago in a disaster relief operation. An internal enquiry decided against transparency in order to protect the reputation of the charity, yet this decision, now revealed, has had the opposite effect with an immediate impact on donor trust. The board should have known that secrecy would be a reputational time bomb. Was this down to cognitive dissonance, they just didn't appreciate the severity? Or was it down to anchoring and adjustment based on familiarity with resolution of previous staff misdemeanours? Was it perhaps an escalation of commitment and a determination to justify a course of action because too much time had passed?
KFC has lost a lot of customers and been forced to close branches due to food shortages. This followed a switch in chicken distributor, a cost saving in logistical overheads. Unfortunately the new distributor (DHL) could not replicate the branch supply schedule of the previous distributor (Bidvest) and hence stores ran out of stock and had to close. Did the board of KFC question the rationale of changing distributor or did the head of logistics reassure them of the upside cost saving rather than the

downside supply risk? It turns out that Burger King had previously switched to DHL but quickly reverted to Bidvest when they saw that it wasn't working. Did the KFC board use this information or were they hypnotised by obedience to authority or attitude polarisation?

What should boards do to make better decisions and protect value? It would be nice to think that codes of governance emphasised the need to guard against cognitive bias, especially as the dangers have been known for over 40 years. A recent report by the Leadership Foundation for Higher Education found that governing bodies of universities do not take sufficient notice of heuristics and biases. This is true in the corporate world where 'groupthink and polarisation run counter to the predictions of rational choice decision making'. Boards need to appreciate the stewardship risk of misplaced certainty: to consider the personalities and agendas that collide in collective consensus.

*Written by Garry Honey, founder of **Better Boards,** CEO, **Chiron Reputation Risk** and SAMI Associate, published 7 March 2018.*

# Countering the Threat from Terrorism

*In this blog, and in the one following, Tony Diggle looks at two recent publications relating to the work of the Millennium Project, a voluntary think tank of futurists, scholars, scientists, business planners and policymakers worldwide.*
*This first blog looks at the proceedings of an Advanced Research Workshop on the "Identification of Potential Terrorists and Adversary Planning" held in Washington DC.*

In July 2016, under the auspices of the NATO Science for Peace and Security Programme, an Advanced Research Workshop on "Identification of Potential Terrorists and Adversary Planning – Emerging Technologies and New Counter-Terror Strategies" was held in Washington DC. It was organised by the Millennium Project USA and the FIRST2T group, Israel, and the updated proceedings were published last year. They make sombre reading.

Introducing the volume, Jamie Shea, a NATO Deputy Assistant Secretary General, pointed out that twenty years ago terrorism was problem for a limited number of countries and followed a predictable pattern. Nationalist groups such as the IRA had well-known political agendas. Now terrorism had become a universal challenge, with many more groups, increasingly networked, and some of which like ISIS had acquired a global outreach and appeal. Whereas the old terrorists focussed on state institutions or representatives, the new brand was more focussed on the liberal way of life and all its manifestations, in other words the ordinary man in the street – everywhere.

In a presentation from the two organising groups on potential counter-measures made by Ted Gordon and others, attention was drawn to a worrying vulnerability: the proposed approaches for monitoring, detection, trend analysis and archival resourcing currently under consideration by the counter-terrorism community all depended on the continuous availability of electricity. This made them vulnerable in toto to hostile cyber attacks. Gary Kessler reminded the workshop that shortly before it was held, NATO had officially recognised cyberspace as an operational domain, adding this dimension of warfare to air, sea and land.

Paul Werbos, former Program Director, National Science Foundation, USA, underscored this further in addressing the consequences of "cyberblitzkrieg" on electricity and other critical infrastructure. Recent releases of information widely reported in the media had revealed among other things detailed information about how the Stuxnet type of cyberattack could be used to destroy large electric power generators. The potential damage of such an attack on a number of big generators in the U.S. simultaneously could be comparable to that of a major Electromagnetic Pulse Event (EMP). Mr Werbos quoted Trent Franks, a Congressman with access to classified information, as saying in discussing EMP:

> *"Your folks are only worried because you do not have all the facts. If you had all the facts, you would be terrified out of your minds."*

Fortunately, technological solutions were available, but required tougher compliance and regulation to be implemented.

In short, technology by itself might cause as many problems as it solved when it came to trying to prevent terrorism in the future. A wider sweep at the problem was required. But what was the problem? Philippe Destatte, Foresight Associate Professor at Paris-Diderot University, pointed out that terror was inherent to violence and war. In Julius Caesar's "Commentaries on the Gallic Wars", he told of how his brilliant and brutal

attacks both retained his friends in their loyalty, and by fear, obliged the wavering to accept offers of peace. Although terrorism might seem an immoral form of war, the profound collapse that the moral code of behaviour underwent in almost all wars on the part of all parties in the 20th century, including the targeting of civilians, showed that the difference between terrorism and other forms of war was one of interpretation. Professor Destatte referred to Guy Standing, a professor at the University of London, who had described a large part of the adult population (at least a quarter) as alienated, anomic, anxious and prone to anger, in political disengagement: the precariat. Professor Standing had written:

> *"A group that sees no future of security or identity will feel fear and frustration that could lead to its lashing out at identifiable or imagined causes of its lots."[1]*

The context was explored further by Adrian Pop, Director of the Centre for Regional and Global Studies, Bucharest, Romania in a presentation focussing on the security challenges on the south-eastern flank of the Euro-Atlantic border. In a period of economic recession and high unemployment, increasing numbers of European citizens were disillusioned by what they viewed as mainstream government's inability to protect them from foreigners who threatened their values and undermined their economic development (irrespective of whether there was any justification for such a position). Yet in 2014, the countries with some of the highest levels of internally displaced peoples had the highest numbers of deaths from terrorism: Iraq, Pakistan, Afghanistan and Syria. These four countries were all accessible to Europe by land via its south Eastern flank, and this had become a transit corridor for millions of refugees. More than anecdotal evidence suggested that refugee camps could serve as breeding grounds for terrorism.

Recommendations made by the report to deal with the threat included engaging sources of potential terrorism in the political process and inter-religious dialogue. Countering social media terrorist propaganda remained of key importance, and the efforts of a UN Working Group focussed on this area needed to be developed further. Initiatives aimed at educating people (including people with a "Western" mindset) to "see the world as others see it" needed to be increased not scaled back as was too often the case. An "all-of-society" approach was needed, and the need to develop a system of values such as individual liberty, equality, social coherence and solidarity crucial for the future development of counter-terrorist measures.

All this is complex, and far easier said than done. In this brief review, I have only been able to scratch the surface of an extremely dense and probing publication that contained fifteen papers in all. The report underlined the seriousness of the problem. The proceedings are available in hard copy and in electronic format. Full bibliographic details are given below.

"Identification of Potential Terrorists and Adversary Planning – Emerging Technologies and New Counter-Terror Strategies" ed. by Theodore J GORDON and others. Proceedings of the NATO Advanced Research Workshop, Washington DC, 24th-27th July, 2016. IOS Press, Amsterdam, 2017. ISBN 978-1-61499-747-4 (print), 978-1-61499-748-1 (online).
Website: **http://www.iospress.nl/** E-mail: **order@iospress.nl**

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1. STANDING, Guy, "The Precariat: The New Dangerous Class", Bloomsbury Academic, London, 2011, pp. 24-25.

*Written by Tony Diggle, SAMI Associate and member of the UK Node of the Millennium Project. He writes in a personal capacity. Published 14 March 2018.*

# State of the Future 19.1

*In his second blog on the work of the Millennium Project, Tony Diggle looks at their latest "State of the Future" report.*

Published at the end of last year, this report is the nineteenth in a series of reports (originally annual and subsequently biennial) produced by the Millennium Project, a voluntary think tank of futurists, scholars, scientists, business planners and policymakers worldwide. It is intended to provide an overview of the global strategic landscape, a context for understanding global issues, opportunities and foreseeable prospects, and offers a systematic framework for understanding global change. It is aimed at thought leaders, decision-makers and interested parties generally. The Project's diversity of opinion and global views is ensured by its sixty-three nodes around the world in all continents.

The heart of the report is a description of fifteen interdependent global challenges and actions to address them: these are transnational in nature and trans-institutional in solution. The challenges listed are as follows:

1. Sustainable Development and Climate Change
2. Water and Sanitation
3. Population and Resources
4. Democratization
5. Global Foresight and Decision-Making
6. Global Convergence of ICT
7. Rich-Poor Gap
8. Health Issues
9. Education and Learning
10. Peace and Conflict
11. Status of Women
12. Transnational Organised Crime
13. Energy
14. Science and Technology
15. Global Ethics

The report finds that the world overall is expected to continue to improve over the next ten years. For example, extreme poverty has fallen from 51% in 1981 to 13% in 2012

and less than 10% currently. On the other hand environmental conditions, armed conflicts, terrorism and organised crime are getting worse. Distinctions between the last three have begun to blur increasing threats to democracies, development and security. Technological developments are expected to lead to a “fourth industrial revolution” making use of artificial intelligence, but as the developing world grows, water consumption per capita will increase giving rise to the possibility of serious water crises and migrations.

The body of the report dealing with the fifteen challenges individually is shorter and punchier than in previous years, but can still come across at times as a rather bland “statement of the case” with a wish list of solutions attached. But since the Millennium Project has been rated as among the top think tanks in the world for “new ideas and paradigms”, perhaps this should be seen as a virtue.

Naturally one challenge of particular interest to futurists is the fifth one, which addresses the problem of global governance systems not keeping up with global interdependence. A general long-term view of the future with long range goals is needed, and this requires a means of linking research and development agendas to such goals. National foresight and decision-making can be improved. Recommended actions include: establishing permanent Parliamentary Committees for the Future (as Finland has done), establishing or improving future strategy units for heads of state and in government and linking these government units with strategy units in other appropriate institutions to improve international strategic coherence and co-ordination.

A supplementary section deals with some other recent work done by the Millennium Project. It has run a number of country workshops to explore the future of work and technology to 2050. The underlying theme that has emerged is that work will increasingly be rendered unnecessary or taken over by technological developments, and some sort of universal basic income will need to be generated. In the most optimistic scenario, men and women will be freed from the necessity of having a job and instead achieve self-respect in the “self-actualising” economy.

The report concludes that there is a greater consensus about the global situation as expressed in these challenges and the actions to address them than is evident in the news media. It boldly asserts that slowly but surely, a globally oriented planetary stewardship consciousness is emerging. Yet it also warns that the world is in a race between implementing ever-increasing ways to improve the human condition and the seemingly ever-increasing complexity and scale of global problems.

Given its contribution to the work on the threat from terrorism discussed at length in the preceding SAMI blog, and also reported in summary in this report, this is not a caution to be treated lightly.

More information on the Millennium Project is available from their website **www.millennium-project.org**.

“State of the Future 19.1” is available as a paperback and as a download from **http://www.millennium-project.org/state-of-the-future-version-19-1/**.

*Written by Tony Diggle, SAMI Associate and member of the UK Node of the Millennium Project. He writes in a personal capacity. Published 21 March 2018.*

# The new UK Corporate Governance Code – time for boards to get their heads out of the sand

The New **UK Corporate Governance Code** looks very different from previous versions. It is shorter, places greater emphasis on applying governance principles and for the first time explicitly requires boards to consider stakeholders other than shareholders and to assess and monitor culture. Will it make any difference?

A test of its efficacy is whether it would have helped prevent the **failure of Carillion**. It can only be a theoretical test because the failure was in the past and, arguably, it is hard to spot such a failure before it happens – ask the Carillion directors and its auditor **KPMG**. Hard to spot? – perhaps but not impossible. It is relevant to consider whether the new Code would have made failure less likely. Previous codes were, it would seem, ineffective.

The governance statement in the **Carillion's 2016 Annual Report** (reported against the 2014 Code) gave the impression of a well governed company. Amongst other things its statement on its reviews of board and individual director effectiveness claimed they were all highly effective. It also reported the audit committee had concluded the board could have 'a reasonable expectation that the Company will be able to continue in operation and meet its liabilities as they fall due over the three-year period of their assessment'.

A key factor to emerge from the collapse was whether the financial statements overstated the value of work in progress on its various contracts. Reassuringly the governance statement said 'a significant proportion of the (audit) Committee's time is spent reviewing contract judgements given the Group's extensive portfolio of contracts. The Committee reviewed, through discussions with management and the external auditor, the positions and judgements taken by management…. the Committee concluded that the positions and judgements taken in relation to the contracts reviewed and the licence income recognised were reasonable'.

With the benefit of hindsight, and the findings of the **Parliamentary Investigation,** it seems clear that the directors and the board were not effective, that contracts were significantly overvalued and that the viability review was flawed. We may never know whether the directors knew in early 2017 that Carillion was close to insolvency and allowed misleading statements to be made in the 2016 annual report or whether they were ignorant of the gravity of the situation. In spite of years of refinement since the

first **(Cadbury) governance code in 1992**, and the lessons from numerous subsequent corporate failures, it would seem we have not yet found way of constructing a governance regime that prevents knowingly or negligently misleading statements about a company's financial position and board effectiveness.

The new 2018 Code may at first sight offer little improvement in this respect. But there is some scope for optimism, requiring, as the new Code and new draft legislation do, boards to make public statements on how they have had regard for various stakeholder interests and other factors set out in S172 of the 2006 Companies Act could make it harder for boards to flout the interests of employees, contractors and pension funds. A company which makes misleading statements runs the risk that stakeholders, including employees, will call foul. In the Twitter age this could mean rapid significant negative publicity for the company and public censure for directors. The requirement for boards to assess and monitor culture may also help; if boards actually look for culture risks they may help spot a culture which, for example, encourages misplaced optimism and discourages staff from raising concerns.

Ultimately whether or not a company thrives or fails is down to the leadership of the board and particularly the chair and the CEO. CEOs are paid to be optimistic and take calculated risks. It is largely up to the chair to ensure that this is in pursuit of long-term value creation and that the board sufficiently understands the risks being run and provides proper checks and balances. Unfortunately, not all boards want to understand the risks properly. The more you look the more you are expected to know. Chairs and non-executive directors may hope that nothing blows up while they are in office. Like Ostriches sticking their heads in sand they may choose not to ask the right questions thinking that ignorance is a reasonable defence provided they can demonstrate they went through the motions.

This may work in a court of law but not in the court of public opinion; it is hardly professional nor can it be particularly satisfying. A more thorough approach to risk involves boards and senior executives thinking outside their normal boxes to think the unthinkable and ask what could bring the company down or break the business model and what could be done to make the business model more resilient. The new **FRC Guidance on Board Effectiveness** invites boards to consider using **scenario analysis** to help assess the strategic importance and potential impact of challenges and opportunities. The guidance also encourages boards to test key decisions for alignment with values and consider the risk that a decision could encourage undesirable behaviours. This is good advice. SAMI Consulting is the home of **scenario planning** and helps organisations to **make robust decision in uncertain times**. Its governance experts can help boards who want to do more than go through the motions to ensure that risk governance not only ticks the box but can make a real difference.

*Written by Paul Moxey, SAMI Fellow and Visiting Professor of Corporate Governance at London Southbank University, published 15 August 2018.*

# Not all about risk…

When we try to understand, interpret and plan for whatever the future holds then using scenarios and similar future thinking techniques are a great help. So why is so much of this about managing risk – and so little about searching for opportunity?

I have been struck over the past month, when working with clients in classroom settings and in their offices, by quite how focussed their thinking is on risk, risk management and risk mitigation. I suspect there are a couple of reasons – firstly, the general environment is distinctly uncertain. From the more global background issues of nuclear proliferation and climate change; to unpredictable presidents and Brexit, the rise of populism on the right and left of the political spectrum; to individual issues – in the UK at least – of a cost of living which barely keeps pace with inflation to the increasing recognition among the young that house owning may forever be beyond them. This is an environment of constant neurosis, so an increased sensitivity to risk is perhaps to be expected.

The second issue is more of our own making. Companies have Chief Risk Officers. They do not seem to have Chief Opportunity Officers. Companies have to make explicit provision for risk management; annual reports and public offering documents have to have overt risk sections. Compliance and health and safety functions are explicitly about the management of and mitigation of risk – largely regulatory risk, but risk nonetheless (and this is a separate issue – legislation introduces risk into a business, it rarely introduces opportunity).

It seems that the corporate world has become focussed on keeping what we have; managing risk to an obsessive degree; and in doing so in creating a mental model where opportunity comes second place.

This may be cultural. National models of risk tolerance vary substantially – it is a commonplace that no-one takes you seriously on Wall Street without at least one bankruptcy behind you, because it shows you are a risk-taker, whereas a bankruptcy in Britain is still seen as a disgrace – but in Europe risk is certainly seen as a pre-eminent factor.

Of course, one could argue that some of the global risks – electing a president whose public pronouncements seem occasionally odd, leaving a trading bloc for the insecurity of the wider world, and so on – are in fact the search for opportunity. This is a political judgement, though, created by unsatisfied, unlistened-to electorates by narrow margins, motivated by anger and a search for different routes forwards, and by themselves introducing risk into the system.

But back to the clients. Looking at their risk-focussed models, I was struck by how much opportunity there was in them. A burgeoning new technology is either a risk to your business or an opportunity to develop. The fall of one social class and the rise of another means a loss of existing customers and the appearance of others. Even futures which look at the outset to be almost dystopian contain within them seeds of prospects and openings where it is possible to create new markets, develop new products, take advantage of change in a positive way. Seeing furrowed brows round a scenario model turn to an understanding of an impending "aha moment" is very satisfying – but it requires an ability to see, or to be guided to see, the hidden opportunities.

With colleagues in SAMI, we have been thinking about what we are currently calling "positive futures" – lenses through which one can view scenario spaces as opportunity generation, as methods of thinking about the world and the business in ways which actively promote a clear-eyed view of success. Risk management in such situations become matters of risk acceptance – less of avoiding risk but mitigating it in a way which promotes what a former colleague of mine described as "rightwards and up".

After all, if we are to make "robust decisions for uncertain times", those robust decisions should be about succeeding, within and despite the times. An understanding of risk is important; an understanding of the opportunities hidden within those risks is key. We're getting to grips with that at SAMI and look forward to working with clients to grasp it as well.

*Written by Jonathan Blanchard Smith, SAMI Fellow and Director, published 28 September 2018.*