By Douglas Enns

Risk—How Should Boards Manage the Upside?

We take risks to pursue opportunity and generate returns for our stakeholders. Yet, we seem to manage risk by focusing almost exclusively on building contingency plans to defend us— or by just downright avoiding adverse consequences. Are we missing something?

Boards are seized with meeting their responsibility to ensure that risk is well managed. That's a good thing. National Policy 58-201 sets out the responsibilities of the board's role in risk management, but doesn't specifically define risk.

ISO 31000,[1] our Canadian ERM standard, defines risk as "the impact of uncertainty on objectives." It's a definition that carefully avoids assigning any value judgments in defining risk. The inference is that risk or uncertainty can have both positive and negative consequences. We just don't know with certainty the degree to which either might materialize.

Being able to respond to both the negatives and the positives is the key to risk management and good stewardship. We have a robust set of tools to help us deal with downside risk, but do we have as many to deal with upside risk?

DEFINING UPSIDE RISK

How can we better define upside risk, and what responsibility does the board have to ensure it is effectively managed? Perhaps some examples will help.

Imagine the scrambling that goes on in an organization that finds itself successful beyond its wildest dreams. Raising capital in a hurry to build infrastructure and hire people you never thought would be needed can give competitors a chance to catch up. Cultural rigidities that don't allow for directional quick changes may halt winning new ideas in their tracks before they see the light of day. Pulling the plug too early can be just as dangerous as waiting too long to walk away.

We may fail to see the full implications of our success. One of the biggest challenges in organizations is getting bright ideas from bright people and putting these ideas into action. Because of the inherent need to keep things orderly and protect against loss, we're careful to husband new ideas economically to ensure they can compete against established products and services for resources. The problem is that once we get a "new ideas culture" established, it will have gained momentum. In this environment, good ideas don't come in manageable doses—they come in droves. Therefore, we may not be able to capture all of them and may lose a lot of potential in the bargain.

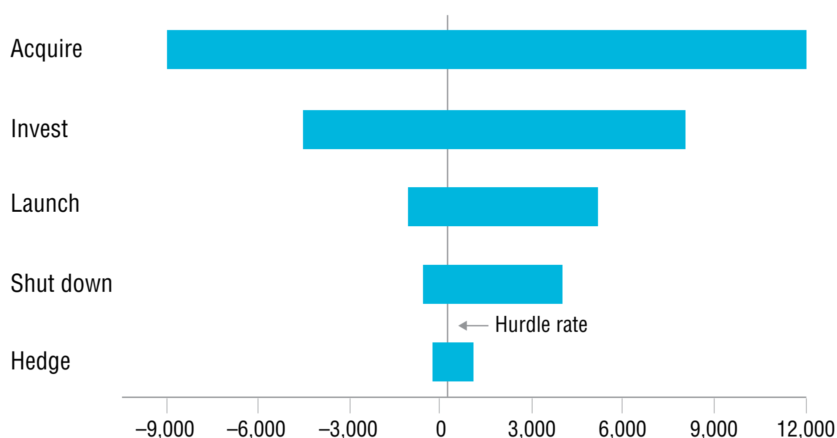
Performance that exceeds expectations almost always opens new opportunities that, if captured, build value. Upside risk is the danger of not generating potential when potential is there to be generated, and not taking full advantage of that which has been generated. Good stewardship should result in better returns to stakeholders. But that can't be accomplished by simply avoiding losses. We must make sure we're taking advantage of opportunities as they arise. Risk management policies and governance practices both must reflect that advantage.

MANAGING UPSIDE RISK

For boards that have not had much exposure to managing upside risk, it is useful

1 For a full description of ISO 31000, visit www.iso.org/iso/home/standards/iso31000.htm.

Exhibit 1
Five-Year Return on Capital/Tornado Diagram



Source: Douglas Enns

The Tornado Diagram

In the example, the riskiest project—acquiring a competitor—could generate returns ranging from a loss of 17 per cent to a gain of 35 per cent over five years. Investing in an existing product could cannibalize some of the existing market, but could also generate a return of 30 per cent. Launching a new product currently under R&D looks to be on balance, and positive.

Shutting down production of a declining product line provides cost savings and reinvestment opportunities. Hedging FX risk is a low-risk undertaking by design that will lock in return rates in foreign markets.

Source: Douglas Enns.

to do a bit of experimenting, starting with risk oversight relating to new initiatives.

First, a foundation must be laid. When setting the tone at the top—in addition to discussing ethics, values, and mission—the board and CEO need to ensure upside risk is considered. To do so, they need to address three important questions:

1. How do we as an organization define risk and how will we measure it?
2. Why do we take risk, what is our appetite for risk-taking, and how we will monitor the level of risk?
3. Under what conditions will we rethink our position?

Organizations that buy into the idea that risk is uncertainty can get a measure of potential risk by determining the degree of variation between best- and worst-case outcomes.

A practice sometimes used by U.S. risk managers to measure risk parameters is to plot the degree of variation using a tornado diagram.[2] (See Exhibit 1.) By plotting best- and worst-case outcomes against the internal rate of return or "hurdle rate," a sense of relative variability (hence uncertainty) can be gained. Less variability = less uncertainty.

Assessing the degree of variability requires an organization to go beyond determining the feasibility of new initiatives and into the world of risk assessment. Because a new initiative seems as if it will generate a positive return does not mean it will. Nor is it certain that the level of the initiative's success will be limited to the estimates provided.

Organizations provide capital to finance risk. If it is certain that new initiatives are certain that they can be financed out of earnings, then no capital is required. That is rarely the case. On the principle that we will starve losers and feed winners, consideration needs to be given to the conditions that merit the investment of capital in the first place. Those decisions will invariably have to consider the degree to which proponents have identified the potential upside returns and downside losses.

Providing new initiatives falls within the organization's risk appetite. Operational indicators can be developed to provide early warning signals and to define parameters for measuring risk tolerance. The indicators play an important role in telling the board whether their initiatives are staying on track or becoming more risk-laden. Early indications that "we could have a game-changing winner on

2 The tornado diagram was originally posted by Babou Srinivasan in 2009. It was extracted from Google Images, and then modified for use in this article.

our hands" are not so easily discernible. The reason is that most organizations have very little contextual experience managing these types of conditions.

Here are some steps the board can take to better oversee the management of upside opportunity.

- When reviewing strategic and operating plans that include new initiatives, make sure management has given consideration to developing scenarios in which success significantly tops estimates.
- For organizations that have had no experience with LEAN innovation systems, ask management how they will ascertain if the new initiatives are gaining traction. As well, ask management which pivot points would cause them to consider either changing direction or investing further capital to pursue an unexpected opportunity.
- Make inquiries about the organization's capacity to respond in terms of attracting people, getting new infrastructure on line, and countering new competition.
- When establishing risk appetite statements, make sure they are clear.
- When establishing risk tolerance parameters, determine those operational indicators that can give early insight into the direction that new initiatives are taking to enable the most optimal response. Ensure these are tracked throughout the year.

Boards play an important role in ensuring that upside risks will be effectively and proactively managed. They provide clarity as to the role of risk when risk-taking is among the criteria that define the tone at the top. Ensuring there is a firm mandate to capture and leverage undiscovered value is integral to good stewardship. When approving risk appetite statements, the board provides direction and adds impetus to be vigilant for new opportunities throughout the organization. By ensuring that the organization spends time thinking through how it will respond to unanticipated opportunities, effective risk management plans emerge. Boards that can meet this challenge can rightfully claim they have done their part to add value for stakeholders.

Douglas Enns
FCPA/FCA, MBA
President
Upturn Consulting Ltd.

Douglas Enns is the president of Upturn Consulting Ltd. Upturn provides a range of clients with consulting services on corporate reorganizations, strategic planning, risk management, and governance. Douglas is a member of the faculty of the Directors College where he teaches introductory risk management for directors. He is a chartered director and currently chairs the board of Ralmax Industries. As well, he is an FCPA/FCA and holds a MBA from the University of Wales.