



Strong

relationships

David Archer and **Alex Cameron** explain why it is critically important to understand the risks associated with relationships between companies.

We live in an interconnected world. Across all industry sectors successful businesses rely on a complex network of suppliers and partners to design, develop and manufacture new products. The vertical integration and top-down control model that was once a cornerstone of 20th century industry has given way to the concept of flexible networks with competing and collaborating partners. Indeed, it has been argued that Google's ability to manage these creative relationships has enabled it to overtake Apple in the smartphone operating system market. The top of organisations boards have had to evolve too, developing ways of working that will safeguard their shareholders' interests and manage new sources of risk.

Relationship risk pitfalls

The reality of business interdependence means that some strategic risks will lie at the boundary between organisations, or outside the board's specific organisation altogether. Boards must pay attention to these 'relationship risks', which historically have not been handled well. In many cases boards have based their relationship risk mitigation plans on a belief in either: their own power and superior expertise, tightly defined legal contracts or partners they personally trust. However, these beliefs can sometimes be misplaced, rendering the confidence they engender a dangerous myth.

The myth of superiority

The oil spill in the Gulf of Mexico from the BP Macondo Well is a salutary case study for any board seeking to pursue a new strategy which is highly reliant on close relationships. In the late

1990s, when BP set a new strategic direction to become the number 1 in deep water oil exploration and production, the board knew that it had very little experience of drilling in deep waters – certainly not as deep as those encountered by the Deepwater Horizon rig drilling the Macondo Well. Yet the board believed that the company's size, power and superior expertise would enable it to direct its suppliers safely and successfully in these challenging conditions. These suppliers were Transocean, who operated the rig for them, and Halliburton, the specialist engineering contractors responsible for supplying and pumping the cement that should have sealed the bottom of the well – some 3.5 miles below the rig.

BP executives may have thought that they were the smart guys in charge and that they could directly control the success of the enterprise and the safety of the operation, however, reports from the Presidential Oil Spill Commission make damning reading for all concerned. The commission identified the causes of the disaster as being systematic failures of management, rather than one-off technical problems, and at the heart of this was a failure of the 'many ambiguous dotted line relationships

within and between the companies involved'. Detailed analysis carried out by the Commission shows that many people across the three organisations had access to individual pieces of the information jigsaw, which may have shown that a blowout was likely to occur, and later would have shown what steps could have been taken to avert the disaster once high pressure hydrocarbons started entering the bore hole. Yet because those pieces were not put together no-one was looking at the big picture.

The myth of the watertight contract

A reliance on tight legal contracts to remove relationship risks is also flawed. Look at the public-private partnership (PPP) contract that London Underground had with the Metronet consortium to maintain and upgrade large parts of the tube network. When that relationship failed, London Underground and the taxpayer were left with a bill of £410 million according to the Public Accounts Committee. Indeed, many commentators trace the causes of failure to the immensely detailed and rigid contract itself. Similarly, British Airways (BA) thought it was transferring the risks of managing a complex catering operation when it outsourced its in-flight food production to Gate Gourmet. But when catering staff went on strike in 2005 it was BA's reputation that took the hit.

The myth of personal trust

Some boards base their approach to handling relationship risk on trust, which often translates as trust in specific interpersonal relationships. Of course high-level interpersonal relationships are important, but in a complex world they are not enough; people move on and the organisations they manage are themselves increasingly complex.

Furthermore, it may be the case that relationships at the top are good, but that the ticking time bomb is hidden several layers down the company, which you are planning to partner with or acquire. If the sub-prime

audit analyse the problem and then mitigation is based on reinforcing standard procedures or authority levels – factors which an executive can directly control. Crucially relationship risks require a different approach. Like it or not, in interconnected business systems control of strategic risk is shared. So what is a board to do? There are four areas that a board can focus on:

The big picture

Boards should manage risks at the right level and have proper scrutiny of relationship risks. All businesses have risk registers, which should be periodically reviewed by the board. In reality, much of this work is delegated to a risk and/or audit committee. This means that not all of the non-executive directors (NEDs) have the opportunity to feed their different experiences of risk into the mix. Complex issues, such as the relationship between organisations, need to be discussed by the whole board. If future success depends on building strong partnerships, the UK Corporate Governance Code provides a vehicle for boards, during their annual board evaluation process, to check that the risk register reflects the need to manage the relationship risks that are inherent in the board's strategy.

Thinking ahead

Set up early warning systems for relationships. The key to any successful risk management system is monitoring the precursors. When this involves several different organisations it's much harder for boards to identify cross-organisational warning signs. In your own organisation experience may help you pick up signs intuitively – something may just not feel right – but between organisations these signs are often much more difficult to read. Indicators of trouble ahead include stalled decision-making, communication breakdowns, non-attendance at critical meetings or public arguments between leaders. It's important to scrutinise the cross-organisational key performance indicators (KPIs). Is the data your partners are providing you with



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upwards communication of 'bad news' and ensure that this sort of open communication happens with partners too. Boards need to ensure that the right development processes are in place to build collaborative leadership capability.

Building relationships

Leaders should review and actively build partnerships. Like any marriage, strong enduring relationships don't happen by accident and they have their ups and downs! Relationships between businesses need carefully tending. This means jointly developing; clear governance to identify how the parties will work together (and resolve their differences), a single, agreed set of performance data to avoid arguments about delivery, and collaborative leaders who recognise the need to invest time and resources in making the partnership work.

It's not all bad news

The UK Corporate Governance Code spells out the risk challenge to a board in the clearest possible terms: 'The board is responsible for determining the nature and extent of the significant risks it is willing to take in achieving its strategic objectives. The board should maintain sound risk management and internal control systems.' Yet from BP's Macondo disaster to the crash of HBOS and RBS we've seen organisations brought to their knees by catastrophic system failures triggered by the actions of third parties, which certainly weren't at the top of the relevant board's risk register.



Relationship risks matter. Although, by definition boards cannot directly control them, they have a responsibility to understand their possible impact and to build the collaborative leadership capability necessary to manage critical relationships safely. The latest Financial Reporting Council guidance on board effectiveness emphasises the importance of the company secretary in this process: 'The company secretary can also add value by fulfilling or procuring the fulfilment of other requirements of the Code, in particular director induction and development... consistent with the board's evaluation processes.' Adding value in this way, through developing collaborative leadership capability, can be about opportunities for growth as well as risk mitigation. By understanding relationships and the risks that come with them, and by developing the capability to manage these effectively, a board can also grasp new creative business opportunities. ■

High-level interpersonal relationships are not enough.

mortgage disaster teaches us anything, it is that hidden liabilities can have very far-reaching consequences. Who would have thought that lending decisions taken by small US banks would play such a key part in bringing down UK institutions like RBS and LloydsTSB, following their mergers with ABN Amro and HBOS?

What to do?

Traditionally board risk management processes focus on the risks that are – or appear to be – directly controllable, emphasising financial risk and internal controls. The risk avoidance steps taken often begin by having internal

about the relationship realistic, or are they telling you what they think you want to hear?

Leading collaboratively

Leaders' ability to work collaboratively should be increased. The Presidential Commission stated that 'a culture of leadership responsibility' was lacking on the Deepwater Horizon project. It identified the need for a culture in which 'individuals take personal ownership of safety issues with a single-minded determination to ask questions and pursue advice until they are certain they get it right.' A culture such as this requires leaders who build open relationships, encourage

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