UNDERSTANDING ORGANIZATIONAL RISKS

1. Organizational risks

Organizational risks are those risks inherent within an organizational model that can prevent it from fulfilling its function and achieving its purpose, and may threaten its future or fundamentally change the ownership structure. All forms of human organization have inherent risks, quite simply because the behaviour of the people involved can never be entirely predictable and some individuals will always be inclined to use their position within an organisation to further their own interest rather than to devote their energies towards carrying out the proper function of the organization and to forwarding its true purpose. The actions of such individuals may not only result in the organization failing to achieve its purpose but there is also the ever present risk that their actions may result in the collapse of the organisation, or to a change in the ownership structure.

2. Well-known risks

Two rudimentary problems are evident in many organizations. The first is that the essential purpose of the organization frequently becomes lost within the vagaries of day-to-day operations. The second is that many organizations are susceptible to 'hijack' by individuals who contrive to ensure that the organization serves their objectives as individuals, rather than actively pursuing the essential objectives of their owners.

Many will be familiar with the types of risk often associated with specific forms of organization. For example: in many family businesses there is often a high risk that when succession occurs the next generation may not be endowed with the aptitudes or skills of their predecessors. In shareholder companies 'insider-trading' can take place where those running the company make personal profit by using this knowledge. In many public companies the top executives contrive to secure for themselves grossly high personal rewards disproportionate to the rewards accruing to ordinary shareholders.

Most commonly, all organizations are at risk from those that may misappropriate funds and assets, and this is intended to be prevented by systems of audit, both internal and external. In times past the main concern was that employees may steal the petty cash but in more recent times it is not uncommon for executives to steal the enterprise.

3. Specific risks in MCEs

When people choose to set up or join a member-controlled enterprise they do so because they can see the advantages that this form of enterprise can bring in terms of achieving the outcomes that they want. However, it is important that they also become aware of the potential inherent risks of this form of enterprise and what steps need to be taken to mitigate such risks.

Such risks may include:

- ***Failing to exert adequate financial control.*** As obvious as it may seem that all enterprises must be economically viable, too often this is not the case. Sound systems and constant vigilance are required to maintain financial viability and stability. Clearly, any enterprise that becomes bankrupt cannot fulfil its purpose. The major threats to the viability of the enterprise usually arise when the market changes and the response of its leaders is inappropriate.

- ***Misunderstanding the economic basis.*** In all cases MCEs need to achieve a market return on all capital deployed in the enterprise, reach or surpass industry standards in terms of labour productivity norms, and ensure that all assets are deployed productively. In addition, they must generate a surplus sufficient to cover the risks involved in the enterprise and to provide adequate funds for reinvestment in the future development of the enterprise. Running a member-controlled enterprise is all about resource optimization[1]. Also, MCEs must not engage in speculative activities, all too often when they do the result is to destroy the enterprise.

- **The absence of sufficient 'pressure to perform'.** The absence of 'shareholders' pressing for higher returns, as is the case in an investor-controlled company, can sometimes mean that the use of resources (finance, labour and other facilities) are not optimized, especially where management has access to funds held in reserve or raised from members/the community in excess of immediate need. When the organization fails to provide adequate controls and oversight, those running the enterprise may not be under sufficient pressure to perform.

- ***Loss of purpose and demutualisation*** [2.] Where member-controlled enterprises grow, in terms of the number of members and/or turnover, they are frequently beset by multiple problems. They often appear to lose sight of their original purpose, are prone to switch towards serving the interests of senior executives (or cliques) rather than the bulk of their members, and become remote from the members. As a consequence, some Member-controlled enterprises come to be regarded as irrelevant to the lives of their members. In the worst case, they are hijacked by self-interested groups and ultimately demutualised, as has been the fate of many UK building societies, agricultural co-operatives, and other forms of member-controlled enterprise.

- ***Takeover by special interest groups.*** Principally because the membership has lost interest in the original purpose of their enterprise, and where it has not adapted so as to achieve the outcomes that are of real interest to its members, this vacuum of interest is often filled by special interest groups with their own agenda. Member-controlled enterprises can attract all manner of special interest groups, ranging from political and religious groups to those with altruistic objectives or minority viewpoints on all manner of issues. It is not a question of whether or not such special interest groups are right or wrong, but no matter how worthy the cause it must not be allowed to override the essential function of the enterprise, which is to carry out its purpose and to deliver those outcomes desired by the membership in its entirety. In many parts of Europe consumer co-operatives have been lost to demutualization because the members lost control. In most cases the organizations in question were, in the early stages of the process, taken over and dominated by their professional managers.
- ***Mergers.*** For MCEs to achieve their purpose and remain viable, it sometimes becomes critical that they can secure greater economies of scale[3] often such economies of scale can be achieved by merger with another MCE. When mergers between MCEs are contemplated, some individuals will inevitably want to maintain the *status quo* (along with their own positions), while others may see an opportunity to extend their own power and influence. However, as with all decisions in MCEs, the decision about any possible merger must be made in the best interest of the membership in its entirety. In many cases the alternative of a federal arrangement between similar MCEs may yield much better results in the longer term.

5. Oversight

A system of structural checks and balances that is a crucial element missing is from many MCEs that drift away from their common purpose. Whenever those running an enterprise are not the same people who own it, a vigorous system of oversight becomes essential; otherwise the owners are likely to find the benefits accruing to those running the enterprise. (The term 'owners' refers to the shareholders in the case of a shareholder company, 'trustees- in the case of a charity, and 'the members' in the case of a member-controlled enterprise). Financial audit systems are, of course, essential but proper oversight must go far beyond this. Proper oversight is required to ensure that the enterprise actually carries out its function and remains committed to the purpose established by the membership. More information about governance in MCEs is provided in the *Co-oppundit download* 'Corporate Governance for MCEs'.

End notes:

1. 'Resource optimization' is the main function of management in 'not-for-profit'. enterprises, including MCEs. The role of top managers within MCEs are closer to those of a general leading a citizen-army than to those of an executive in a commercial business. Just as a general must achieve campaign objectives with the resources that are available, managers of 'not-for-profit' enterprises must set about accomplishing their organization's purpose optimizing those resources that are available; this contrasts with the main function of managers of commercial businesses which is profit maximization.

2. 'Demutualisation' - When MCEs are hijacked by self-interested groups and are demutualised by a process of converting them into shareholder companies. This has been the fate of many UK building societies and agricultural co-operatives. It is no coincidence that these same demutualised building societies were among the first to encounter problems at the start of the current financial crisis. They should never have been allowed to be hijacked by the directors, managers and advisers who sought to enrich themselves at the expense of future generations.

3. Economies of scale result when an enterprise obtains cost advantages (savings) through expansion. They commonly arise in purchasing (bulk buying of goods or materials), management (increased specialisation of managers), finance (obtaining lower-cost finance when borrowing and/or gaining access to a greater range of financial instruments), marketing (spreading the cost of advertising over a greater range of sales or output), and technology (spreading costs such as research and development). Conversely, diseconomies of scale may also arise, especially in organizational terms.