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EDITORIAL

Does Flexibility Mitigate or Enhance Risk?

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Abstract *In volatile, uncertain, chaotic and ambiguous (VUCA) environment, flexibility is often used as a mechanism to hedge the risk. It would be worthwhile to have a discourse on this complex relationship of flexibility with risk. Risk, in general, is associated with uncertainty and can be measured in terms of probability of failure. In this short discussion of relationship between flexibility and risk, we will restrict the discussion on business risk and managerial risk only. As flexibility composes of options and change mechanisms, it might act as a suitable hedging mechanism for business risk. There are ample examples that indicate both the balancing and reinforcing relationships of flexibility with business risk. Another type of risk is more internal, that is, managerial risk. Flexibility initiatives to change internal functioning to implement both innovative processes and actor-based flexibility are assumed to reduce internal risk of managing various activities. The discussion in this paper points towards flexibility as a double-edged sword; on the one hand it has contributed to reduction of the risk, whereas it led to enhancement of the same on the other. It thus advocates a valuation of flexibility initiatives from a risk management perspective.*

Keywords Business risk · Flexibility · Managerial risk · Risk · Valuation

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In volatile, uncertain, chaotic, and ambiguous (VUCA) environment, flexibility is often used as a mechanism to hedge the risk. Flexibility is characterized by multiple connotations such as openness, adaptability, responsiveness, and agility. It has evolved from antithesis of rigidity to bimodal (e.g., centralization and decentralization) to encompass the whole continuum from thesis to the antithesis. It is thus defined in terms of options (across the continuum), change mechanisms, and freedom of choice. If a system is having only one option, it may be treated as rigid, whereas multiple options provide a necessary condition of flexibility. In a VUCA environment, the risk of failure appears to be higher with only one option in place as it may not be able to fulfill the changing requirements that are volatile and uncertain. Thus, multiple options supported by dynamic change mechanisms might help in mitigating the risk to some extent. But, at the same time, each option is accompanied with its own risks. It would be worthwhile to have a discourse on this complex relationship of flexibility with risk.

Risk, in general, is associated with uncertainty and can be measured in terms of probability of failure. When the uncertainty goes high, the probability of failure or risk is also expected to be high. The risk can be of multiple types such as business risk, managerial risk, entrepreneurial risk, financial risk, and operational risk. In this short discussion of relationship between flexibility and risk, we will restrict the discussion on business risk and managerial risk only. In a similar manner, the relationship of flexibility with other types of risks can be deliberated. Business risk is associated with external volatility and uncertainty in the business environment. This is associated with the failure of any one or more of the business initiatives such as new product launches, mergers and acquisitions, diversification into new areas, introducing new technology, and entering into new

market segments, whereas managerial risk is more to do with change initiatives within the organization such as restructuring, reengineering, automation of processes, implementation of new HR approaches, innovations in business processes and procedures, and many more internal change initiatives. Some risk parameters could be linked with political uncertainty, attrition, data insecurity, technological obsolescence, and so on.

First, let us take the case of business risk and examine how the introduction of flexibility would relate to it. As flexibility composes of options and change mechanisms, it might act as a suitable hedging mechanism for business risk. It is usually more risky for a single business firm to profitably sustain in the VUCA environment keeping in view the variability of demand, fluctuations in the cost of inputs, obsolescence of technology, changing needs of customers, and competition from unknown quarters. The oil and steel businesses have been greatly influenced by the uncertainty of cost of crude and iron ore, respectively. Whereas the businesses close to the customer such as automobiles, white goods and mobile handsets are influenced to a great extent by the uncertainty of the demand and failure of new models introduced in the market. Thus, the flexibility in terms of a portfolio of businesses might help, to some extent, in reducing business risk. It is an old saying that 'don't put all your eggs into one basket.' In the context of pharma business, the probability of success of a single product is very low and thus it requires high degree of flexibility to create a large pool of synthetic molecules by intensive R&D. Providing choice to customers in terms of different models is used commonly in durables industry such as automobiles. If one model is not acceptable or fails, the other ones might succeed, thereby hedging the business risk. But it has the other side of the coin as well. Adding any new option brings its own risks. For example, failure of a single new product of Samsung (Note 7) has adversely affected its business prospects. Thus, the flexibility in business might also enhance risk rather than only mitigating it. Any flexibility option has its expected benefits, but certainly has associated costs as well, which if are not put under control might add to risk. There are ample examples that indicate both the balancing and reinforcing relationships of flexibility with business risk. Honda has used both the price and product flexibility to alleviate the business risk in Indian automobile market to arrest its falling market share. To enhance innovation and mitigate business risk, 3 M has used the HR flexibility (in terms of 15% rule). Cisco has resorted to more than 150 acquisitions of innovating firms to enhance its portfolio of innovative products. However, at the same time, flexibility initiatives may also enhance risk in some cases. Some notable ones are: recall of cars from American market by Toyota resulting into the reduction of its valuation; failure of many M&A deals such as Daimler–Chrysler, Arcelor–Mittal, HP and Compaq; reduction in market valuation of Snapdeal and Flipkart after heavy discount options in e-retail, among others.

Another type of risk is more internal, i.e., managerial risk. Flexibility initiatives to change internal functioning to implement both innovative processes and actor-based flexibility are assumed to reduce internal risk of managing various activities. Managerial risk is characterized in terms of inefficient processes, lower quality, higher costs, high turnover of employees, and poor industrial relations. Flexibility in work practices as well as at the level of actors involved may cut down such risks within the organization. For example, flexitime and flexiplace would help in reducing the employee dissatisfaction in view of better work-life balance, but might enhance the risk of non-completion of activities in time due to lack of coordination. It may also add to psychological stress due to stretched working hours at home. Some employees feel more at ease with defined working hours and may not like to take their work home. Similarly, flexible compensation schemes might boost the involvement of employees to raise productivity, but may add to dissatisfaction of not so highly performing employees. A large class of employees need assurance of the pay package and compensation parity with the peers. Similarly, flexibility by reengineering internal processes might result in a dramatic improvement in performance in terms of reduction in cycle time, but might not always be acceptable due to the traditional culture and mindsets. The success rate of many reengineering programs had been fairly low as pointed out by past researches. In a similar manner, many restructuring and downsizing efforts aimed at high productivity and profitability could not deliver the expected benefits, instead lead to reduced employee morale, thereby adversely affecting productivity. Many researches on outcome of restructuring have indicated toward temporary benefits only, but largely these added to the organizational risk.

The above discussion points toward flexibility as a double-edged sword; on the one hand, it has contributed to reduction of the risk, whereas it led to enhancement of the same on the other. However, it may be noted that even low success rate of flexibility initiatives might give high returns and, thereby, help in mitigating overall risk. A flexible organization is a dissipative structure that needs a continuous vigil like tight rope walking. If flexibility and openness are found useful, it would result in demand for higher freedom in more and more areas and if in the process strategic focus is slipped, it might result into chaos. On the other hand, if it is seen to be complex and risk enhancing, this may result into more planning, policy definitions, rules, standard operating procedures, and so on. That might push it toward rigidity, which may also add to risk. Managing flexibility, both externally and internally, is a balancing

process to take both continuity and change side-by-side. The innovative change initiatives, generating new options to contain risk, are leveraged by vital continuity of the organization to give it stability with dynamism. It thus necessitates a valuation of flexibility initiatives from a risk management perspective. There is a need to develop comprehensive flexibility valuation models trading off the risk with returns. Well-managed flexibility initiatives may mitigate risk, but defocused flexibility would enhance it. Thus, it requires a healthy mix of flexibility initiatives that not only add value but also manage the overall associated risk for the organizations.