

Board Perspectives: Risk Oversight

Facing Change With Confidence

Issue 74

Facing change with confidence is the name of the game in a rapidly changing business environment for any enterprise, whether public, private or nonprofit. Below we discuss the what, why, when and how underlying “facing change with confidence.”

In a global survey involving 275 board members and executives across multiple industries, one of the top 10 risks cited was that resistance to change may restrict an entity’s ability to make necessary adjustments to its business model and core operations.¹ This finding is important. Change is *inevitable* and *necessary* because if organizations fail to improve their products, services, processes and capabilities continuously, they will ultimately encounter serious performance gaps relative to more adaptive competitors.

Change provides both *opportunities* to enhance and *threats* to impair enterprise value. It can be *disruptive* in challenging the fundamental assumptions underlying a company’s strategy and business model. Therefore, change must be *expected and embraced* by organizations. In this era of continuous and disruptive change, early movers are the ones most likely to survive and prosper.

¹ *Executive Perspectives on Top Risks for 2015: Key Issues Being Discussed in the Boardroom and C-Suite*, North Carolina State University ERM Initiative and Protiviti, 2015: www.protiviti.com/en-US/Pages/Top-Risks-Survey.aspx.

Identifying Incremental Change

Probably the most important aspect of the change process is correctly diagnosing the opportunity or issue precipitating the need for change. If there is confidence in the diagnosis, most managers believe they can allocate the appropriate resources to address the needed change.

Change comes in small and large doses. Small doses usually result in incremental improvements in business processes. When operational and financial results fall short of quality, time, cost and innovation performance goals, focused efforts are undertaken to eliminate non-value-added activities and enhance suboptimal processes.

Incremental change may address new requirements arising from changes in laws and regulations, contracts and internal policies. Alternatively, it may focus on improving customer and employee satisfaction levels. Whatever the drivers, it leads to continuous improvement in processes that achieve business objectives.

In addressing change, it is important to look beyond symptoms and focus on root causes. A root cause is a condition or a sequence of events that can, or is likely to, lead to process underperformance or an undesired consequence or outcome. Root causes can point to external factors such as an emerging technology that is gaining acceptance in the marketplace, or a specific opportunity to improve products, services and the customer experience. They can also point to issues such as poorly written policies, a process or system failure, or inadequate training.

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Root cause analysis is a technique directed to systems and processes to source fundamental causal factor(s) underlying a variation in performance that, if eliminated, would improve performance. Once the correct opportunity or issue is fully understood and defined, relevant data is gathered and evaluated, possible underlying causes are identified and systematically reduced, multiple interrelated causes are considered, and corrective actions are formulated to eliminate root causes at the source. Actual results are then monitored over time, and the technique is applied again until acceptable results are achieved.

Identifying Disruptive Change

Breakthrough improvements are often disruptive. Today, managers face disruptive change to business models and even entire industries. Whereas disruptive innovations may have once taken a decade or more to transform an industry, research shows that this elapsed time is not only compressing, but continues to shrink, leaving very little time for reaction. Sustaining a business model in the face of digitally enabled competition requires constant innovation to stay ahead of the change curve.²

There are powerful forces reshaping our world, forcing leaders to rethink the assumptions underlying decisions relating to consumption, resources, labor, capital, competition and more. One group of authors asserts there are four great disruptive global forces that, collectively, are shaping a radically different world:³

1. **The shifting locus of economic activity to emerging markets and cities within those markets** – Nearly half of global gross domestic product growth between 2010 and 2025 will come from 440 cities in emerging markets – 95 percent of which are currently not well known.⁴
2. **Acceleration in scope, scale and economic impact of technology** – Always a significant force in overturning the status quo, the growth in processing power and connectivity through technology has been exponential. There is also the concurrent data revolution, which delivers unprecedented amounts of information to consumers and businesses in increasingly convenient ways, spawning new ways of analyzing data, doing business and fulfilling customers.
3. **Changing demographics** – The human race is aging as fertility falls. In 2013, about 60 percent of the world's population lived in countries with fertility rates below those needed to replace each generation.⁵ The consequence of this trend is staggering, if left unabated.
4. **The increasing degree to which the world is becoming more connected through trade and movements in capital, people and information flows** – This connectedness matters because it is changing the competitive landscape. Well-established incumbents must prepare for entrants from anywhere, build new global ecosystems and become more agile.

The reality is clear: To stay ahead of the disruption curve, business leaders must quickly discern the vital signs of change and the related implications to their business model. To do that, they must do these four things well:

1. Understand the critical assumptions underlying the business model.
2. Apply contrarian analysis to evaluate plausible and extreme events or combinations of events that could invalidate one or more critical assumptions.
3. Conduct competitive intelligence activities focused on the vital signs.
4. Distill timely information about assumptions, scenario analyses and intelligence-gathering, and report insights obtained to decision-makers.

² *Big Bang Disruption: Strategy in the Age of Devastating Innovation*, Larry Downes and Paul Nunes, Portfolio/Penguin, 2014.

³ *No Ordinary Disruption: The Four Global Forces Breaking All Trends*, Richard Dobbs, James Manyika and Jonathan Woetzel, PublicAffairs, New York, 2015.

⁴ *Urban World: Cities and the Rise of the Consuming Class*, Richard Dobbs, Jaana Remes, James Manyika, Charles Roxburgh, Sven Smit and Fabian Schaer, McKinsey Global Institute, June 2012.

⁵ *The Global Spread of Fertility Decline: Population, Fear and Uncertainty*, Jay Winter and Michael Teitelbaum, Yale University Press, 2013.

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The implications of transformative market trends can be highly disruptive to established business models. In this environment of constant change, the status quo has no future and is constantly “on the clock.” Executives and directors need confidence that they have the insights necessary to recognize the effects and implications of the profound sea change unfolding before them.

Acting on Change

Time to act is a precious asset in a rapidly changing environment. It arises only when there is timely recognition of performance issues, market opportunities and emerging risks, and an understanding of their implications to the enterprise’s processes and business model. Time to act means that root causes of subpar performance and the implications of emerging trends may be evaluated in the cool of day rather than the heat of the moment when it’s too late; therefore, options to act can be formulated for decision-makers with confidence.

Unfortunately, time to act can be squandered. Having knowledge of poor performance or an emerging opportunity or risk without converting that knowledge into hard choices and actionable plans to innovate processes and offerings is as useless as having no knowledge at all. To ensure timely reaction, management must:

- **Foster an organizational culture that facilitates sourcing of root causes of subpar performance and consideration of the impact of changing market realities on critical business model assumptions** – Managing by fact and empowering process owners and stakeholders can drive continuous improvement of business processes when subpar performance and/or trending metrics signal the vital signs of change. With respect to changes in the marketplace, a continuous dialogue among business areas, alignment of incentive compensation with short- and long-term performance goals, senior management involvement, and an active board help shape the desired culture of understanding the reasons for and implications of change.

- **Incent managers to translate root cause analysis and altered assumptions into actionable revisions to strategic, business and product plans and to process improvements** – Incentives skewed to maximize revenues without fostering sensitivity to changing market realities can create serious organizational blind spots.
- **Seek organizational resiliency** – Insulation from reality in a rapidly changing world is lethal. When companies don’t respond to disruptive change, it’s usually because they don’t have a single version of the truth. This dysfunction can arise from incentives that do not encourage resiliency and from management being out of touch with the customer and uncommitted to managing by fact.

In summary, facing change with confidence means accelerating the decision-making process regarding actions to address recognized performance issues, market opportunities and emerging risks. Disruptive change is a double-edged sword, simultaneously presenting one of the biggest opportunities and risks a company can face. What separates winners and losers in managing disruptive change is the ability to recognize the vital signs and act on them with confidence.

Managing the Change Process

The improvement of products, services and processes and the implementation of new strategic initiatives require focused and disciplined approaches consistent with the organization’s structure, culture and operating philosophy. To enable continuous or breakthrough change with confidence, buy-in must be obtained from executive management, starting with a committed chief executive officer and executive management team who demonstrate unwavering support for undertaking action plans that create and sustain momentum for change. With executive management’s assistance, the change implementation team must develop a business case that clarifies why change is the only option, focus on the “big picture” with a compelling shared vision, set realistic goals, develop a clear plan of action, and make periodic use of management checkpoints.

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In addition to executive management support, key stakeholders – such as line-of-business leaders, operating personnel and process owners who will be most affected by the change – must own the implementation of that change. Their buy-in is obtained first through evidence of executive management support. They also need to be convinced that their interests and the interests of the enterprise in effecting the change are inextricably linked.

Once the support of key leaders throughout the organization is obtained, the implementation team should establish accountability for results; focus on the “human side” of the change effort; align organizational, process and individual performance measures; and align the change process with the firm’s culture.

If the above change enablement practices are executed effectively, they lead to sustainable change with confidence of achieving expected results. If not, nothing is likely to happen.

Questions for Boards

The following are some suggested questions that boards of directors may consider, based on the risks inherent in the entity’s operations.

- When framing the real opportunity or issue precipitating change, is the board comfortable

that management considers the business context, understands root causes and manages by fact? Does management mitigate the effects of bias on the fact-gathering and analytical processes leading to identification of the real change opportunity or issue?

- Does management recognize root causes of unacceptable performance variability on a timely basis? Does the organization monitor the vital signs of new market opportunities and emerging risks arising from disruptive market forces? Does management act in a timely manner on knowledge of the need to change?
- Once there is commitment to act, does the organization have an effective change enablement process that drives its key personnel from awareness to buy-in to ownership to give management and the board the confidence that the change is sustainable?

How Protiviti Can Help

Protiviti assists directors in public, private and nonprofit entities with identifying and managing their organizations’ key risks. We provide an experienced, unbiased perspective on issues separate from those of company insiders and an analytical assessment approach that is aligned with the unique characteristics of the risks the company faces.

About Protiviti

Protiviti (www.protiviti.com) is a global consulting firm that helps companies solve problems in finance, technology, operations, governance, risk and internal audit, and has served more than 60 percent of *Fortune* 1000® and 35 percent of *Fortune* Global 500® companies. Protiviti and our independently owned Member Firms serve clients through a network of more than 70 locations in over 20 countries. We also work with smaller, growing companies, including those looking to go public, as well as with government agencies.

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Protiviti is partnering with the National Association of Corporate Directors (NACD) to publish articles of interest to boardroom executives related to effective or emerging practices on the many aspects of risk oversight. As of January 2013, NACD has been publishing online contributed articles from Protiviti, with the content featured on www.nacdonline.org/Magazine/author.cfm?ItemNumber=9721. Twice per year, the six most recent issues of *Board Perspectives: Risk Oversight* will be consolidated into a printed booklet that will be co-branded with NACD. Protiviti will also post these articles at **Protiviti.com**.