Board Perspectives: Risk Oversight

To Manage Disruption, Understand Strategic Assumptions

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When it comes to managing the risk of disruption to the business model, what executive management and the board don't know can harm the organization. This article discusses why management should identify and consider the key assumptions underlying the drivers that shape the organization's strategy. Likewise, the board should review and constructively challenge those assumptions when evaluating the strategy.

A recent study determined that strategic risks showed the largest year-over-year increase for 2014, compared to macroeconomic and operational risks.[1] Risks are strategic when they could potentially affect the validity of an organization's plans to pursue growth opportunities.

In today's rapidly changing world, it behooves executive management and boards of directors to be knowledgeable about potential future events that could invalidate fundamental assumptions underlying the strategy. These risks can arise from both internal process issues and disruptive change in the external business environment due to actions of competitors, changing customer wants, technological advances, changes in financial markets and the economy, and actions of regulators, among other things.

[1] *Executive Perspectives on Top Risks for 2014: Key Issues Being Discussed in the Boardroom and C-Suite, Research Conducted by: Protiviti Inc. and North Carolina State University's ERM Initiative,* available at www.protiviti.com.

Key Considerations

Strategic risks can be lethal. They represent potential "enterprise value-killers." More important, they might not be known to management and the board. And nothing can be more dangerous in a rapidly changing environment than not knowing what we don't know.

To illustrate, innovation can advance quality, create new markets, reduce costs, extend a product range, replace products and services, and dramatically improve processes. Innovation can be disruptive if it improves a competitor's product or service in ways the market does not expect, typically by lowering the price significantly or designing a product or service that transforms the way in which the consumer's needs are fulfilled.

There are many examples of disruptive innovation – minicomputers displaced mainframes, personal computers displaced minicomputers, digital photography displaced chemical photography, laptops displaced personal computers, and tablet technology appears to be displacing laptops. The point is that innovation can be disruptive, and present both an opportunity and a threat. The questions are: On which side of the disruption wave will an organization position itself? Will it ride the wave that creates or accelerates disruption – or be swept up by it?

Example of Disruptive Change for a Book Retailer

Strategy	Key Assumptions	Contrarian Statement	Implication Statement
Expand and refine the core domestic superstore business and drive international growth by expanding established markets and leveraging infrastructure investments (the growth strategy for Borders, as reported in 2003).	Expansion will continue to increase topline performance; diverse geographic presence of over 1,200 bookstores in six countries on four continents will augment brand recognition and improve distribution network economics; and expansive selections of a variety of media, including many hard-to-find titles, will make the company's stores "the place to go."	Physical plant expansion and store refurbishment "doubles down" on the current cost economics business model at a time of significant change in the industry; big merchandising bet to go heavy on CD music sales may backfire as the industry goes digital; and the emergence of the Internet as a retailing channel for content and media poses a significant threat.	The "one-stop shop" retail brick-and-mortar bookstore vision becomes a relic of the past, as customers increase use of the Internet to procure what they want and competitors beef up online sales and develop e-reader technology. Accordingly, evaluate the continued validity of key assumptions underlying the strategy and business model using appropriate metrics around competitor actions, financial performance and market activity to gain insight into what's really happening in the marketplace.

Innovation presents an opportunity to leapfrog the competition. Conversely, it presents a threat of being displaced due to reacting too late to competitor actions and other market developments that could make a company's offerings obsolete. This is why a company cannot afford to "lock in" to executing its business model when that model is based on assumptions subject to change – and almost every business model is. In essence, companies have a choice. They can be "early movers" in seizing market opportunities or addressing emerging risks, or they can cede that option to competitors.

Above is an illustrative example of the forces of disruptive change involving Borders, a book retailer that filed for bankruptcy in 2011. The above scenario looks back at past events and experience to illustrate how an understanding of critical assumptions underlying the strategy could have led to identification of vital signs that should have been monitored over time to ensure disruptive change wasn't rendering one or more strategic assumptions invalid. These vital signs might have included metrics relating to competitors' actions (e.g., web-based sales and pricing differentials), financial performance (e.g., inventory levels, working capital trends and web-based sales versus in-store sales) and market activity (e.g., mall traffic trends, comparability of store fronts and locations with competitors, per day customer traffic, and percent of browsers who do not buy anything), among others, to gauge whether the strategy was working.

In looking forward, consider the potential effects of disruptive technological developments within the industry that could outpace the organization's ability to compete and/or manage risk appropriately if changes to the business are not made. These disruptions may arise from substitute products, services or channels that attack the viability of the current business model. Examples include the impact of friendlier, more intelligent devices; increased mobile connectivity; bigger/thinner TVs; 3D displays; greater bandwidth availability; and speech recognition, all of which can influence consumer behavior and the workplace dramatically.

Disruptive market forces can present a formidable impact. In addition to the effect of new competitors entering the marketplace, consider the effect of: significant demographic changes arising from aging populations and concentrations of people in resource-stressed regions; intensifying fiscal pressures on the viability of affected regions; political and social instability in emerging economies; scarcity of natural resources, resulting in highly volatile commodity markets; and regulatory changes affecting the production and delivery of products or services.

Emerging new and/or unexpected threats are another potentially disruptive force (e.g., the impact of cybersecurity incidents on critical infrastructure, brand image and reputation). To what extent could these forces of disruption affect an organization's strategic assumptions and business model?

While death, taxes, the earth being round, and the sun rising and setting every day are fundamental truths we can count on, almost everything else is an assumption about the future. Strategic assumptions represent management's "view of the world" for the duration of the strategic-planning horizon. They pertain to such drivers as: the enterprise's capabilities; competitor capabilities, behaviors and actions; customer preferences and bargaining power; supplier availability, performance and bargaining power; technological trends and innovation; capital availability; legal and regulatory trends; and absence of catastrophic physical phenomena, among other things.

Each assumption generally contains an implicit expectation regarding one or more of the above (or other) drivers. Collectively, all of the assumptions provide a foundation for understanding sources of uncertainty in the strategy through identification of relevant scenarios. In effect, strategic assumptions are management's "white swans" because they reflect management's views of the environment in which the "extended end-to-end enterprise" will operate during the planning horizon. Disruptive change can alter these assumptions either slowly over time or in a heartbeat.[2]

Management's assumptions should be developed in the context of articulating the strategy. A well-thought-out SWOT (strengths, weaknesses, opportunities and threats) analysis is one possible source of inputs into this exercise, as it is often used to identify the internal and external factors that are favorable and unfavorable to achieving a desired end state or strategic objective.

If the company doesn't have a clearly articulated strategy, the focus may be on the assumptions underlying its business model. Porter's Five Forces is an example of a framework that provides a useful context for identifying critical assumptions about a company's relative positioning in its industry.

All told, it is important for management to identify the key assumptions or drivers to making the strategy or business model work. Likewise, the board should review and constructively challenge those assumptions when evaluating the strategy. This process will facilitate understanding the hard spots and soft spots in the strategy, how much the forces of disruption can hurt the organization and, more important, the specific aspects of the strategy that may require revisiting to manage the effects of disruption if and when it becomes a reality.

Questions for Boards

The following are some suggested questions that boards of directors may consider, consistent with the entity's objectives:

- Is there a common understanding between management and the board as to the critical assumptions underlying the enterprise's strategy?
- Is there a process for challenging underlying assumptions? Are key factors that provide insight regarding the continued validity of the critical underlying assumptions monitored over time? Does the monitoring process consider the potential for disruptive change?
- Is the board satisfied that management is evaluating changes periodically in the business environment to identify emerging opportunities and risks? Does the process consider plausible "black swan" events and result in appropriate response plans, exit strategies and other contingencies on a timely basis?

2 The reference to "white swans" was noted on pages 86-87 of *Surviving and Thriving in Uncertainty: Creating the Risk Intelligent Enterprise,* Frederick Funston and Stephen Wagner, 2010.

How Protiviti Can Help

Protiviti assists boards and executive management with assessing the enterprise's risks and the capabilities for managing those risks. We help organizations identify and prioritize their risks, including emerging risks that can impair their reputation, brand image and enterprise value. We assist companies with integrating their risk assessment process with their core business processes, including strategy-setting, and with improving their risk reporting to better inform the board risk oversight process.

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 40 percent of FORTUNE 1000® and FORTUNE Global 500® companies. Protiviti and its independently owned Member Firms serve clients through a network of more than 70 locations in over 20 countries. The firm also works with smaller, growing companies, including those looking to go public, as well as with government agencies.

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.directorship.com author/jim-deloach/ in the "Blogs & Opinion" section. A compilation of blog posts and articles is maintained and categorized by author's name. 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.**

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