Board Perspectives: Risk Oversight

Sooner or Later, Your Fundamentals Will Change

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Change is a double-edged sword. It presents an opportunity to take a business to another level. Conversely, it can be a sign of the beginning of the end. Whichever side of the change curve management and the board find themselves, few would disagree that disruptive change itself cannot be taken lightly. The key is embracing its inevitability.

One of the classics in business literature is former Intel CEO Andy Grove's *Only the Paranoid Survive: How to Exploit the Crisis Points That Challenge Every Company*, published in 1996. In the book, Grove coined the term "strategic inflection point," which he defined as "a time in the life of a business when its fundamentals are about to change."

That a company can be the subject of a strategic inflection point but also the cause of one is a sobering market reality. Nearly 20 years later, Grove's premise is as applicable today as it was before the turn of the 21st century, if not more so. As he so eloquently observed, "The ability to recognize that the winds have shifted and to take appropriate action before you wreck your boat is crucial to the future of an enterprise."

Key Considerations

Half-life is the amount of time required for something to decline to half its value as measured at the beginning of a stated time period. Intuitively, everyone recognizes that the half-life of virtually everything – knowledge, product life cycles, product design cycles, new technologies and speed to market – is compressing and has been for some time.

But the accelerating pace of change is old news. What we're facing today is 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 the elapsed time frame has compressed to half that time. More important, it 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. And eventually, the business model itself runs out of steam.[1]

Innovation can touch many things. It can dramatically improve quality, time and cost performance to create superior products and services for customers at affordable prices. It can create new markets, extend a product range, or replace products and services. It can be disruptive if it improves a product or service in ways that the market

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

does not expect, typically by lowering price significantly, or by designing a product or service that transforms the way in which the consumer's needs are fulfilled. It can disintermediate intermediaries within the value chain that links producers and customers (e.g., when Internet-based businesses use the World Wide Web to eliminate middlemen and sell their products directly to customers). Facing such change with confidence is the only viable alternative to becoming a victim of the speed of this never-ending cycle of innovation.

To get and stay ahead of the disruption curve, an organization must first quickly discern the vital signs of change. This is not a matter of luck but a capability in which the company is able to do four things really well:

1. **Understand the critical assumptions underlying the business model –** Management's assumptions about markets, customers, competition, technology, regulatory behavior and other external factors are fundamentals that shape the organization's strategy. Because the organization's business model is typically designed to function within the business environment envisioned by management, a dramatic shift in any of these drivers would likely require an evaluation of the model's validity.
2. **Apply scenario analysis capabilities to evaluate situations in which an event or combination of events could invalidate one or more of the critical assumptions –** Scenarios help management understand and identify the factors that can most impact the failure or success of the business model. They help focus attention on the potential sensitivity of changes in any of the fundamental business model assumptions. For example, industries that lack strong entry barriers may be especially susceptible to technological shifts; therefore, they are more likely to face new and unexpected sources of competition.
3. **Conduct competitive intelligence activities aligned with the most important drivers evidencing that scenarios of greatest concern are either developing or have occurred –** To facilitate the timely recognition of change, the competitive intelligence function ensures that there are mechanisms in place that enable managers to take a fresh look at the organization's processes and customer interactions and re-examine and challenge assumptions underlying the business model as the market changes. The function aligns its activities with the most critical assumptions by offering relevant perspectives and insight about evolving conditions through a wide range of quantitative and qualitative measures. Thus, competitive intelligence creates enterprisewide transparency by seeking out nontraditional information and data that may offer decision-makers a contrarian view.
4. **Distill timely information about assumptions, scenario analyses and intelligence gathering and report insights obtained to decision-makers –** Executive management must receive timely, quality information regarding customer behavior and what's working and what's not in fulfilling the customer experience. This information must be unfiltered, meaning it must be received directly from customers and provide an accurate view of their experiences interacting with the organization and its offerings. For example, are customers remaining loyal to the company, or are they "one and done"? Do we know why?

Time to act is a precious asset in a dynamic environment. It arises from timely recognition and enables management to capitalize on critical opportunities and risks arising from disruptive change. In essence, it provides the gift of being able to evaluate emerging trends and formulate options to act with confidence.

Recognition is made possible through transparency. However, there are two "transparency killers" that can lead to strategic error: (1) unduly relying on the past in predicting market behavior and (2) allowing silos to constrain the depth and breadth of enterprisewide communication.

If hierarchical and siloed organizational structures filter information moving up the management chain, delays and distortions of the message are likely to occur. Silos tend to compartmentalize information such that relevant information gathered by one business unit may not be shared with other business units. Thus, there will be an absence of timely discussion about market conditions between business unit leaders and executive management. The result is the potential for isolated decision-making and, even worse, multiple versions of the truth.

As important as recognition is to managing disruptive change, it alone isn't enough. Timely reaction must follow. Having knowledge of an emerging opportunity or risk without undertaking a process to convert 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 consideration of the impact of changing market realities on critical business model assumptions –** Continuous dialogue between business areas, alignment of compensation and other incentives with the goal of balancing short- and long-term performance, senior management involvement, and an active board help to shape the desired culture. When trending metrics signal the warning signs, it helps to engage a diverse group of stakeholders who understand the customer, the strategy, the direction of technology and the evolving marketplace to evaluate the signals, formulate ideas, and recommend how to proceed and where to experiment going forward.
- **Incent managerial ingenuity to translate altered assumptions into actionable revisions to strategic, business and product plans –** Compensation arrangements that skew incentives to maximize revenues without fostering sensitivity to changing market conditions can create serious blind spots in any organization. To illustrate, if signs of vulnerability begin to arise – such as next-generation innovations offering diminishing improvements – and are ignored, that's a problem. If process and product owners have difficulty identifying new ways to enhance offerings, that's another sign of trouble. If feedback from customers indicates they are considering alternative offerings that are increasingly acceptable to them, then disruptive change is brewing. If there are no incentives to question the durability of the business model, then the road traveled leads to that dead end when obvious market pressures and declining financial results force acknowledgement that the business model is stagnant. By that time, it's either too late to salvage it or the change process becomes more painful than it needs to be.
- **Seek organizational resiliency –** The ability and discipline to act decisively on revisions to strategic, business and product plans in response to changing market realities are the hallmarks of a resilient organization. Insulation from reality in a rapidly changing environment is lethal. We often hear the trite observation that management needs to ensure that the right information is given to the right people at the right time. To position the organization as a resilient early mover, this simply means that decision-makers must be in direct contact with the unvarnished truth. Armed with knowledge of the truth and supported by the board, they can apply the right tools to analyze information for decision-making with a bias for the action needed to sustain superior long-term performance. When companies don't respond to disruptive change, it's usually because they don't have a clear view or single version of the truth. This dysfunction can arise from either incentives that do not encourage resiliency or management simply being out of touch with the customer.

In business environments exposed to disruptive change, adaptive processes are needed to alter underlying assumptions rapidly to reflect newly changed circumstances. As stated earlier, disruptive change is a double-edged sword, simultaneously presenting one of the biggest opportunities and risks a company can face. What separates the winners from the losers in facing change with confidence is the ability to recognize the vital signs and act on them decisively.

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:

- Is there a common understanding between management and the board as to the critical assumptions underlying the enterprise's business model?

- Is management periodically evaluating changes in the business environment to assess the related impacts on assumptions inherent in the business model? Is there a process for challenging the durability of the business model?
- Does the organization monitor key factors that provide insight regarding the continued validity of key assumptions underlying the business model?
- Does the organization have adaptive and experimental processes to address the opportunities and risks associated with disruptive change and to drive innovation in its processes and offerings?

How Protiviti Can Help

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

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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.**

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