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Face the Future with Confidence

Board Perspectives:
Risk Oversight

Managing the Effects of Short-Termism on Risk Oversight

Short-termism is not a new concept by any means, but it has become a hot topic of discussion for many boards of directors in recent years. In this article, we explore the implications of short-termism to the board's risk oversight process and how the board can ensure its oversight is not compromised.

Short-termism can mean many things, but it typically refers to an environment in which the focus on short-term results is so myopic that it results in the neglect of important longer-term interests. In a recent survey of more than 600 public company directors and governance professionals, 75 percent of respondents indicated that pressure from external sources to make short-term gains is compromising management's focus on long-term strategic goals.[1] This pressure can also affect the board's risk oversight.

Key Considerations

Short-termism manifests itself in many ways. Some examples include:

- Focusing on quarterly earnings at the expense of funding long-term sustainable growth
- Pursuing risky merger and acquisition (M&A) deals for growth's sake without clear linkage to the overall corporate strategy
- Releasing new products to market without sufficient testing
- Allowing cost and schedule considerations to undermine safety on significant projects (e.g., deferring maintenance or taking risky shortcuts)
- Forgoing employee training
- Assuming or ignoring huge risks
- Taking on excessive leverage to pursue an activity that is currently generating attractive returns

Short-termism is a complex topic because its underlying root causes reflect powerful dynamics. For example, globalization, technological developments, improved

[1] *2016–2017 NACD Public Company Governance Survey*, National Association of Corporate Directors (NACD), December 2016, available at www.nacdonline.org/PublicSurvey.

transparency and reduced transaction costs have facilitated capital flows to the point where investors can easily reallocate their assets to seek the highest yields. There is also an increasing trend in which hedge funds and other activist shareholders acquire a small stake in a company with the objective of steering profits to shareholders immediately (through, say, higher dividends, stock buybacks, asset spinoffs and/or downsizing in lieu of investing in innovation to develop products and processes to improve productivity and drive future growth). Still another example is the compensation structure emphasizing executive pay over the near term to the detriment of long-term shareholder interests, skewing management's decision-making toward maximizing short-term profits at all costs.

To be sure, the complexities surrounding short-termism make it a tough nut to crack. Two things are certain, however: In all its forms, short-termism is not sustainable in a rapidly changing world. It is also an issue on which boards, executives and shareholders should all reflect.

Companies constrained by a short-term focus risk their future growth, innovation, productivity and financial performance. There are also consequences for their employees' wages and the employment rates and living standards in the communities and nations in which businesses operate. All that said, in no way are we suggesting that short-term matters aren't important.

The financial crisis of 2007-2008 presents an object lesson on how extreme and dangerous negative consequences can be when risks are undertaken beyond an enterprise's capacity to bear risk. Looking back, the pervasive "volume and speed" subprime lending business model that contributed to the crisis was driven by a combustible mix of factors: excessive borrowing by households enabled by historically low interest rates and lax underwriting standards; cavalier risk-taking by Wall Street to satisfy the insatiable global demand for high-yield, fixed-income securities; dramatic breakdowns in corporate governance in many firms; and the inability of policymakers and regulators to address the snowballing effect of dysfunctional behavior in the financial systems they oversaw.

Dramatic growth in the shadow financial system (e.g., nondepository banks, investment banks, hedge funds, money market funds and insurers), as well as a surge of activity in the derivatives markets, helped further fuel the credit and housing price explosion. The onslaught of toxic, opaque mortgages; troubling imbalances in "heads I win, tails you lose" compensation structures; and unengaged boards exacerbated the problem, contributing to the lack of accountability for long-term shareholder interests.

As U.S. housing prices peaked and began declining in mid-2006, defaults escalated. The tipping point was the sheer volume of activity by mortgage brokers, lenders, mortgage insurers, investment banks, credit default issuers and institutional investors. Not enough of these market players knew when to stop. Too many followed the herd simply because they were making too much money, creating a housing bubble of massive proportions. When the bubble finally popped, financial institutions and investors were forced to write down the value of their subprime assets. Sad to say, for many financial institutions, the long-term risks and risk management discipline were irrelevant.

The point is that there are complex forces driving the short-termism phenomenon. Directors need to ensure that the organizations they govern seek a healthy balance in addressing short- and long-term interests of the organization's senior executives and stakeholders. Our focus here is on concrete steps that the board can take to ensure short-termism does not compromise risk oversight, as it did for many boards during the financial crisis. Following are six recommendations:

1. **Focus the board's oversight on risks that matter:** If risk management is focused primarily on operational matters, chances are management may be moving "known knowns" around on a risk map through periodic risk assessments rather than focusing attention on the right question: *Do we know what we don't know?* To face the future confidently, both management and the board need to focus the risk assessment process on (a) identifying and managing the critical enterprise risks that can impair the organization's reputation, brand image and enterprise value; and (b) recognizing emerging risks looming on the horizon on a timely basis. Even though the day-to-day risks of managing the business are important, they should not command the board's risk oversight focus except on an outlier basis when truly pressing issues arise.

2. **Lengthen the time horizon used to assess risk:** The focus on quarterly performance, annual budgets and business plans may lead to a risk assessment horizon of no more than three years. That period may be too limiting because strategic opportunities and risks typically have a longer horizon — even with the constant pressure of disruptive change on business models. For example, the World Economic Forum uses a 10-year horizon in its annual risk study. Likewise, more companies are using a longer horizon to elevate their assessment process to a strategic level. Longer horizons are more likely to surface emerging issues, along with new plausible and extreme scenarios, that might otherwise be missed with a shorter time frame. Given the uncertainty of these volatile times, the board needs to satisfy itself that management is using an appropriate horizon to enable preparedness for issues down the road.

3. **Understand and evaluate strategic assumptions:** One way to ensure that risk management is focused beyond the near term is to understand the external environment and internal operating impacts that invalidate the critical assumptions underlying the strategy. Strategic assumptions are management's "worldview" for the duration of the strategic planning horizon. They pertain to such attributes as the enterprise's capabilities, competitor capabilities and propensity to act, customer preferences, technological trends, capital availability, and regulatory trends, among other things. Accordingly, directors should weigh in on management's assumptions underlying the strategy. Doing so could reveal insights into sources of disruptive change. Insights from thinking strategically about risk and opportunity can increase the robustness of the strategy and greatly enhance investor communications.

4. **Integrate risk and risk management with what matters:** Short-termism can render risk to an afterthought to the formulation of strategy. Risk management similarly can become a mere appendage to performance management. The strategy, therefore, may be unrealistic and may involve taking on excessive risk. In addition, performance management may be overly focused on retrospective, backward-looking lag metrics. As an effective understanding of risk of necessity entails looking forward beyond the near term, the board should ensure the strategy-setting process considers risks arising from strategic alternatives, risks to executing the strategy, and the potential for the strategy to be out of alignment with the organization's mission and values. Directors also should insist that prospective, forward-looking lead metrics be used to complement the more traditional metrics used to manage day-to-day operations.

5. **Watch out for compensation imbalances:** Publicly listed companies on U.S. exchanges are currently required to disclose in the proxy statement whether the company's system of incentives could lead to unacceptable risky decision-making in the pursuit of near-term rewards. The compensation committee typically conducts a review for excessive risk-taking in conjunction with its oversight of the compensation structure. Board concerns with respect to short-termism are a red flag for the compensation committee to sharpen its focus on the potential for troubling compensation issues. For example, if one or more operating units and/or star performers are making a disproportionate amount of money and senior leaders are unaware or indifferent as to how they're achieving such results, then directors need to ensure that there is an absence of bet-the-farm behavior.

6. **Pay attention to the culture:** Short-termism can contribute to a dysfunctional environment that warrants vigilant board oversight. For example:

    - Management may continue to execute the same strategy and business model regardless of whether market conditions invalidate the underlying strategic assumptions.
    - The organization may be insular in its outlook and fail to regularly "reality test" its assumptions about markets and the business environment.
    - Unit and process owners may be fixated on making artificial moves (e.g., deferring investments) and manipulating processes (e.g., cutting costs to the bone) to achieve short-term financial targets, rather than on fulfilling customer expectations and enhancing the customer experience by improving process effectiveness and efficiency.
    - Risk management responsibility may not be adequately defined or linked to the reward system or, worse, the incentive compensation program rewards unbridled risk-taking over the short term.

- Management may be reluctant to consider investments that may not pay off in the short run, even though there is long-term shareholder value-creation potential.

These and other red flags warrant the board's attention because they signal the possibility of unacceptable risk-taking that must be addressed.

In summary, short-termism is an area of concern on the part of many companies. Boards need to ensure their risk oversight process isn't compromised by short-termism. A strong focus on linking risk and opportunity can help overcome some of the "blind spots" that a myopic outlook can create.

Questions for Boards

Boards of directors may want to consider the following questions in the context of the nature of the entity's risks inherent in its operations:

- Is the board's risk oversight focused on issues that matter? Is the board satisfied that short-termism is not creating unacceptable risks that warrant immediate attention?
- Does the board insist that management adopt a long-term view for assessing risk? Is there sufficient attention given to understanding strategic assumptions and risks inherent in the strategy?
- Do the company's compensation and rewards systems foster a short-termism mentality? Does the board ensure that key executives have "skin in the game" so they will take risks prudently in the pursuit of value-creating opportunities?

How Protiviti Can Help

Protiviti assists boards and executive management with assessing the enterprise's risks, either across the entity or at various operating units, and the capabilities for managing those risks. We help organizations identify and prioritize the critical enterprise risks that can impair their reputation, brand image and enterprise value. Our intent is to help companies increase the robustness of their business strategy through better anticipation and management of risks arising from, and in the execution of, the strategy.

Is It Time for Your Board to Evaluate Its Risk Oversight Process?

The TBI Protiviti Board Risk Oversight Meter™ provides boards with an opportunity to refresh their risk oversight process to ensure it's focused sharply on the opportunities and risks that truly matter. Protiviti's commitment to facilitating continuous process improvement to enable companies to confidently face the future is why we collaborated with The Board Institute, Inc. (TBI) to offer the director community a flexible, cost-effective tool that assists boards in their periodic self-evaluation of the board's risk oversight and mirrors the way many directors prefer to conduct self-evaluations. Boards interested in using this evaluation tool should visit the TBI website at http://theboardinstitute.com/board-risk-meter/.

Learn more at
www.protiviti.com/boardriskoversightmeter

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We have served more than 60 percent of *Fortune* 1000® and 35 percent of *Fortune* Global 500® companies. We also work with smaller, growing companies, including those looking to go public, as well as with government agencies. Protiviti is a wholly owned subsidiary of Robert Half (NYSE: RHI). Founded in 1948, Robert Half is a member of the S&P 500 index.

Protiviti partners 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 https://blog.nacdonline.org/author/jdeloach/. Twice per year, the six most recent issues of *Board Perspectives: Risk Oversight* are consolidated into a printed booklet that is co-branded with NACD. Protiviti also posts these articles at protiviti.com.

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