

Challenges and Changes

Learning from High Profile Business Crises: Two Pitfalls to Avoid

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As the economic crisis grinds on, much attention is being paid to the high profile business crises making the front pages of the papers. From U.S. and European banks and insurance companies to the struggling auto, housing and retail sectors, examples abound of corporate giants brought to their knees.

At the same time many Canadian businesses, particularly small to medium-sized companies, are fighting to survive the recession. Regardless of the differences in size and scope, some of the factors thought to have contributed to the downfall of companies once considered “too big to fail” are equally relevant to smaller players in today’s turbulent markets.

This article highlights two pitfalls to avoid, as seen in recent corporate disasters:

- from banking and financial services: fostering a culture of excessive risk-taking; and
- from the auto industry: failing to anticipate strategic change.

No board consciously decides to expose the company to excessive risk with potentially devastating consequences, or to cling to an outmoded business model despite mounting evidence of a changing world. It happens gradually, incrementally, and generally without being formally acknowledged. It is not until the post-mortem conducted by investors, the financial press, the regulators or the courts that the problems are fully identified, and, with the benefit of hindsight, questions are asked about how directors could have failed to see the danger.

Wise directors will learn from the examples of high profile business debacles, will investigate the situation facing their companies and will ask the right questions to protect their companies from falling into similar traps.

Guarding against a culture of excessive risk-taking

Excessive risk-taking, once considered the exclusive domain of rogue traders, but now recognized as systemic, has been identified as a contributing factor in the collapse of various players in the global financial markets.

When the financial sector was flying high, risky products and strategies generated high returns. In order to preserve and grow their market share, some financial institutions allowed the trend towards increased risk-taking to escalate. Some compensation programs and bonus schemes encouraged and rewarded it, creating an inappropriate focus on short-term revenues at the expense of long-term stability.

Arguably, innovation in financial instruments outstripped the capacity to manage them. It appears that management and boards did not fully understand the risks that companies were exposed to or the behaviours they were motivating among employees. Some boards failed to recognize or address the creeping increase in risk-taking in their organizations, and may have

neglected to question whether the business practices that were becoming commonplace really served the institution's long-term interests.

Directors can guard against the danger of allowing a culture of excessive risk-taking through their work in several key areas of their mandate.

Risk Oversight

One of the board's most critical responsibilities, one that is currently receiving a great deal of public attention, is the oversight of risk. Risk oversight includes the organization's risk tolerance, which has two components:

- appetite for risk - the company's willingness to take risk, which is linked to its strategy; and
- capacity for risk – the company's ability to withstand risk, which includes the likelihood of succeeding in new initiatives and recovering from setbacks.

Effective risk oversight involves setting risk tolerance levels that optimally balance risk and opportunity, and then guiding the company to stay within them. When approving new initiatives, directors must consider whether they are in line with the company's risk tolerance. An increase in practices that push the boundaries of established risk tolerance levels should raise red flags.

In order to oversee risk successfully, directors must have a solid understanding of the business risks the organization faces, both those specific to the company and those relating to the industry in which it operates. If it is not provided, directors should request ongoing board education in these areas.

It may be wise for boards to review their company's risk tolerance and strategic direction in order to determine whether they continue to be appropriate in the current economic environment.

Executive Compensation

Key in guarding against the creation of a culture of excessive risk-taking is the board's oversight of compensation. This should include the compensation not just of executives, but also of senior management - beyond the CEO and named executive officers whose compensation must be disclosed. This is an area of growing shareholder scrutiny.

The company's compensation philosophy should clearly articulate the principles under which compensation is set. The board, through its compensation committee, should assess the link between pay and performance and determine whether the compensation program aligns the interests of executives and senior management with those of the company. The committee should review the incentive plans and resulting awards in order to avoid programs that inadvertently reward behaviors such as excessive risk-taking or create a focus on short-term results at the expense of the long-term well-being of the company.

Tone at the Top

The board directly influences the company's approach to risk-taking via the "tone at the top". Directors must exemplify a measured approach to risk-taking when making strategic decisions. They should have a healthy skepticism, and ask management tough questions that challenge assumptions and focus on the interests of owners and other key stakeholders.

Avoiding the Trap of Failing to Anticipate Strategic Change

Another notable sector in which corporate behemoths have been crippled during the current crisis is the North American auto manufacturing industry. Some manufacturers are struggling to respond to changing market conditions, and observers note that the corporate strategy and business models which served them well for decades appear out of touch with present day realities.

These companies were affected by several changes occurring over a period of years, such as rising gasoline prices, intense competition from foreign car manufacturers and increased environmental sensitivity among consumers. They were then hit hard during the financial crisis by the rising cost of raw materials and decreased consumer spending.

Directors can play a critical role in preventing reliance on an outdated paradigm from putting their own company into jeopardy.

Strategy

A key part of the board's stewardship responsibility is the oversight of strategic planning and the approval of the corporate strategy. Directors are responsible for setting the overall vision and long-term direction of the organization. Their contribution has been described as "oversight, insight and foresight". Directors contribute their experiences and wisdom, not to second-guess management, but to supplement and enhance executive decision-making. They can provide a perspective that helps management identify those opportunities most worth pursuing.

Essential to the oversight of strategy is the assessment of strategic risks. It is crucial that directors understand the risks associated with a particular strategy, their probability of occurrence and their potential impact. These risks should be spelled out in the strategic plan. Directors should consider only those strategies where the associated risks are deemed to be tolerable given the potential for return. The board should be assured that the organization has in place a risk management system for measuring and monitoring known risks, estimating their impact, mitigating their occurrence or effect and identifying emerging dangers.

Regular reviews of strategy and strategic risks will help assure directors that the corporate strategy remains appropriate in light of current industry conditions.

Recognizing Early Warning Signals

Directors should be constantly vigilant for the early warning signs of trouble. Most business failures occur not as a result of a single catastrophic event, but as the culmination of a series of minor events or a pattern of ongoing problems. Such problems may weaken an organization to the point that it cannot cope with a sudden crisis. Noticing "red flags" as they arise allows boards to take remedial action before problems escalate to the point that they threaten the viability of the company.

Early warning signals may come from customers, competitors, employees, investors, regulators or others. Signs that the company's strategy or business model is out of synch with current realities may include declining sales, loss of market share to competitors, lack of innovation or diversification of products, and failure to respond to regulatory, economic or social changes in the business environment.

The board can help safeguard the company by watching that management anticipates potential crises in its strategic planning, risk management and other processes, and has procedures in place for monitoring performance and identifying early warning signals of potential crises.

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