An early-warning system to guard against failure

In the post-Sarbanes-Oxley environment, companies are seeking to reduce their risk of organizational breakdown. Here’s an effective way for family business leaders and boards of directors to identify and manage risk.

BY SYDNEY FINKELSTEIN AND ERIC M. JACKSON

Business failure has been one of the most discussed topics in the corporate landscape for the past five years. With the deflation of the “Internet bubble” in 2000 and the corporate scandals engulfing Enron and WorldCom, understanding and lessening risk has become more important to CEOs and boards than ever before. And just when those debacles are beginning to fade from our collective memories, a new one seems to erupt, such as Refco in the U.S. and Livedoor in Japan. Clearly, there is more work to do to improve the level of corporate governance and to lessen the risk of future imbroglios.

In our experience, family-owned businesses are sometimes held even more under the microscope than other businesses. Adelphia Communications, unfortunately, gave family businesses a poster-child case of corporate failure. Beyond these extreme cases, however, outside analysts, media, customers, suppliers and directors are more commonly speaking out in favor of tighter internal controls that ensure that family-run businesses, especially those held under majority control, are transparent and beyond reproach in terms of their risk practices. At times of succession from one generation to the next, there is even more concern about business continuity and avoiding a major catastrophe.

What can family business leaders and their advisers do to avoid breakdowns in their organizations? Although we have greatly improved our understanding of business failure, business risk and corporate governance over the last five years, in truth, most organizations’ conception of business risk today is limited to implementing additional financial controls, protecting information technology and preparing for disaster recovery or business continuity. We are still in our infancy when it comes to understanding business risk in relation to leadership, strategy and the internal processes. Yet what is more important to a company’s success, and its survival?

If there is one thing that all family owners and board members will agree on, it’s that a major breakdown or failure cannot be allowed to take hold on their watch. When you get right down to it, there are dozens—even hundreds—of decisions that are made in companies that keep the ship moving forward, and no CEO, senior team or board can possibly control them all. But if these decisions (and sometimes non-decisions) push an organization to the precipice of failure, the owners and directors will be the ones held responsible. The solution, we believe, is to develop an early-warning system that can identify—in real time, not after the fact—a company’s vulnerabilities that can lead to failure. Armed with this information in a timely manner, family leaders can make the necessary real-time adjustments before it is too late.

Seven years ago, an outside observer would have said

Adelphia was a successful family-run business.

Measuring business risk today

To serve organizations’ growing interest in better understanding and managing their exposure to risk, a number of large accounting and consulting firms have set up “enterprise risk management” practices. Of course, this work typically zeroes in on an organization’s financial controls and whether they are in compliance with the Sarbanes-Oxley Act. Opinions are also rendered on the quality of an organization’s internal audit. “Business continuity planning” is another service designed to allow organizations to quickly recover and resume operations after a large disaster. Some critics have pointed out that such analyses are conducted in isolation and can result in redundancy across the organization. Others have complained that, beyond the high cost of financial control compliance, Sarbanes-Oxley can distract managers from focusing on the factors critical to organizational success. A recent study by IBM and the Economist Intelligence Unit...
found that chief financial officers are so swamped with earnings reports and compliance work that only a third thought that they were highly effective at growing their companies and driving shareholder value.

While Sarbanes-Oxley compliance procedures and traditional enterprise risk management activities serve a useful purpose, they fall far short in addressing the most critical issue facing business leaders: the effective long-term stewardship of their organization. Companies today have precious few models and tools for assessing their vulnerability to major breakdowns. Doing so requires direct attention to what our research has identified as the major drivers of long-term success and failure: leadership, strategy and organizational processes.

Organizational problems of this type are not often readily apparent to outside observers. And how often do insiders take the time to check where they stand on the seemingly fuzzy topics of leadership, strategy and process? In our speeches to senior executives and boards, we often ask participants to tell us about their early-warning system for identifying failures. The most common answer we hear is something along the lines of: “We look to our quarterly returns for signs of trouble.”

The problem is that by the time financial reports provide evidence on breakdowns, it is usually too late. Financial reports do not identify risk; they report on what happened in light of the risks that already existed.

A new way to measure risk

We have spent the last eight years conducting research with companies in the United States and Canada, Europe, Asia and Australia to try to understand the underlying causes of business failure. Much of this research came together in the 2003 book Why Smart Executives Fail, but since its publication we have extended our research to identify the early-warning signs of business failure—the key factors that differentiate high-performing firms that stay successful from those that are successful for a while and later fail.

According to our research, most successful organizations (family-owned or not) fail because they choose to ignore information—or focus on the wrong data—about their leadership, strategy, structure or internal processes. In contrast, the most enduring and successful organizations equip themselves with a corporate early-warning system that ensures that “lost signals” vital to the organization’s long-term success are tracked down and monitored consistently. This system benchmarks for an organization’s senior executives and directors the degree of risk they face, providing critical information on the barriers that prevent them from fully executing their stated vision and strategy.

According to our research, you must constantly focus on three important dimensions in order to ensure your family-owned organization does not slip into some of the patterns that derailed other previously successful companies:

- **Leadership.** Have you addressed the family succession issue? Whom are you grooming to take over in key positions, and how are you doing this? Do your executives and directors exhibit the right knowledge, attitudes and behaviors? Do you possess the best top team/board structure and process to optimize debate and rigorous analysis? Who are your company’s outside directors (besides family members), and how do they participate?

- **Strategy.** Like many other family-run businesses, are you relying too much on the formula for success that’s worked in the past (as opposed to what will work today)? Have you examined the underlying assumptions on which your strategy is based, and are they still accurate in light of recent competitive pressures? Are key stakeholders aligned with the strategy, or are “blockers” present?

- **Process.** Is a clear organizational structure and process in place, or does the organization still operate as it did when it was smaller? Are the values of the organization from the past being transmitted to the next generation of leaders? Does information from the far reaches of the organization get to board or management team members in a reasonably unfiltered fashion so that they can act on it in a timely manner? Does your culture and employee commitment support the implementation of the strategy?

A corporate early-warning system can be instituted through annual surveys of directors, officers and key organizational leaders for their views on the keys areas listed above. Of course, there will be differences in opinions among these groups on how well the organization is doing in each of the areas. These differences should serve to provoke further discussion about whose perceptions are the most accurate.

In our experience, the survey results can be even more powerful when tracked year-over-year and when compared against other organizations (especially family-owned ones). If the survey questions are constructed properly, the company will understand where it stands in these key areas and what its vulnerabilities are in each area. For example, our research has found that the most critical attributes of leaders in organizations that continue to thrive when compared to their peers in failing organizations are:
1. The degree of open-mindedness to new ideas, criticism, and different perspectives. This is sometimes problematic when there is a strongly opinionated founder-CEO still present in the organization.

2. The extent to which senior management team members exhibit a bias toward personal accountability, going beyond their assigned job description to speak out with questions, comments or criticisms about some aspect of the business that they don’t understand or don’t like.

3. The degree of energy that key executives direct toward learning new management practices and competitive moves.

While there are countless tomes (and advisers) on strategy and its design that business leaders can consult for guidance, our research suggests the major differentiators between success and failure boil down to strategic alignment and analyzing underlying strategic assumptions. Take the latter point. How often do senior leaders or the board of directors take the time to identify the underlying assumptions that form the core of a company’s strategy (especially when this has worked well in the past)? Time and again, we found that critical assumptions that no one thought to question were actually outdated, outmoded or just plain wrong—and yet, the founder-CEO couldn’t believe that was the case.

A corporate early-warning system should assess the extent to which the most common assumptions that lead to failure are still operative in a company. By identifying the strategic vulnerabilities in a company that emanate from inappropriate or incorrect assumptions, and doing so in real time, executives can take corrective measures before the costs of failure have substantially accumulated.

Think of the two cases of Adelphia and Comcast. Seven years ago, an outside observer would have said that both were successful family-run businesses. We know that’s only half true today. Yet, were the directors and management of Adelphia to ask some tough questions about their internal leadership, strategy and process factors, they might have been surprised at the answers. More important, however, they likely would have had time to take corrective actions before it was too late. Today, their reputations have been tarnished forever. By contrast, Comcast continues to power away, with Brian Roberts now firmly in command. Even though Comcast has been very successful, you do not breathe a whiff of “entitlement” when you speak to those in command. They know they are only a few bad moves away from falling behind in their very competitive market. Therefore, they retain a form of “proactive paranoia” about working hard to stay on top.

Insurance against business breakdowns

There is no fail-safe way to guard against business breakdowns. But CEOs, senior executives and boards can at least reduce the odds that such breakdowns will happen in their organizations. Traditional risk assessments are essential weapons for companies to use, but they are not designed to get to the core elements of a company—its leadership, its strategy and its processes.

Our research suggests that implementing a corporate early-warning system that surveys board members, senior managers and key leaders on these important areas can identify a family-owned organization’s vulnerability to fundamental business breakdowns. Such a system helps uncover the “red flags” that exist in many companies but are left unseen.

The logic behind an early-warning system is compelling. Of course, it is important to identify what might be going wrong, or could go wrong, in a company. In fact, the opportunity to address these risks in real time is a make-or-break issue for executives and boards. It is a form of insurance. Without regularly monitoring the signals that come from an early-warning system, companies are actually increasing their risks, something that no senior executive group or board of directors can let happen on their watch.

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