Sydney Finkelstein proposes a system of early warnings to protect against business failure

Business failure has been one of the most discussed topics on the corporate landscape for the past five years, as the scandals engulfing Enron, WorldCom and others, are proof. The red flags on the system of early warnings to protect against business failure, which Sydney Finkelstein proposes, are becoming more important to CEOs and boards than ever before.

What can leaders and their advisers do to avoid such missteps? Although our understanding of business failure and corporate governance has improved over the past five years, in truth most organisations’ concept of managing uncertainty is limited to implementing new financial controls, protecting the business from market volatility and trying to effect a disaster recovery. We are still in our infancy when it comes to understanding uncertainty that arises from leadership, strategy and the information technology and preparing for disaster recovery. We are still in our infancy when it comes to understanding uncertainty that arises from leadership, strategy and the information technology and preparing for disaster recovery. We are still in our infancy when it comes to understanding uncertainty that arises from leadership, strategy and the information technology and preparing for disaster recovery.

If there is one thing all senior executives and board members agree on, it is that a major breakdown or failure should not happen on their watch. When you peer down to it, there are dozens, even hundreds, of decisions that are made in companies that keep the ship moving forward, and no senior group or board can possibly control all. But if these decisions (and sometimes non-decisions) push an organisation to the precipice of failure, the senior group and board will be held responsible. This was certainly the case with many of the high-profile business breakdowns of the 1990s. Companies such as Tyco, Rite Aid and Ford saw a revolving door at the top, and when things go wrong in such a public way, personal reputations often fall by the wayside as well.

The solution, I believe, is to develop an early warning system that can identify – in real time and not after the fact – the vulnerabilities that can lead to a company’s failure. Armed with this information, leaders are in a position to make the necessary real-time adjustments before it is too late. The purpose of this article is to describe what an early warning system is, what it can do for you and how it can work in your organisation.

A new way to measure uncertainty

The Sarbanes-Oxley Act and similar types of legislation designed to increase transparency and reduce uncertainty in organisations have turned out to be remarkably counterproductive. Not only are they reporting requirements onerous, there is also a danger that senior executives, boards and investors will be lulled into believing that the major vulnerabilities confronting a company are “under control”. In truth, what Sarbanes-Oxley does not do, and what is of primary importance for senior leaders and boards, is to identify the real vulnerabilities they face. Companies are often effective at solving particular problems or handing off tasks to subcontractors, but there is no effective way for them to assess their vulnerabilities to major breakdowns. To do so requires direct attention to what our research has identified to be the major drivers of vulnerability: dependence on key individuals, ineffective leadership, strategy and organisational processes at the heart of the business.

A further complication is that organisational problems of this nature are often not apparent, even to top leaders. How often do insiders take the time to check where they stand on these seemingly fuzzy topics? In speeches to senior executives and boards, I often ask participants to tell me about their early warning system for identifying failures. The most common refrain: “We look to our quarterly returns.” The problem is that by the time financial reports provide evidence of a breakdown, it is usually too late.

I have spent the past eight years conducting research with companies in North America, Europe and Asia to try to understand the underlying causes of business failure. Much of this research came together in our book Why Smart Executives Fail. Since then, I have extended our research to identify the early warning signs of business failure and the key factors that differentiate high-performing companies that stay successful from those that are successful for a while and later fail. The result is a sophisticated yet easy-to-use diagnostic tool that I call the SMART Early-Warning System.

Our research shows that most successful organisations fail because they either focus on the wrong information in the heat of battle or ignore it altogether. In contrast, smart organisations equip themselves with a corporate early warning system that ensures that “lost signals” vital to long-term success are identified and monitored consistently.

The most enduring and successful organisations, like well-prepared battle units, have a system that constantly scans the environment for relevant information. This serves as benchmarks on which senior executives can assess their potential vulnerabilities to business disaster. And it provides you with the right knowledge, attitudes and behaviours that can lead to a company’s failure.

Smart leadership

The SMART Early-Warning System takes these essential questions and converts them into a validated process for accurately measuring where a company stands and what its vulnerabilities are in each area. Our research has found, for example, that the most critical attributes of leaders in organisations that continue to thrive when compared with their peers include:

- The degree of open-mindedness to new ideas, criticism and different perspectives
- The extent to which a bias towards personal accountability takes hold among each individual
- The degree of energy directed toward learning new management practices and competitive moves alike
- The impact of leadership attributes are critical. For example, while the Rudman report that investigated the collapse of the US mortgage lender Fannie Mae did not blame former CEO Frank Raines for the accountingiasco, it did fault boards for ignoring signs, these types of attitudes and behaviours are among the strongest indicators that trouble is coming.

With respect to strategy, I have found that the major breakdowns and failure booms to strategic alignment and analysis of underlying strategic assumptions. Take the latter. How often do board members or the board of directors for that matter, take the time to identify the underlying assumptions that form the core of a company’s strategy? Time and again, I have found that critical assumptions were not articulated, endorsed or questioned.

Business history is replete with examples. For example, Motorola experienced a meltdown in market share from 60 per cent to less than 20 per cent because senior managers wrongly assumed that customers preferred analogue phones despite the rise of digital. Only now, almost ten years later, is the company recovering under new leadership.

The SMART Early-Warning System assesses the extent to which the most common assumptions that lead to failure are still in place. By identifying the strategic vulnerabilities in a company and from inappropriate or incorrect assumptions and doing so in real time, executives can take corrective measures before the costs of failure set in.

Conclusion

There is no guarantee an end to business breakdowns. However, senior executives and boards can do much more to reduce the odds that they will happen. Traditional risk assessments are essential weapons for companies to use, but they are not designed to grasp the core elements of a company. We call the SMART Early-Warning System our best weapon in a company’s battle – or ignore it altogether. In contrast, smart organisations equip themselves with an early warning system that ensures that “lost signals” vital to long-term success are identified and monitored consistently.

Sydney Finkelstein is a Steven Roth professor of management at the Tuck School of Business at Dartmouth College, and author of "Why Smart Executives Fail." (Portfolio, 2001).

sydney.finkelstein@dartmouth.edu