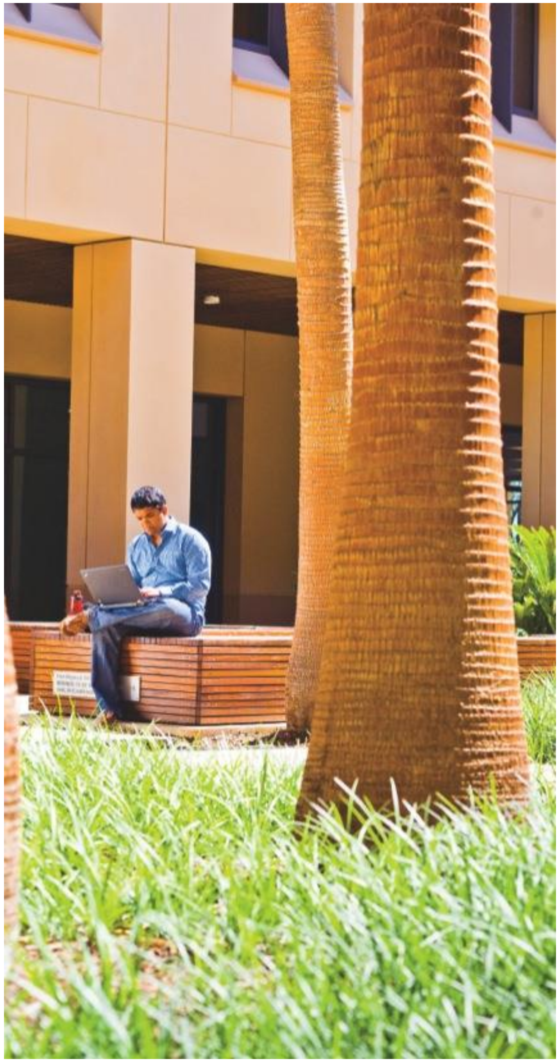
Organizational Strategy, Business Models, and Risk Management

Professor David F. Larcker

Center for Leadership Development & Research

Stanford Graduate School of Business



Strategic Development and Oversight

- OECD: One of the primary responsibilities of the board is to "ensure the strategic guidance of the company."
- Higgs Report: Directors should "constructively challenge and contribute to the development of strategy."
- NACD survey data: Directors consider strategic planning and oversight to be their most important responsibility.

- How exactly does the board perform this function?

Strategic Development and Oversight

- Strategy development and oversight involves four steps:
  1. Define the corporate strategy.
  2. Develop and test business model.
  3. Identify key performance indicators.
  4. Identify and develop processes to mitigate risk.
- Board does not perform these tasks (management does).
- Board evaluates and tests the work of management to ensure that it appropriately builds and protects shareholder value.

Strategic Development and Oversight

Management		Board of Directors
Proposes	Corporate Strategy "How will we create value?"	Reviews
Develops	Business Model "How does strategy translate into value?"	Tests
Identifies	Key Performance Indicators "How will we measure our performance?"	Monitors
Identifies	Risk Management "What can go wrong?"	Reviews

Corporate Strategy

- Identify the organization's overarching mission.
- Identify the process by which the company expects to create long-term value.
  - Scope: The activities the firm will participate in.
  - Markets: The markets it will participate in.
  - Advantage: The advantages that ensure it can compete.
  - Resources: The resources required to compete.
  - Environment: Market factors that influence competition.
  - Stakeholders: Internal/external constituents that influence firm's activities.

Considerations in Developing the Strategy

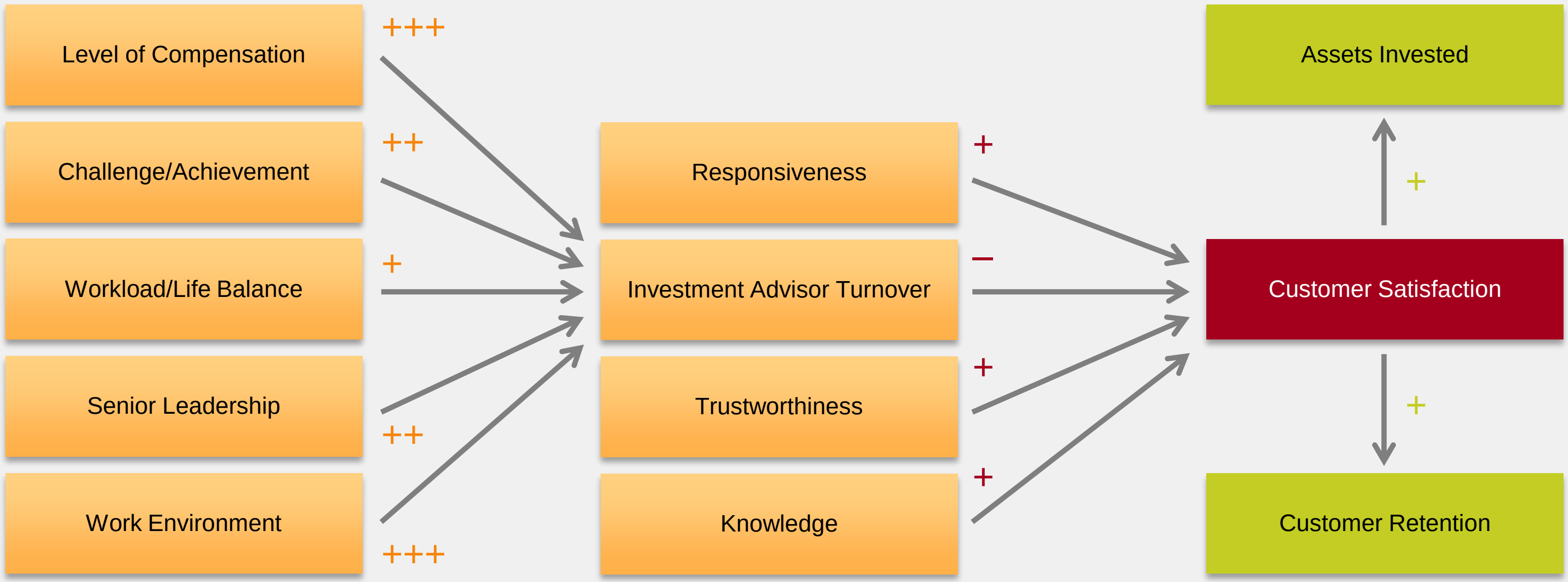
- Strategy development may not be a formal (linear) process.
- Company might refine strategy over time (iterative) or stumble on strategy and articulate it later (random).
- Board needs to understand how the specific strategy was selected and when to change approach.
  - Is management anchoring on current activities?
  - Does the strategy bind the future too closely to the past?
  - Does management understand the dynamics, pressures and resources required to achieve company objectives?
  - Is there proper information sharing across functions?

Business Model

- Develop a causal business model that explains how the corporate strategy translates into shareholder value.
- A business model links specific financial and nonfinancial measures in a logical chain to delineate how the firm’s activities create value.
- The business model lays out a concrete plans that can be tested through statistical analysis.
- It then provides the long-term basis for measuring management performance and awarding compensation.

Example: Investment Advisory Firm

- Customers invest more assets with the firm when they are satisfied with their advisor.
- What drives customer satisfaction?



Considerations in Developing Business Model

- The business model is based on rigorous, statistical analysis (not management intuition).
- Board relies on business model to test management assumptions and satisfy itself that the strategy is sound.
- Board evaluates for logical consistency, realism of targets, and statistical evidence that relationships are valid.
- Board should be aware of challenges.
  - Management might take shortcuts.
  - Management might resist scrutiny.
  - Relevant data might be difficult to obtain.

Key Performance Indicators

- Key performance indicators (KPIs) are the financial and nonfinancial metrics identified during the business model process that validly reflect current and future performance.
- KPIs should be used both to track performance and to award compensation.

Prevalence of Measures Used for Corporate Employees

Financial KPIs	Nonfinancial KPIs
Earnings Per Share (29%)	Customer Satisfaction (8%)
EBIT/EBITDA (19%)	Service/Quality (6%)
Net Income (16%)	Strategic Goals (6%)
Cash Flow (16%)	Safety (3%)
Operating Income (15%)	Employee Satisfaction (2%)
Economic Value Added (8%)	

Confidential survey (2005). Sample includes 343 industrial and service companies.

Considerations in Developing KPIs

- Sensitivity: How sensitive is the measure to performance?
- Precision. How much measurement error is embedded?
- Verifiability: Can measure be audited or verified?
- Objectivity: Is measure objective (# of safety incidents) or subjective (level of employee commitment)?
- Dimension: Would measure be interpreted differently if expressed differently (#, %, survey scale, yes/no, etc.)?
- Interpretation: What attribute is measured (i.e., does product failure rate measure quality of manufacturing or design)?

How Are Boards Doing?

- There is a surprising disconnect between the metrics that are important drivers of firm performance and the KPIs companies actually use to track results.
  - >90% of directors believe nonfinancial KPIs are critical.
  - <50% get good information on nonfinancial KPIs.
- There does not appear to be a good reason.
  - 59% say that the company has “undeveloped tools for analyzing such measures.”

If true, this is a serious lapse in oversight by boards.

Deloitte (2004, 2007). Sample includes 250 directors and executives at large international corporations.

Risk and Risk Tolerance

- Risk represents the likelihood and severity of loss from unexpected or uncontrollable outcomes.
- Risk cannot be separated from the corporate strategy. They are intimately related.
- Each company must decide its risk tolerance. This decision should involve the active participation of the board.
- The risks that the firm is willing to accept should be managed in the context of the strategy.
- The risks that the firm is unwilling to accept should be hedged or transferred to a third party (insurance, derivatives, etc.).

Risks to the Business Model

- The risks facing an organization are comprehensive and touch all aspects of its activities (operations, finance, reputation and intangibles, legal and regulatory, etc.)
- The business model provides a rigorous framework for identifying risks.
- By stress testing key linkages and assumptions, the board and management can determine what might go wrong and the consequences of the problem.
- Management can then develop very detailed risk management analyses around each key issue.

Risk Management

- Risk management is the process by which a company evaluates and reduces its risk exposure.

- COSO framework on risk management:
  1. Internal Environment: Philosophy toward risk.
  2. Objective Setting: Evaluate strategy in this context.
  3. Event Identification: Examine risks of each opportunity.
  4. Risk Assessment: Determine likelihood/severity of each.
  5. Risk Response: Identify actions to deal with each.
  6. Control Activities: Policies to support each response.
  7. Communication: Create information system to track.
  8. Monitoring: Review data from system and take action.

Committee of Sponsoring Organizations (1990).

Considerations in Risk Management

The board has four important responsibilities in this area:

1. The board determines the risk tolerance of the company, in consultation with management, shareholders, stakeholders.

2. The board evaluates the company’s strategy and business model in the context of the firm’s risk tolerance.

3. The board ensures the company is committed to operating at an appropriate risk level. It relies on risk KPIs to help make this assessment.

4. The board should satisfy itself that management has developed necessary internal controls and that procedures remain effective.

How are Boards Doing?

- Survey data suggests that boards could stand to improve.
  - Most companies do not integrate risk management and strategy.
  - Instead, it is treated as an isolated function (internal audit, risk management function, etc.).
  - 58% of companies consider risk when making decisions.
  - 84% of financial officers rate their risk management as "immature" or "moderately immature."
  - 44% of senior executives believe that their business managers have "effective risk expertise."
- Risk management might be delegated to the audit or risk committee, but it is likely best handled by the full board.

The Conference Board(2007); AICPA (2010); The Economist (2009)

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