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The Early Warning Summit: A Practical Application of Governance

Vigilance can be a subjective word, as in the responsibility of directors to monitor a company's financial progress. Or, some directors are more vigilant than others. However, a board of directors can protect itself from surprises, whether in earnings announcements or CEO misbehaviour by implementing a series of early warning signals and regularly convening an Early Warning Summit. This author, who has helped companies put theory into practice, has valuable advice.

By Douglas J. Enns

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While corporate governance has improved since Sarbanes-Oxley we still must ask if directors have really kept pace and if the tools that directors work with serve them well.

Directors' responsibilities are onerous. Few of them receive thanks when corporations perform well; on the other hand, when organizations fail, the impact on directors' reputations and personal finances can be catastrophic.

Concerns about directors' liability are one of the main reasons that new governance initiatives have been so easily adopted. But new governance requirements have meant increasing costs of compliance. This in turn has drawn fire from a growing number of executives.

The costs and complexities of governance are now so high that perhaps the balance has tipped too far, says Dominic D'Allessandro, CEO of Manulife Financial. He simply put into words what many directors have felt for some time. South of the border, the U.S. Chamber of Commerce has launched an all-out attack on the escalating costs of governance and compliance.

So where does that leave directors? When all is said and done, an abatement of governance requirements will do nothing to lessen investor expectations. Directors will need to develop new tools if they are to continue to meet stakeholder expectations.

An Early Warning Summit is one such tool that allows directors to take charge. The Summit is a structured meeting through which directors and officers can brainstorm and decide whether there are early warning signals that should be heeded. This article discusses the Early Warning Summit.

Why a Summit?

The purpose of the Summit is to build an inventory of early warning signals that can be used to:

- ensure effective performance,
- spot signals that may indicate difficulties that lie ahead,
- avoid difficulty, and
- ensure capital continues to be effectively employed.

The mega-failures of the early 2000s led to cries of "Where were the directors?" With the benefit of 20/20 hindsight, it has been easy for authors and

analysts to point to any number of failed companies and claim that the signals were there. But it's not that simple: catching concerns in real time poses huge challenges.

Each phase of the failure process carries distinct, observable conditions that provide possible early warning signals of issues that may lie ahead. By identifying an inventory of early warning signals, directors and officers stand a better chance of determining if slippage is occurring, and that in turn will help to reduce the probability of failure.

In a world that changes quickly, it's difficult to understand how directors and officers can afford any level of protection unless they are forewarned of potential pitfalls. The lead time to formulate the correct response to emerging issues, and the window of opportunity to effect solutions, is now so short that unless responses are ready to be implemented when the issue hits, the battle can be lost before it even begins.

An Early Warning Summit is a meeting or series of meetings reserved to focus solely on the identification and discussion of early warning signals. Often facilitated by external professionals, the Early Warning Summit offers a safe haven for board members to meet in camera and with senior executives to discuss emerging issues in a frank and open manner. More importantly, a Summit builds place markers in the minds of directors that can be referred to in their decision making as the organization moves forward.

Why hold one? After all, don't most organizations have control systems in place already? Does the investment in Enterprise Wide Risk Management, governance and compliance systems count for nothing?

The answer is, of course, that they do count, but it is rare for directors to be asked to consider the outputs provided by all control systems at a single point in time. It's even rarer that they would think of them as early warning signals.

A leading insurer was interviewed to determine if the outputs of all control systems were ever reviewed concurrently. The answer was no. When asked what early warning signals were provided by the control systems, he replied that he had "never really thought about it that way. We haven't looked for early warning signals."

Control systems don't track everything. Changes in executive behaviour, marginal changes in competitors and changes in the political landscape with no immediate consequences are examples of issues that may have drastic, longer-term consequences. Any and all of these signals can be overlooked. Often, these may be the most important early warning signals of all.

The process of business failure

Air carriers were in trouble long before 9/11. The arrival of discount carriers on the outside and the emergence of an entitlement mentality on the inside were soon reflected on the bottom line. When the dust cleared, the value proposition had been destroyed-air seats became commodities and the hub-and-spoke business model was in shambles. The next stop was the government handout wicket, and after that, bankruptcy protection. Eventually, even the most successful traditional carriers faltered. Why, and what started the process?

An almost imperceptible change in the competitive dynamic, such as the entry of a new competitor or new products, can wreak havoc if not taken seriously enough. A subtle change within the organization itself, such as the emergence of dysfunction, is hard to spot and can build to disastrous longer-term consequences.

It is in these marginal changes that danger signals lurk. Had Tyco's board been more aware of changes in the expenditure patterns of the CEO, shareholders might have been spared a great deal of grief. Had

banking software suppliers not discounted the threat posed by India's upstart Infosys, more of them might be alive today. As it is, Infosys is now the darling of the New York Stock Exchange.

Changes in the competitive or human dynamic begin to register their impact on an organization. A company may soon fail to generate an economic profit/cash flow. Although the company may still be profitable, it may not be profitable enough to adequately reward shareholders. For start-ups, the expenditure burn rate may have indicated the company would run out of cash. For not-for-profits, the organization was not delivering on its mandate. Regardless of the type of organization, concerns should begin to mount when stakeholders first experience a loss.

Declining performance can be easy to rationalize, but left unchecked, it can indicate that the organization's value proposition and/or its business model is becoming ineffective. A major reorganization or perhaps reorientation may be needed to salvage the situation.

Unless arrested, the company may face insolvency, with a financial reorganization likely to follow.

Examining other organizations can be instructive. By understanding how the failure process may have affected another company, board and management gain an understanding of how the failure process might play out in their own organization.

Early warning signals for directors
In the early stages ....

Here are some early warning signals that might crop up in the early stages of failure:

- a reduction in entry barriers, as a result of re-regulation, is a welcome mat for new competition,
- new products, processes and techniques allow competitors to differentiate and gain cost advantage,
- key customer segments begin to experience difficulty, leading to extensions of the sales cycle, inventory buildups and the need for more favourable terms to move product, and
- changes such as these, coupled with declining margins, slowness to break-even on new products and increased concerns on the part of sales and service personnel provide clues that dangers may lay ahead.

Early warning signals began to ring in a North American services provider when it failed to respond to its dissatisfied customers and to new pricing competition. The company had just gone public, and so was exposed to coverage by the likes of CNN and Goldman Sachs. It became convinced by its own media coverage that it had built a company assured of repeatable success. Momentum carried stock prices to new heights, even though sales languished. In the post mortem, it was clear that an Early Warning Summit would have disclosed that the direction of key performance indicators and the value of the stock were headed in different directions. Success had been illusory.

Directors should be particularly alert if management remains unconcerned about the arrival of new competitors or the organization continues to be convinced that its products can't be eclipsed by the competition. Markets and customers are never static.

As hard as it may be to notice and then face up to subtle changes on the competitive front, it may be even more difficult to notice subtle changes occurring within the organization itself. Some examples of warnings that might raise director interest are:

- Management can become convinced that past successes are repeatable and that the organization can coast, no longer needing to apply the same energies and rigour that made for success in the first place.

- Overconfidence and complacency can set in, and crucial disciplines will begin to break down. Companies in which management got carried away with themselves have caused no end of grief to stockholders.
- The growth in perception of managerial excesses is usually inversely related to the returns paid to shareholders.
- When companies become fixated on meeting analysts' expectations, concerns should begin to mount, particularly when management remuneration is tied to the short-term performance of the stock.
- In dysfunctional companies, major decisions may not receive the appropriate level of due diligence.
- The lack of appetite to question the status quo may signal a lack of resolve to continue the fight for constant improvement.
- Past successes that take on legendary status may typecast the organization, draining needed creativity to face new and emerging challenges.

The net effect is likely to be missed production deadlines and new products that fail on introduction, and even these may be discounted as unimportant developments.

Internal conflicts can affect the functioning of the company as rigid silos begin to emerge. Rigidity affects communication, and can soon have an impact on service quality and new product launches.

Slippage of any ethical standard is an almost certain indicator that trouble lies ahead. Blasé attitudes to quality assurance checks, tardy reporting to regulators and the emergence of an overly dominant member of the executive team can all signal unsavoury behavior. Discord in the boardroom, breakdown of accountability and a need to either push or restrain the CEO are certain indicators that leadership is breaking down.

The stakes increase: Financial early warning signals

A U.S. supplier of banking services began to notice that the VP of Finance and the CFO were devoting more and more time to analysts on the phone, and more and more time to wordsmithing the earnings guidance. With two years of missed sales targets and a sales cycle increasing from 18 to 24 months, it was apparent future prospects were dimming. The VP of Finance knew it, the CFO knew it, but they could not dissuade the CEO from setting tougher stretch objectives. An Early Warning Summit with the board and executive team in attendance would have picked up on the need to change strategies.

Changing competitive circumstances and growing dysfunction within the organization can eventually cause cash flows and earnings to become variable and diminish. The company may remain profitable, but perhaps not profitable enough to adequately reward shareholders for the risk they are taking.

Missed sales targets and escalating costs serve as early warning signals that parts of the company may be underperforming. Although temporary lapses in performance are unavoidable, these can easily extend, reducing free cash flows to the point where dividends and ongoing capital expenditures cannot be met without relying on external financing or asset sales. Eventually, the company's capital formation may become more reliant on general stock market performance than earnings.

During periods when corporate earnings become variable, it is important that the audit committee remain vigilant. Cash flow, earnings and net debt transactions must all remain reconcilable. A push for more liberal accounting treatments and a narrowing of the focus of reporting to the board may signal that management is concerned about the near-term performance of the company.

It is important to remember that accounting practices are based on assumptions that can be interpreted in different ways. Revenue can be

reported more aggressively by recognizing it earlier; acquisitions can be pursued to even revenue flows, and practices changed (e.g., rigging incentives) to stuff channels and restructure contracts. Expenses can be deferred. Inventory costing methods can change. Asset values can be manipulated by one-time write-offs. Liabilities can be confused by asset securitization, short-changing the pension plan and relying on preference shares when credit sources are uncertain.

Although issues in accounting may arise when times toughen, the more serious issue that directors need concern themselves with includes assessing whether the pressures on earnings are indicative of longer-term shifts. Earnings volatility is most often associated with cyclical changes. It may be much more serious than that. There may be basic fundamental shifts that are occurring, capable of transforming entire industries.

Major customers may be undergoing significant change in their own right; it may be that new competitors are beginning to dominate or that the company is simply no longer configured efficiently enough to remain competitive.

Reorganization or reorientation lurks

Failing companies may become accustomed to a constant state of missing targets, underperformance on the financial front and a growing level of discontent within the organization. The ability to rationalize is almost limitless. There does come a time when the organization must recognize that matters are reaching a head and that some significant steps need to be taken if the company is to be kept from failing outright. Significant and sometimes painful reorganization may be needed, retrenchment may be considered and perhaps even a reorientation of the entire company.

Here are some additional warning signals to consider:

- Warning signs will be present on the sales front. Successive sales forecasts may have been missed.
- Key products that require substantial margins to remain viable are competing against commodities.
- Inventory turnover rates are by now much lower than industry average, and inventory writedowns are now required, at the same time that increasingly favourable sales and financing terms are now on offer.
- A struggle to retain customer satisfaction is evidenced by loss of repeat business, and a loss of key customers in succession.
- Customer satisfaction surveys are revealing disquieting trends regarding the issues of trust and brand.
- Management is simply at a loss to deal with the growth in complaints, as it has now become difficult to pinpoint specific areas that are responsible and that are prepared to accept responsibility.

Within the organization there may be other noticeable changes. Turf wars between sales and production, a bunker or victim mentality, dysfunctional silos and the resignation of key personnel may signal a growing level of pressure within the organization as it wrestles with stresses of growing evidence of failure.

The organization's financial structure is now under severe pressure. Generating net incomes and positive cash flow is becoming increasingly challenging. A growing reliance on debt may be driving bankers to increase the strength of their covenants while bond rating agencies struggle with revising their ratings. Management may be having a difficult time supporting planning proposals based on known cash flows, and will be keenly interested in what analysts are saying about the stock. Chat room activity will also be increasing, and becoming increasingly negative. Investment bankers will be advising against going to market because they view the current market cap to be unsupportable.

Management is now giving increased attention to seeking mergers and other cure-all solutions.

The last gasp

The cumulative impact of the failure process, if it is not arrested, will be chronic insolvency. Although some companies do recover, it's hard to argue that they've succeeded. The cost to shareholders and creditors, opportunities denied and the impact on organizational culture take a severe toll.

A role for directors

Directors play an important role by being proactive.

Failing organizations may emit early warning signals different from the examples provided. Nevertheless, it's important for directors to understand that failure is a process that can start without notice. Directors and officers must ensure that applicable early warning signals are drawn out and discussed.

Early warning signals can come from every part of the organization-from control systems, to management reports to accounting systems to organizational research. Taken together with observations the board can make about changing behaviours and the way in which management responds to changes in the competitive dynamic, board and management can build an effective inventory of early warning signals to guide decisions.

The key is to bring all information together through an Early Warning Summit, where energies and thinking can be focused. Hopefully, early warning signals such as those presented here will serve as a good starting point. I