corporate governance / by Graham Kenny

Strategic Liability

The corporate blowtorch that has for so long been trained on employees, with massive redundancies, and customers, with depleted services, has now been pointed at senior management – with a vengeance. But this time it's different. It's not just "management" that's being labelled "crooked" and "incompetent" but, specifically, CEOs, boards, individual directors and chairs of boards.

With names like Enron, WorldCom, HIH and One.Tel ringing in their ears, is it any wonder that shareholders and the general public are wondering: Are there any competent CEOs out there? Are all boards and directors either crooked or asleep?

Mindful of the load media scrutiny is now placing on boards and CEOs of small and large businesses alike, we're reluctant to add to it. But add to it we must because shareholders have a right to demand better from boards and CEOs when it comes to strategic planning. Why better? Most current levels are not meeting best practice standards and are significantly short-changing shareholders.

This leaves CEOs, boards, individual directors and board chairs open to further claims of incompetence and knowing underperformance.

This article reviews the current state of practice in strategic planning and explores the risks directors face in this vital area of management and director responsibility. It is based primarily on our Australian experience but applies equally to New Zealand.

What if?

What if a board failed to ensure that:
1. An organisation had a strategic plan, or
2. The strategic plan was an effective one, or
3. The strategic plan was implemented, or
4. The strategic plan was modified in the light of changed circumstances?

As an organisation's strategic plan is the central instrument for achieving competitiveness, financial success and shareholder returns, would any of the above conditions constitute grounds for action by shareholders of companies, members of associations, and so on? (I refer to "shareholders" throughout this article, but I include these other groups as well.)

The answer is "yes". A board has at least the responsibility to ensure that an organisation's strategic plan is formulated by following best practice procedures, that its content is in line with best practice and its implementation is reviewed and continually monitored.As evidence of a board's responsibility consider the 1992 Australian case of Rogers CJ ruling in the *AWA Ltd v. Daniels & Ors* (trading as Deloitte Haskins & Sells). He ruled that the board's function was fourfold:

- set the goals of the company
- appoint the company's chief executive
- oversee the plans of managers for the acquisition and organisation of financial and human resources towards attainment of the company's goals
- review at reasonable intervals the company's progress towards attaining its goals.

Australia's *Duties and Responsibilities of Directors and Officers* (17th edition), concludes that "the duties of a director of a company on a day-to-day basis are now very wide-ranging and daunting" (p83) and that "the areas of law giving rise to personal liability continue to grow" (p145).

Creating competitive strategy

Failure to have a strategic plan (point 1) leaves an organisation open to attack by competitors, with consequent loss of revenue, market share, profit and shareholder value. Equally, for a board to allow management to operate an organisation with an out-of-date plan could not be seen to advance shareholder interests. Both conditions would render a board liable to claims of negligence.

Here we focus on the less obviously damning point 2 – failure to ensure that the strategic plan's contents are effective. It is essential to follow best practice when creating and writing competitive strategy. Without effective competitive strategy, a strategic plan cannot be successful, and every organisation needs a strategic plan to compete for resources.

Our evidence regarding current practice in the area of strategic planning comes in two forms. Firstly, our 15-year dealings with organisations in the private, public and not-for-profit sectors. Secondly, the research we have conducted on the extent to which organisations achieve their competitive potential.

Managers repeatedly mistake activity for strategy. They leap from their views about industry direction to what individuals or department heads are going to do within their organisations.

The organisation that hasn't developed any competitive strategy leaves itself open to competitive attack. This inevitably

leads to the erosion of shareholder value.

We recently studied 16 organisations with between 20 and 4500 employees, they ranged across a span of industries. We asked them to rate the extent to which their strategies were really competitive strategies – rather than descriptions of internal activity. Their answers varied from a high of 80 percent to a low of five percent, with a median value of 40 percent.

On average therefore, 60 percent of the strategies that purported to advance their organisations competitively actually had no chance of doing so. It is our view it could be construed as deceptive or negligent if a CEO and a board let such material be passed off as advancing shareholder interests, particularly since it could be avoided by following best practice.

What if a board fails to ensure that an organisation's strategic plan was implemented (point 3)?

Many strategic plans, once completed and approved by their boards, simply gather dust until the next round of the strategic planning process begins. Boards then concentrate on monthly financial results, and fail to review progress against the strategic plans. In such organisations, managers and boards effectively deceive their shareholders. We believe boards which do not put mechanisms in place to monitor the strategic plan's implementation are culpable. The Rogers' ruling places emphasis on overseeing the plans and reviewing at reasonable intervals an organisation's progress towards attaining its goals.

On the other hand many organisations start with good intentions to implement their strategic plans, but only accomplish a percentage of them. Our research showed that, on average, only half of the strategies management contracted to implement were carried out.

So, could this level of achievement be construed as deceptive and negligent? If by following best practice, management could achieve a far better result, where does this leave a board in terms of liability?

Competitive potential

Let me introduce a new concept here – competitive potential. If we multiply the 40 percent of strategies that have any hope of producing a competitive edge by the 50 percent of those implemented we obtain 20 percent. This is the average extent to which our organisational sample reached its competitive potential. The percentage would increase if an organisation wrote "true" competitive strategies. The overall result would also be higher if the 50 percent were higher. This can only occur if management and board focus their attention on effective implementation.

Should management and a board settle for achieving 20 percent of an organisation's competitive potential when the figure could be raised significantly by following best practice.

Auditors' liability

With recent events auditors too have come under scrutiny. Did you know that it is now routine for auditors to review an organisation's strategic plan and its implementation processes? The purpose is to assess strategic risk – part of assessing the broader concept of business risk.

Auditors address questions such as:

- Do we (the auditor) understand their strategies?
- Do the strategies support one another and link together?
- Do we understand how the client goes about formulating its strategies?
- Are we able to evaluate the effectiveness of client strategies?

But what if an auditor did not employ a best practice model in answering these and similar questions? Wouldn't its responses be flawed? Wouldn't it be liable to a board and shareholders if, consequently, its assessment of strategic and business risk were deficient? The answer to questions two and three is yes.

The organisations we researched should never have passed on strategic risk yet all of them did. The best competitive potential level was only 40 percent.

Our experience says these results are typical. A host of organisations should be failing on strategic – and hence business – risk. Unfortunately many consultants also fail to deliver best practice strategic planning advice.

Conclusion

There are two key points to this story. Firstly, a strategic plan is the fundamental driver of every organisation's competitiveness, financial success and, ultimately, shareholder interests. Without effective strategic planning, organisations fail.

Second, best practice lies at the heart of effective corporate governance.

Much current practice fails the best practice test, which leaves directors legally liable for underachieving on financial results and shareholder value. M

Graham Kenny is managing director of Australian-based Strategic Factors, which specialises in developing and implementing strategic plans. Email: gkenny@strategicfactors.com