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Red flags on the horizon

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Business failure has been one of the most discussed topics on the corporate landscape for the past five years. With the deflation of the “internet bubble” in 2000 and the scandals engulfing Enron, WorldCom and others, reducing the downside from uncertainty has become more important to CEOs and boards than ever before.

What can leaders and their advisers do to avoid such mishaps? 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 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 internal workings of organisations. Yet what is more important to a company’s survival?

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 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 senior group or board can possibly control them 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 in many of the big 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 controversial. Not only are 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 today do not have effective models or hands-on tools to assess their vulnerability to major breakdowns. To do so requires direct attention to what our research has identified to be the major drivers of long-term success and failure: the leadership, strategy and organisational processes at the heart of the business.

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A further complication is that organisational problems of this nature are not often 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 for business failure – the key factors that differentiate high-performing companies that stay successful from those that are successful for a while and later falter. 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 battalion 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 time-sensitive, critical information on the barriers that prevent them from fully executing their vision and strategy.

There are three pillars at the heart of the system:

- **SMART Leadership** Do you have the right knowledge, attitudes and behaviours among your executives and directors? Do you possess the best team, board structure and processes to optimise debate and engage in rigorous analysis? Do you have the depth of talent to ensure future succession needs?
- **SMART Strategy** Have you examined the underlying assumptions on which your strategy is based and are they still accurate in the light of recent technological innovations or competitive pressures? Are key stakeholders aligned with the strategy or are there “blockers” present?
- **SMART Process** Is there a clear organisational structure and process in place? Does information from the far reaches of the organisation get to the board or management team in a reasonably unfiltered fashion so that action can be taken in a timely manner? Do your culture and employee commitment support the implementation of the strategy?

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 in failing organisations are:

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- 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 leader
- The degree of energy directed toward learning new management practices and competitive moves alike

These 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 accounting fiasco, it did describe “an attitude of arrogance”, “an absence of teamwork” and “a culture that discouraged dissenting views”. You can’t get much farther away from the ideal than that! Coupled with some of the other key warning 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 difference between success and failure boils down to strategic alignment and analysis of underlying strategic assumptions. Take the latter. How often do senior leaders, 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 outdated, outmoded or just plain wrong.

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 that result from these 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 way to 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 – its leadership, strategy and processes. Based on years of research, I can offer a different type of diagnostic tool specifically designed to identify an organisation’s vulnerability to breakdowns. The SMART Early-Warning System is all about uncovering the red flags that are not instantly visible.

The logic behind an early-warning system is compelling. It is a form of insurance. Without regularly monitoring the signals that come from an early warning system, companies are actually increasing their vulnerabilities, something that no senior executive group or board of directors should let happen on their watch

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