20 Questions

Directors Should Ask about Crisis Management

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Chartered Accountants of Canada

How to use this publication

Each "20 Questions" briefing is designed to be a concise, easy to-read introduction to an issue of importance to directors. The question format reflects the oversight role of directors which includes asking management – and themselves – tough questions.

This document is intended to serve three purposes:

- To show how good governance practices can reduce the risk of crises,
- To help directors identify the early warning signals of potential crises, and
- To guide directors in their responses to crises.

The questions are designed to encourage directors to speak frankly among themselves about their organization's situation, the performance of management and concerns expressed by individual directors. Boards may choose to discuss the questions in in-camera sessions or assign specific issues to committees to consider (also in camera) and to report back. The board may use standing committees (audit, governance, risk, etc) or appoint a special committee. Individual directors may find this publication useful in clarifying, validating and expressing their concerns to the board.

The comments that accompany the questions provide directors with a basis for critically assessing the answers they get and digging deeper as necessary. Each answer summarizes current thinking on the issues and, where appropriate, suggests "Recommended practices". These are not intended to be comprehensive checklists, but rather a way to provide insight and stimulate discussion on important topics. Although the questions apply to most medium to large organizations, the answers will vary according to the size, complexity, sector of the economy and domestic or global presence of each individual organization

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INSTITUTE OF CORPORATE DIRECTORS

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Preface

The Risk Management and Governance Board (RMGB) of the Canadian Institute of Chartered Accountants has developed this briefing to help members of boards prepare for and handle crises. It is intended primarily for directors and boards of publicly-listed companies but, as good practice, will be of value to other organizations.

This document was originally published as "Crisis Management for Directors" in 2001 — just after the attacks on the World Trade Center on September 11, 2001 and shortly before the collapses of Enron and other major corporations. This updated version reflects the lessons from these and other events which represent extreme examples of crises for organizations and the people who are affected by what happens to them.

This briefing provides suggested questions for boards to ask themselves, senior management and others. For each question there is a brief explanatory background and some suggestions. We hope that directors and CEOs will find it useful in assessing their approach to crisis management.

The RMGB acknowledges and thanks the members of the Directors Advisory Group for their invaluable advice; Doug Enns and Hugh Lindsay, who wrote this briefing under their guidance; and the CICA staff who provided support to the project.

Tom Peddie, FCA
Chair, Risk Management and Governance Board

How could it have happened?

Catastrophic events — such as 9/11, Hurricane Katrina, the collapses of Enron, Worldcom and other major corporations, and the 2007 "liquidity crunch" in capital markets — illustrate situations in which organizations ignored or overlooked the potential for crisis and were poorly prepared to respond to crises.

Crises have many sources, some of which are common to all organizations. Others are specific to certain industries. For directors, it may be helpful to consider them as fitting into one of three groups, based on their severity, frequency and timing. These can be described as Operational Incidents, Sudden Crises and Potential Crises. All three have the potential to inflict damage to the organization's property and, often more significantly, to its reputation.

Operational incidents are the day-to-day, minor crises of running the organization and serving individual customers. With good management these can be avoided or promptly resolved.

Directors are not normally involved in operational incidents unless they are symptoms of problems in executive performance or strategic planning.

"A company's corporate governance regime is often viciously tested in extraordinary circumstances and in times of crisis. So the likelihood of an extraordinary circumstance and a crisis should be assumed, in my view, when structuring, assessing and realigning one's corporate governance regime.

If that is done properly, not only should shareholders and other investors be confident that the company will weather the extraordinary circumstance or crisis, but that such events will most likely be avoided, or at least, the consequences from them will be minimized."

Lawrence E. Ritchie
Vice Chair
Ontario Securities Commission

Do we have a crisis?

Recognizing that there is a crisis is often the most difficult aspect of crisis management. One approach is to apply a "litmus test." The following questions are from *Crisis Management: Planning for the Inevitable* by Steven Fink.

1. Is there a good chance that this situation will, if left unattended, escalate in intensity?
2. Might the situation foster unwanted attention by outsiders, such as the news media or some regulatory agency?
3. Is it likely that the situation might interfere with normal business operations in some manner?
4. Could it make you look bad or cause people (the public at large, or investors) to lose confidence?
5. How is it going to affect your bottom line?

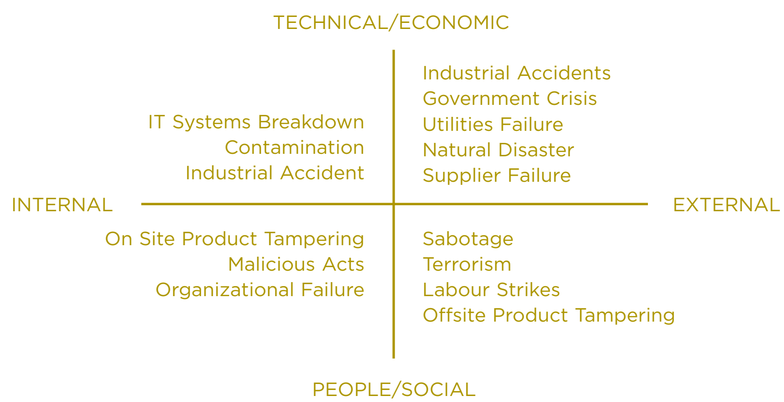
This test can apply to any kind of crisis.

Sudden crises are events that occur unexpectedly and have a major effect on the organization. These include natural disasters, sabotage and outages of vital services such as power, water or computers. They may also result when operational incidents are mismanaged or when a neglected potential crisis becomes a real crisis.

The CEO should have plans for business continuity in times of sudden crises and test the plans through realistic scenario-based simulations.

Sudden Crises

Examples of different types of crisis



Potential crises are serious problems that grow larger over time and become critical if they are not addressed. In some cases there are clear signals that the organization is experiencing problems: persistently declining sales, profits and share prices, failure to respond to new competition, investigations by regulators, and financial difficulties. In others, particularly when the organization is successful and growing fast, the problems may be overlooked, ignored or brushed aside. Potential crises may weaken an organization to the point that it cannot cope with a sudden crisis. Operational incidents may be symptoms and warning signals of potential crises.

Although sudden crises make the headlines, they only represent 34% percent of all crises, according to the Institute of Crisis Management. The rest typically occur when a neglected problem flares up—in most cases as the result of a combination of several factors. The neglect of potential crises has become an increasingly severe problem as the world moves faster, time lines are shorter, expectations are higher and business processes become more complex and interdependent.

This briefing describes how directors can become more aware of the potential for crisis and how they can contribute to crisis management. There are four sections of questions and suggestions on the elements that contribute to successful crisis management:

- Responding to Sudden Crises
- Detecting Early Warning Signals
- Responding to the Early Warning Signals of Potential Crises
- Conclusion and Learning From Experience

Ranking crises

Some organizations have a ranking system for operational incidents and sudden crises that determines who is responsible for declaring and handling the crisis, and identifies the organizational level or individuals that should receive reports on the crisis. One approach is to assign categories to crises e.g. levels 1, 2 and 3. The board receives reports on the most serious (level 1) crises.

Ranking systems encourage effective responses to crises at the lowest appropriate corporate level and limit the volume of reporting to senior management and the Board. It is essential, however, to train employees in crisis management and response so that they will interpret and apply the guidelines effectively.

Responding to Sudden Crises

Sudden crises call for prompt, decisive action, effective communication and teamwork between the CEO and board. They also call for leadership, discipline, calmness, and judgement based on sound principles. Directors should ensure that the organization has a commonly understood approach to crisis management and plans for business continuity. Board members need to know what to look for and make sure it happens. Anything less can make the crisis worse.

Being prepared for a crisis involves more than the capacity to manage the crisis itself, it means having the resources and resilience to continue operations. Organizations that have survived crises were best able to recover if they:

- Had a well-tested Business Continuity Plan
- Had a leader who could rise to the occasion and take prompt, decisive action to deal with the immediate crisis
- Communicated promptly and frankly with employees, customers, suppliers, other important stakeholders and the news media
- Demonstrated practical compassion for the injured, frightened and bereaved
- Were prepared for the mundane and predictable problems of business continuity: alternative computer and communication systems, off-site back up of vital records, contact information and more
- Had the financial and other resources to absorb the effects of the crisis and return to normal—strong balance sheets, positive cash flow and good cost control.

> A crisis need not turn out disastrously. Organizations that respond well and are prepared often bounce back and gain from the experience.

A Business Continuity Plan typically calls for the CEO and management team to respond in three areas:

Crisis response

- Take immediate action to protect lives, property and the environment
- Find out what's going on and identify what the organization knows and doesn't know
- Appoint a core team trained to manage the crisis and free team members from their regular responsibilities
- Promptly notify the company's insurance company and legal counsel of potential claims
- Make sure that day-to-day operations continue as far as possible

Communications

- Designate a single individual to handle crisis-related communications and communicate frankly to stakeholders and the news media
- Demonstrate commitment to communities directly affected by the crisis by sending in the appropriate corporate representative
- Communicate directly and frequently to the company's stakeholders including employees, customers, suppliers, shareholders and regulators—both during the crisis and subsequently
- Appoint a devil's advocate function to provide a reality check on the organization's response to the crisis—this could include outside experts such as public relations consultants and lawyers
- Give the board regular briefings

Business resumption

- Implement or develop a plan to resume normal operations.
- Continue to communicate with the company's stakeholders as the plan unfolds

Crisis response

Effective crisis response happens when:

- There's a written plan that describes what to do in a crisis
- Employees are trained in the use of the plan
- The plan is always available and accessible in print and electronic format
- The plan is regularly tested under realistic conditions
- Employees are empowered to act on their own initiative in times of crisis

Questions 1 through 6 are ones that the board should consider asking in the event of a sudden crisis.

1. How should the board and its members respond to this sudden crisis?

In times of crisis, the job of board members is to make sure the CEO responds promptly, decisively and effectively.

This often means staying calm and letting the CEO and management team manage the crisis. But letting the CEO manage does not mean that the board ignores the crisis. Directors must find out what's going on and satisfy themselves that the CEO has things under control. If not, it is their duty to make sure that the crisis is properly addressed.

Directors should be concerned about:

- Making the crisis worse by jumping to conclusions and overreacting
- Balancing the board's need-to-know and oversight responsibilities with management's responsibility for dealing promptly with many urgent issues
- Talking to the media or anyone else about the crisis—unless they have been designated and briefed to do so
- Letting the board polarize into a disunited group

> We are not able to recognize these decisive moments and we often do not have the time or information we need to make sound choices. We must often make decisions in the heat of battle. It is helpful to think about crises as a continuum, a process or an unfolding pattern of decisive moments. These moments are always connected, but we find it difficult to fully appreciate many of these connections.
>
> **Learning About Risk**

The CEO—or a designate—should contact the board as soon as possible to inform directors of the situation and management's initial response and plans.

The chair of the board, working with the CEO, should convene a meeting or conference call for the CEO and board to review and agree how the crisis will be managed, and to establish an initial process and schedule for reporting and monitoring.

Recommended practices

- Stay calm
- Get the facts
- Assess the situation and management's response
- Take appropriate action
- Assess the board's capacity to respond to the crisis
- Consider the need for independent advice
- Monitor the situation

2. How well is the CEO responding to this sudden crisis?

The CEO and management team have the primary responsibility for responding to sudden crises and implementing the Business Continuity Plan.

CEOs have a tough job and are expected to cope with an amazing range of challenges. Even very competent and experienced CEOs can face situations they've never met before. The best CEOs are not afraid to ask the board for advice and guidance. Others may need the help but are reluctant to ask for it. The board should monitor the CEO's handling of the crisis and offer help if necessary.

Directors should be concerned about:

- The absence of a business continuity plan
- The plan failing to work
- Underestimating the scope or severity of the problem
- Management not reacting decisively and effectively
- Management's inclination to provide 'spin'
- A CEO who is out of his or her depth
- A CEO who is defensive or not communicating with the board
- A CEO who is unable or unwilling to seek guidance and advice

After assessing the CEO's response to the crisis, the directors can select the appropriate level of board involvement. This might include one or more of the following options:

- Let the CEO handle the crisis, reporting to the board only if the situation gets worse
- Let the CEO handle the crisis and provide regular progress reports
- Designate one or more specific directors who have the relevant experience and expertise to coach and work with the CEO on managing the crisis
- Bring in an outside expert to coach and work with the CEO on managing the crisis
- Appoint someone other than the CEO to manage the crisis

If the crisis is severe, the board may decide to appoint the best qualified and available director to coordinate the board's crisis-related activities and consider establishing a crisis committee of the board. The issue of replacing the CEO is discussed in question 6.

Recommended practices

- Ensure the CEO responds to the crisis, implements the business continuity plan and advises the board
- Assess the CEO's response and determine appropriate level of board involvement

3. What ongoing information does the board need to have about the crisis?

The board may need a process to monitor, on an ongoing basis, the response by the CEO and management team to the crisis.

Directors should be concerned about:

- Getting too little information from management
- Demanding too much information from management
- Information that is vague or misleading
- Information that contradicts other information received from management or from external sources
- Receiving information that is dated, after the fact, or has already been made public

Signs that your board and CEO are handling a crisis well:

- You get all the information you wish
- You fully understand the information and explanations you are given
- You get explanations that correspond with your own knowledge and common sense
- You are encouraged to ask questions, and to raise and pursue issues
- You are encouraged to offer informed advice and opinions
- You support the crisis plan and are seeing positive action and results

Depending on the circumstances, the CEO may be asked to provide the board with:

- Reports at regularly scheduled board meetings
- Reports on an as-needed basis
- Frequent information-only briefings by voice mail, e-mail, fax, etc
- Frequent briefings by conference phone call that allow for questions and comments
- Briefings at specially-called board or crisis committee meetings

The board or its crisis committee should be prepared to meet without the CEO after briefings to discuss progress and assess the effectiveness of the management of the crisis.

Board members should also consider external sources of information that reflect the public perception such as news media stories, internet websites, blogs and comments from people they meet. These sources can provide valuable feedback to the CEO, and help shape and steer the organization's response.

The board should constantly assess the effectiveness of the monitoring process and be prepared to modify it as necessary.

Recommended practices

- The board and CEO select an ongoing crisis reporting process appropriate to the situation
- Modify it as experience suggests

4. What should the organization communicate to its stakeholders and the public about the crisis?

The organization's communications during a crisis are critical to its success in maintaining its credibility, reputation and ability to resume normal operations.

Directors should be concerned about:

- Making the crisis worse by denying or covering up problems
- Risking damage to the company's reputation, credibility and market valuation by failing to acknowledge the problem and take steps to mitigate it
- Management being defensive when a crisis is the result of negligence, incompetence or a lack of foresight
- Failing to make required disclosures to investors and regulators
- Failing to communicate in a timely manner
- Inconsistent corporate communications

Management is responsible for communications. Employees, customers and suppliers need to know what is going on, how it affects them and what they can do. The news media, the investment community, the public, politicians and regulators expect timely, frank, useful information.

Securities regulators require disclosure of events that affect a company's financial health. This includes immediate disclosure of major crises through press releases that are filed with the securities regulator. The company may be required to file a material change report and include a discussion of the financial implications in the next Management's Discussion and Analysis (MD&A) report.

See *20 Questions Directors Should Ask about Management's Discussion and Analysis*

Acting fast to protect your reputation

It may be better to err on the side of accepting liability than to risk the loss of reputation.

When a contractor ruptured one of its pipelines in Burnaby, BC in 2007, Kinder Morgan, without acknowledging liability, promptly repaired the line and cleaned up the neighbourhood. The story, and criticism of the company, quickly disappeared from the news.

The Board has overall responsibility for oversight of corporate communications.

Recommended practices

- Monitor crisis-related communications
- Act in a way that best protects the company's reputation
- Maintain a list of communications advisors to call on in times of crisis

5. What specific tasks should the board undertake as part of managing the crisis?

In some case the board has a direct role in responding to a sudden crisis. This may include approval of emergency financing or other rescue missions.

Directors should be concerned about the capacity of individual board members to devote considerably more time to the organization's activities in a time of crisis. This particularly affects non-executive chairs or designated lead directors who may find they have to devote most of their time to the organization during the crisis.

One or more of the board's committees will usually be equipped and available to work with management on crisis-related activities and/or transactions. The board may need to appoint a special committee.

The board may also bring in trusted outside advisors who have the necessary expertise and knowledge of the organization to provide independent counsel to the directors on what to do and what questions to ask.

Recommended practices

- Direct one or more committees to oversee crisis-related transactions
- Ensure that management maintains an active list of advisors
- Agree to devote significant additional time to crisis-related transactions

6. Is it appropriate to replace the CEO?

Directors may be faced with the question "Is this CEO the right person for the job?" Good governance requires a strong, experienced CEO in whom the board has confidence. If the directors have reservations about the CEO's performance and ability to avoid or handle crises, the board should act decisively to resolve the problem, preferably before a crisis hits.

Before acting, consider the overall board/CEO relationship, which may involve one of the following:

- The board has confidence in an experienced CEO
- The board has confidence in a less experienced CEO who seeks and accepts advice, guidance and training
- The board has little or no confidence in a CEO, and does not expect a change for the better
- The board has confidence in a CEO who is temporarily in a conflict of interest—as when a potential solution to a company's problems is a management buyout

You should be concerned if your CEO:

- Has no crisis plan
- Fails to inform the board about crises
- Doesn't consult or take advice from the board
- Fails to respond quickly and effectively to crises
- Fails to learn from crises

See *20 Questions Directors Should Ask about CEO Succession*

Sometimes replacing the CEO is the only solution — but only sometimes. It is generally necessary if the CEO is involved in fraud. However, if the problem is one of poor performance in handling a crisis, it is usually much better to keep the CEO. A crisis is a bad time to make a change. If coaching and helping the CEO through a crisis isn't enough, the board may:

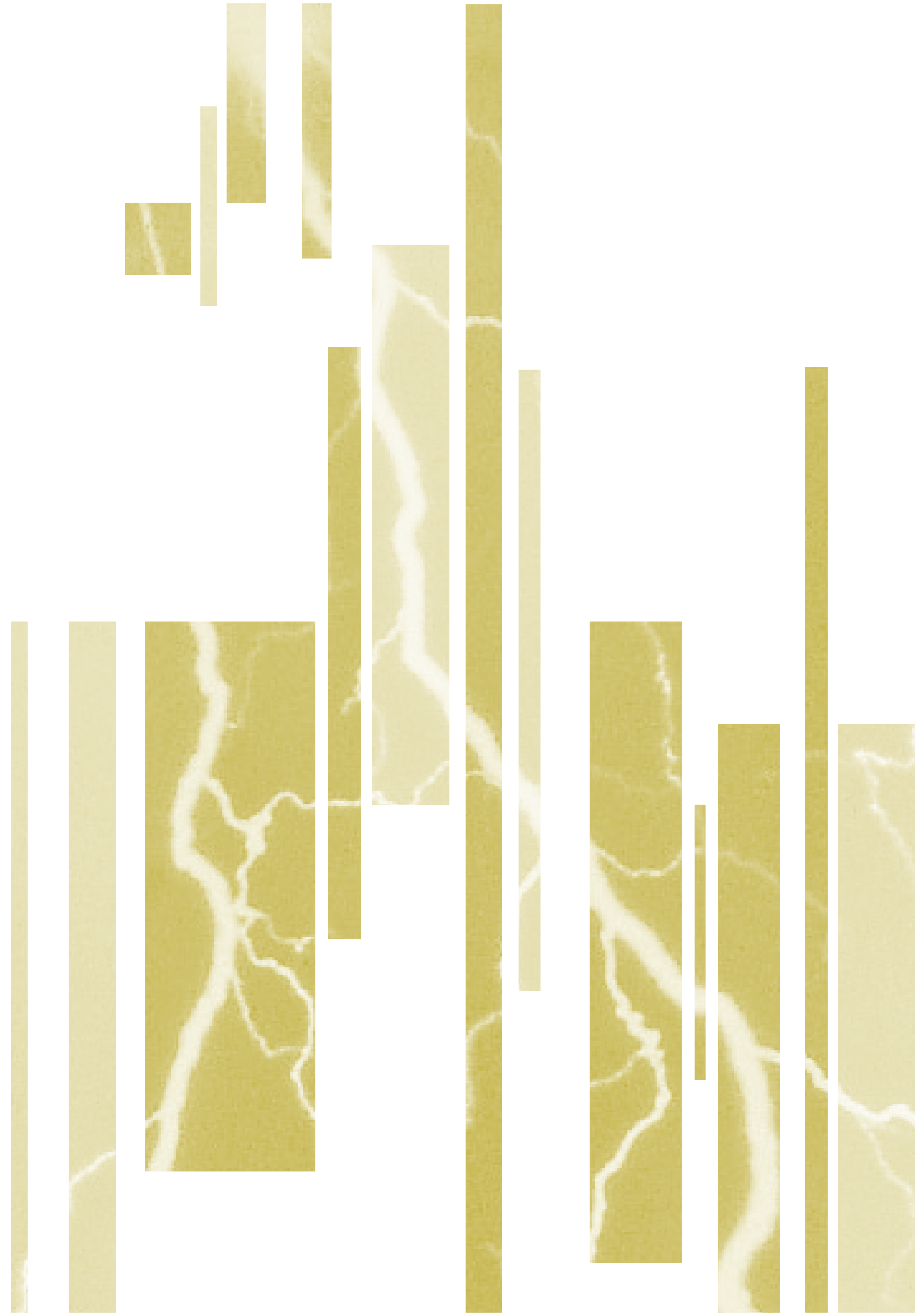
- Use another executive or a director to lead the crisis management team
- Send the CEO on a leave of absence
- Accelerate the CEO succession plan

Boards should try to defer assessing the competency of the CEO until the worst of the crisis is over. They do not need the extra stress of firing and hiring on top of everything else. If the board needs to replace the CEO in a crisis, it should appoint the best-qualified person possible, and be prepared to look outside the organization if there is no strong inside candidate who knows the business and its people and can get up to speed quickly.

When the CEO is temporarily in a conflict of interest, the board must step in, ask the CEO to step aside in the areas where the conflict is operative and appoint another person to act until the conflict has been resolved.

Recommended practices

- Take steps to help and advise the CEO — replace the CEO only if other approaches fail
- Appoint a temporary replacement for a CEO who is in a conflict of interest
- Have an executive succession plan that can be implemented at short notice



Some crises are avoidable, provided that management and the board are alert to early warning signals. Early warning signals exist in all organizations. Finding those that are significant enough to warrant action can be challenging. By understanding the process which might lead to the failure of the business, boards and management can examine their organization to determine if there are early warning signals that warrant that action be taken.

An early warning signal is one that alerts interested parties to issues that may be of concern in the near to mid future. There are a sufficient number of indicators provided by organizations and the environment in which they operate. Separating meaningful signals from background noise can prove to be a challenge. It is the responsibility of management to identify, assess and respond appropriately to early warning signals and to inform the board.

The board should pay close attention to reports from management and be alert to the possibility that management may not have identified or responded appropriately to the early warning signals. The board may also feel it necessary to turn to external advisors to assist in identifying and understanding key early warning signals.

Questions 7 through 13 include examples of early warning signals that management should monitor and report on to the board. They are the equivalent of "what directors should be concerned about". Questions 14 through 17 discuss how the board can use its own governance processes to identify early warning signals and assess the potential effectiveness of the board and management in the event of a crisis.

7. What are our competitors telling us?

The management teams of successful organizations monitor new products and strategies from existing competitors and the arrival of new competitors. They assess the significance of these developments, develop responses and report to the board. The process may include the use of commercial services that track new competitive developments such as product announcements, initial public offerings, strategic alliances, patents etc. that can help improve understanding of the competitive environment.

Early warning signals may include:

- New competitors
- New business models (discount investment brokers, airlines, etc.)
- New manufacturing and distribution processes and infrastructure (e.g., e-commerce)
- New products that offer innovation, better functionality or greater simplicity
- More competitive cost structures
- The commoditization of products (e.g. discount airlines, house and no-name brands, internet banks)

8. What are our customers telling us?

Most companies depend on repeat business from their key customers but cannot take their loyalty for granted. Variations in customer buying patterns and behaviour are important warning signals that require careful analysis to determine if they reflect fundamental changes in customer needs and preferences rather than short-term market or economic factors. When key customer segments experience deep-seated change, the applicability of the current business model and value proposition may need to be re-assessed.

Talking to the customers

Inviting major customers to meet the board — or arranging director visits to customers' premises — can provide valuable insights into key relationships and customer concerns.

Early warning signals may include:

- Declining sales to long-term customers
- Lengthening sales cycles
- Inventory buildups
- Cancelled orders
- Increased product returns
- An increasing need to extend generous sales terms (low-interest financing, deep discounts, generous return policies, etc.)
- Consumer resistance to paying for extra functionality, innovation or additional service
- Customer failure (overdue accounts, etc.)
- Lack of new customers
- Declining customer satisfaction
- Decreased customer retention

9. What are our employees telling us?

A loyal, stable, experienced workforce can contribute significantly to the success of an organization by being productive, delivering high quality products and services and costing less for recruitment, training and supervision. The emergence of dysfunction within an organization is difficult to detect. Subtle changes in behavior within an organization may indicate a change in values, and impact the organization's ability to remain effective.

Monitoring techniques can include a combination of statistical and other information, staff satisfaction surveys and whistle-blower policies.

Early warning signals may include:

- High turnover rates
- Grievances (in union shops)
- Absenteeism
- Declining satisfaction
- High accident rates
- Missed deadlines
- Product quality problems
- Customer complaints
- Ethical lapses
- Unusual patterns of insider trading

Organizations with good information and an open, trusting culture that encourages two-way communication are in a better position to detect and respond to problems.

10. What are our investors and lenders telling us?

Lenders, bond rating services, financial analysts and investors conduct analyses of the operating affairs and prospects of organizations of interest to them. Each in their own way evaluates the financial prospects, strategies, management capacities and competitive relevance of the company.

Because of the early warning signals they provide, it makes sense to track commentary from each of these sources, which include:

- Commentary and ratings by analysts
- Bond rating services
- Articles in the business news media
- Proxy voting by institutional investors (pension and mutual funds, etc.)
- Shareholder proposals
- Publications by investor organizations

Make your enemy your advisor

A leading company, concerned by fierce criticism from an apparently hostile analyst, invited the analyst to address the board. The session provided valuable insights that the company was able to use to improve its strategy, operations and communications.

The MD&A, Annual Information Form, press releases, financial reporting and proxy circulars can also provide further insight as to how management views and is dealing with commentary arising from investors and lenders.

Early warning signals may include:

- Underperforming stock price relative to that of competitors. Undervaluation may indicate concerns with management and strategy.
- Stock shorting — which may indicate the existence of information about the company's affairs which is highly unfavorable but unknown to the general body of shareholders.
- Lower bond ratings, credit downgrades and more onerous banking covenants.
- Withheld votes on director elections.
- Rationalizations or dismissive reactions by management to external ratings and analyses.

11. What are our regulators telling us?

Regulatory agencies are concerned about the condition and prospects of organizations that fall under their jurisdiction. These agencies include those that regulate specific industries (insurance, banking, investment, etc.) and those that regulate issues such as health, safety and the environment. Organizations that receive inspection and other reports from regulators can gain valuable insights and early warning signals.

Regulatory reports can provide independent, objective insights into an organization's financial stability, earnings and capital adequacy. The reports can also include the regulators' assessments in such areas as the valuation of the company, the effectiveness of management and the company's capacity to remain liquid, solvent and appropriately financed.

Non-financial information on such issues as environment, health and safety can also alert companies to potential crises. Deficiencies and violations can be early warnings of conditions that, if not resolved, could lead to major events involving expensive clean-ups, litigation or penalties.

Companies that conduct in-depth assessments of regulatory reporting will derive useful warning signals. Good relationships and communications with regulators provide opportunities for identifying and resolving issues before they become problems. They can also provide the basis for good working relationships in the event of a crisis. Additional insight can be gained by having responses to all regulatory reports and inquiries included in information provided to the board.

12. What is our financial reporting telling us?

Financial accounting reports provide significant information on the status and prospects of an organization. Any time assets or revenues are overstated, or liabilities and expenses are understated, the potential for future difficulties exists. By noting the way in which assets are acquired, costs are capitalized, revenue is gathered and liabilities are recognized, boards of directors can gain additional insight into the operating affairs of the company and management's viewpoints on them.

Working with the CFO, internal and external auditors and other advisors, the audit committee is in a position to identify accounting practices and information that can provide early warnings of potential crises.

Early warning signals may include:

- Accounting for operating affairs in ways that are substantially different from its industry counterparts—making comparison difficult.
- Aggressive revenue recognition may indicate underlying earnings weaknesses or losses in various parts of the organization.
- The recognition of revenue around acquisitions may indicate a growing reliance on acquiring new companies in the face of declining revenue patterns from the company's traditional operations.
- Impairment reserves and write-offs on disposals of assets may indicate previous misjudgment in making those investments.
- Increasing debt, the emergence of unfunded liabilities, cash flow that is not compatible with debt levels or earnings, or an inappropriate level of investment in infrastructure may indicate an underlying weakness in the business model or an inadequate capital structure.
- Complex financing or corporate structures.
- Dividend and other distribution levels that are incompatible with earnings.

13. What is going on in the world that could affect us?

Trends and events in the social and economic environments have the potential to affect organizations. The information is not neatly packaged but scattered through the news media and the publications of economists, academics, think tanks and others. Management is responsible for identifying and considering these factors when preparing, implementing and reviewing strategic plans and risk management programs. The board can enhance the work of management by encouraging individual directors to contribute their own knowledge and experience.

See *20 Questions Directors Should Ask about Strategy*

Areas to monitor for early warning signals include:

- Demographic trends
- Consumer and industry publications
- Political and regulatory developments
- Economic trends and fundamentals
- Capital markets
- Environmental regulation
- New accounting standards
- Globalization of trade patterns
- Technological change and development
- General changes in the business climate
- Changing social values
- Emergence of special interest groups
- Social activism against industries, companies and products
- Cycles
- Changes in educational policy
- Cultural considerations
- Fads
- New capital formation

The board should expect management to be aware of current developments beyond the organization's immediate business environment and to consider them when developing and reviewing strategy.

Warnings of the sub-prime mortgage crisis in the U.S.

News media stories and economic reports provided early warning signals of elements of the credit crunch of 2007. These included:

- A rising level of debt and a negative savings rate in the United States
- US consumers "using their houses as ATMs" to finance consumption
- "NINJA loans" — no income, no job and no assets
- "Liar loans" — credit applications, submitted by mortgage brokers, that overstated the income of the borrowers
- Banks selling asset-backed paper to hedge funds and financing the sales — effectively buying back the risk.

The news media (both formal and informal) can be a particularly valuable source of information on public and political perceptions of the company, its products and its industry. A thorough, dispassionate analysis of media coverage provides a strong basis for initiatives to correct misconceptions or to fix the underlying problems. These work best when the company has developed credibility with politicians and journalists through media and government relations programs.

14. How do our governance processes contribute to identifying early warning signals?

Although there are never any guarantees of success, companies are in a better position to avoid or mitigate potential crises and recover from sudden crises when they have good management and governance processes and follow them competently and ethically.

Directors should be concerned about:

- Establishing a practice of giving automatic approval to management proposals
- Accepting, without question, management reassurance on apparent early warning signals
- Failing to establish and reinforce an appropriate tone from the top

The power of intuition

Your best warning of a crisis may be your experienced-based intuition — the little voice that wakes you up in the middle of the night to warn you that something's wrong. Intuition alone isn't enough to cry "crisis," but it's valuable if it gets your attention and prompts you to ask questions.

The following governance processes, which support the development and implementation of successful strategies, also include features that can provide early warning signals of potential crises. Weaknesses in any of these areas can contribute to crises.[1]

- Strategic planning
- Risk management
- Approval of mergers and acquisitions and other major transactions
- Performance monitoring
- Financial and other disclosures
- Code of Conduct
- Business continuity planning
- Succession planning
- Executive performance review
- Governance assessment
- Oversight of corporate communications

Management is responsible for identifying and assessing the early warning signals of potential crises and reporting to the board on the action they have taken or propose to take. It does this by:

- Anticipating potential crises in its strategic planning, risk management and other processes.
- Establishing processes for monitoring performance, the condition of the organization and the environment in which it operates, and identifying events, patterns and trends that could be early warning signals of potential crises.

The board's oversight responsibilities include confirming that management has established processes, follows them and reports regularly to the board.

Recommended practices

- Ensure management includes consideration of early warning signals in material and presentations related to governance processes
- Ensure board members are independent-minded and resist automatic acceptance or approval of materials presented to them by management
- Request further information on apparent early warning signals identified in the course of governance processes

[1] Most of these processes are discussed in detail in other documents in CICA's 20 Questions series, each of which addresses an area requiring board oversight: Strategy, Risk Management, Codes of Conduct, Building and Assessing Boards, etc.

15. How effective would the board be in the event of a potential or sudden crisis?

Boards and the chair should encourage open discussion and recognize that dissent is not only likely, but a positive attribute of sound governance. Boards and committees that complete rigorous assessments of their own performance and experience provide themselves with an opportunity to recognize early warnings of deficiencies in the boardroom and to take steps to improve.

Directors should be concerned about:
- The board's independence, competence, skills and previous exposure to crises
- The quality of board meetings and decision-making
- The leadership skills of the Chair
- The capacity of the board to devote additional time and resources to governance in the event of a crisis

To be prepared for crises, the board should consider taking the time to confirm that it and the individual directors would have the resources and inclination to act if needed. The resources may include independent advisors and special committees of directors. This could be done as part of the governance assessment process. It is important that upon the completion of the assessment, a follow up plan is put in place for the next year, and that any adjustments are made quickly.

The ability to mobilize leadership and resources to resolve problems identified by early warning signals is essential to protecting stakeholder interests. The board must ensure all necessary actions required to protect the interests of the organization are taken. In so doing, the board must recognize the implications of advising or not advising stakeholders, the impact on board-management relations, and the board's legal responsibilities to meet statutory disclosure requirements.

Recommended practices

- Promote open discussion and questioning to result in good decisions
- Make use of in-camera sessions to address directors' concerns
- Have an effective process for assessing board performance and those of committees and individual directors

16. How effective would the CEO and management team be in the event of a potential or sudden crisis?

A strong management team is vital to the continued success of an organization and its capacity to prevent and survive crises. If crisis strikes, the board must know who is capable of managing the crisis or the company and who could play the CEO's role in his or her absence.

Experienced CEOs generally understand business risks and know how to identify and respond to the early warning signals of potential crises. The CEO's own behaviour and actions however, may represent a threat of potential crises for the company.

> A potential crisis for the board can be said to occur when management fails to identify or respond appropriately to a situation or event that could seriously affect the future of the organization.

Directors should be concerned about:
- A CEO whose strengths, carried to extremes, become weaknesses, for example when confidence becomes arrogance or ambition turns into greed
- A CEO whose past successes lead to complacency
- A CEO who interprets his or her position as a license to do anything
- The CEO not having a plan in place for executive succession or substitution in the event of a sudden crisis
- The CEO not involving members of the senior management team in presentations to the board
- The CEO answering questions asked of other members of management
- A CEO who restricts the directors' access to executives without a sound reason

Board and committee meetings provide opportunities for directors to observe the CEO and other members of the senior management team in action and to test their performance by asking probing and challenging questions. The way in which executives respond is one of the most important indicators directors consider when determining the level of trust they place in management. The board must remain alert to any changes in management behavior that may signal the emergence of potential problems.

> Experienced directors do not confine their observation of executives to board meetings and other formal occasions. Dinners, golf and social events also provide opportunities to get to know the CEO.

If the directors have reservations about the CEO's performance and ability to avoid or handle crises, the board should act decisively to resolve the problem, before a crisis hits.

The board should be prepared to consider concerns raised by directors at any time. If concerns are considered to be serious they can be communicated to the CEO or referred to the an appropriate committee or a special committee for investigation and recommendation.

Recommended practices

- Have an effective process for evaluating the performance of the CEO
- Ensure the CEO is frank and forthright in his or her relationship with the board and its committees
- Maintain a succession plan for business continuity and for crisis situations
- Recieve corporate information and early warning signals from a variety of sources
- Have reasonable access to members of the management team between board meetings
- Provide opportunities for directors to express their concerns about the CEO's performance and behaviour
- Investigate and take appropriate action on concerns raised by directors

17. What are the plans for business continuity in the event of a crisis?

Major crises are severe tests of an organization's resilience — its capacity to keep going while it works to restore normal operations. There can be significant costs involved in managing a crisis, such as replacing lost or damaged facilities and recruiting and training new employees. There may also be a significant interruption of cash flows from sales and other revenue-generating activities. A critical aspect of a good business continuity plan is ensuring that the organization has adequate capital, cash, credit and insurance to survive the effects of the crisis.

Testing business continuity plans

Testing methods include:

- Orientation/walk-through sessions of discussion and training to build familiarity with the plan
- Tabletop/mini drills in which participants apply the plan to a specific event scenario
- Functional testing that mobilizes people in several sites to test communications and coordination
- Full-scale testing of all or part of the BCP that uses actual as opposed to simulated notifications, mobilization of resources and communication of decisions.

Source: Federal Financial Institutions Examination Council: BCP IT Examination Handbook.

Directors should be concerned about:

- Plans that are not kept up to date and have become obsolete
- Deferral of the maintenance and testing of business continuity plans because other activities seem more urgent
- Testing that is not done well and thoroughly. There can be a serious risk that, when a crisis occurs, the people and other resources are not able to react and respond effectively
- The board not being included in the testing of the business continuity plan

The board, as part of its responsibility for risk management, should schedule regular briefings at board or committee meetings. The board should seek assurance from the CEO, chief risk officer, internal auditor and other expert sources that the organization has a comprehensive and up-to-date business continuity plan that has been communicated to employees and others on whom the organization's success depends. If the board requires testing of plans — including the role of directors in a crisis — testing is more likely to happen.

Recommended practices

- Ensure the organization has a comprehensive and up-to-date business continuity plan
- Ensure the BCP is communicated to employees and other key individuals and organizations
- Ensure the BCP is regularly tested
- Ensure the BCP includes the role of directors in the event of a sudden crisis

Recognizing that a number of early warning signals represent a potential crisis that requires a coordinated response is the job of management—and it's incredibly difficult. There is so much going on and so much information. Forensic experts with the advantage of hindsight can spend months piecing together what went wrong. Management is faced with the daily challenge of collecting and interpreting data without knowing what will be relevant. Finding patterns and recognizing potential crises in apparently unrelated messages is a complex challenge. In most cases, potential crises develop from a combination of several problems.

The board should expect management to identify early warning signals and, where appropriate, to present their analysis and proposals to the board. There is a fine balance for the board between demonstrating trust in management to manage, and asking probing questions to clarify the situation and management's proposed actions. If, in the opinion of the board, management fails to respond, or responds inappropriately, the board must be prepared to investigate more deeply and become more closely involved if necessary.

If one or more individual directors are concerned that neither management nor the board is responding to early warning signals appropriately, the directors must consider their duty to the organization and act accordingly.

18. How effective are management and the board in identifying early warning signals?

The processes and early warning signals described in questions 7 through 17 can identify problems but may do so in a piecemeal fashion. A competent management team working with a strong board can provide a powerful combination of checks and balances that can support an effective response and avoid or mitigate a potential crisis.

Directors should be concerned about:

- A lack of board process for assessing management's identification and response to early warning signals
- Insufficient time for board assessment of early warning signals
- The board's inability to get management to respond to early warning signals
- Inadequate board resources for intervening in potential crises

From a board perspective, there are two basic groups of early warning signals:

- Those that management recognizes in the material it brings to the board for information or approval. The board's role is oversight and endorsement of management's actions.
- Those that management fails to identify or mishandles. The board may need to get more actively involved.

Early warning summits

Early warning summits are facilitated sessions during which the Board and management can periodically assess the organization by bringing together numerous observations gathered from control systems, discussions with parties internal and external to the organization and any number of research findings, all at a single point in time.

If the summit identifies significant problems, the organization is in a good position to take corrective action. At the least, the Board and officers will have created an inventory of early warning signals that can guide the decision making process over the next period.

Source: "The Early Warning Summit: A Practical Application of Governance" by Douglas J. Enns. Ivey Business Journal, November/ December 2005

The board can play a valuable role in the identification and response to potential crises. Because it is not involved in day-to-day management it has the potential to see the organization from a more detached and objective perspective. In addition to reports from management there are a number of steps a board can take to determine if there are difficulties that lie ahead, for example:

- The board reserves time on its agenda or at the strategic planning session
- The board schedules regular opportunities for unstructured sessions without management at which directors can raise, brainstorm and discuss matters that concern them

The specific approach is not as important as ensuring that adequate time is provided to conduct a complete assessment of important early warning signals. It is important that the board have the opportunity for some independent reflection.

In most situations the board will be satisfied that management is responding appropriately to early warning signals — which may include asking the board to assist in formulating solutions. If this is not the case, the board must be prepared to use its powers and resources to intervene and even impose solutions. This is not pleasant for the directors who face the prospect of confrontation with the CEO and management team and may need to devote additional (and probably uncompensated) time to resolving the problems.

Recommended practices

- Ensure a formal process for assessing and responding to early warning signals
- Ensure the organization supports co-operative problem solving and resolution
- Ensure management promptly informs the board of potential crises and its plans to address them
- Schedule time for reviewing and discussing early warning signals

19. What should directors do if they believe that the board and management are ignoring warning signals?

One of the toughest, loneliest situations for a director is to be the only person to be convinced that management and the board are ignoring or overlooking warning signals. It is hard to know what to do and frustrating when no one seems willing to acknowledge the concern.

Directors should be concerned about:

- The consequences to the organization of ignoring early warning signals
- The personal liability of directors when the organization mishandles potential crises

"The biggest risks for the board are denial and complacency."

Directors Advisory Group comment

A director will typically need to consider a progression of steps:

- Ask questions of management in board meetings
- Express concern in in-camera sessions if management's responses seem evasive, vague or otherwise unsatisfactory
- Speak privately to the chair of the board if the board's response in the in-camera sessions is inconclusive or otherwise unsatisfactory
- Speak to other members of the board in the absence of the chair if the chair seems unwilling to take the concerns seriously
- Resign from the board if the concern is unresolved

The parking lot moment

Two directors are walking together to the parking lot after a board meeting. One asks the other "Did you understand what the CEO was saying about the new strategy?"

"Not really," says the second director, "I'm not convinced it's a good idea. But the board seemed keen to go with it."

"It's not the first time I've felt like this," replies the first, "Perhaps we should do something."

Has this happened to you?

What would you do?

Directors should seek legal counsel as soon as it is apparent to them that the early warnings are serious and that the board is unlikely to act. They should ask to have their remarks recorded in the minutes of meetings at which they raised concerns. They should also keep records of events, meetings, correspondence and other evidence of the early warnings and their actions.

A particularly difficult decision is that of communicating concerns beyond the organization and its board. It is seldom advisable for directors to speak publicly about their concerns or their reasons for resigning from the board. If they believe that they should do so, it is essential that they obtain legal advice in advance.

Recommended practices

- Raise and pursue concerns if the board and management do not appear to be doing so
- Carefully consider what to disclose about concerns beyond the board.
- Be prepared for a difficult time that might end with member resignation from the board
- Be aware that resignation does not eliminate liability
- Obtain legal advice if directors are unable to resolve their concerns through the board process

Conclusion and Learning from Experience

Crisis management is most effective in organizations that have — and use — good governance processes. The boards and managements of such organizations recognize that achieving success includes avoiding potential crises by identifying and responding to early warning signals. When sudden crises occur, they decisively implement business continuity plans that they have developed and tested. Boards and management work together in a climate of openness and mutual trust, and they learn from their experience.

20. How does the board learn from experience?

Once a crisis is under control, it's tempting to move on and return to normal. A well-written crisis plan will include the requirement for management and the board to review and reflect on how the crisis was managed.

How well did the board perform?

The Governance Committee or a subcommittee of the Board can be directed to study the board's response to a crisis after the fact and present to the board their findings and recommendations for changes to processes and systems.

Post-crisis reviews should be prepared quickly — before memories fade. It is better to record 90% of the lessons quickly than to wait too long for perfection.

A review will be most valuable if it leads to an action plan that the board implements and follows up.

Points to consider in a post-crisis review are:

- Did the board stay calm, get accurate information and assess the situation?
- Was the board's involvement timely and appropriate?
- Did the board recognize and reconcile dissenting views expressed by directors
- Did the board stay on top of the situation?
- Was the board helpful to the CEO?
- Did management conduct a thorough post-crisis review and report on it to the board?
- Did the crisis reveal any weaknesses in strategic planning and risk management processes?
- How might the directors apply what they learned to improve the way the board functions and relates to the CEO?
- How can the board turn this crisis into an opportunity?

Sometimes it takes a crisis to shake the board and executives out of complacency and get action on issues that have been ignored for too long. Companies that survive crises and learn from them can emerge stronger with more efficient products and organizations, and improved reputations.

Where to Find More Information

Canadian Institute of Chartered Accountants publications

The 20 Questions Series

20 Questions Directors Should Ask about Building a Board

20 Questions Directors Should Ask about Codes of Conduct

20 Questions Directors Should Ask about Crisis Management

20 Questions Directors Should Ask about Crown Corporation Governance

20 Questions Directors Should Ask about Director Compensation

20 Questions Directors Should Ask about Directors' and Officers' Liability Indemnification and Insurance

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Understanding Disclosure Controls and Procedures: Helping CEOs and CFOs Respond to the Need for Better Disclosure

Other CICA Publications on Governance, Strategy and Risk

Learning about Risk: Choices, Connections and Competencies

Guidance for Directors: Dealing with Risk in the Boardroom, April 2000

Sabia, Maureen and Goodfellow, James L.,Integrity in the Spotlight: Audit Committees in a High Risk World, 2nd edition, 2005

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More information available at www.rmgb.ca

Notes

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