

# SOX Rocks, but Won't Block Shocks

by Paul Kocourek, Jim Newfrock, and Reggie Van Lee

**H**ere's a fact that bucks conventional wisdom: More shareholder value has been wiped out in the past five years as a result of mismanagement and bad execution of strategy than was lost through all the recent compliance scandals combined. This is a key finding of a recent Booz Allen Hamilton survey and analysis of the performance of 1,200 firms with market capitalizations of more than \$1 billion for the five-year period from 1999 through 2003.

Consider the 360 worst financial laggards. Eighty-seven percent of the value lost by these firms was attributable to strategic missteps — management ineffectiveness in reacting to competitive pressures or in forecasting customer demand — and operational blunders, such as cost overruns and M&A integration problems. Only 13 percent of the value destruction suffered by these companies was caused by regulatory compliance failures or resulted from poor oversight of company operations by corporate boards.

Still, the media went for the headlines on compliance debacles. And the Sarbanes-Oxley Act (SOX) — a legislative attempt to rein in rogue corporate activities through stringent new rules for governance, data integrity, and disclosure — was passed to help U.S. businesses move on from the Enron saga. Obviously, compliance is vital, and the Sarbanes-Oxley legislation can help.

But it will do little to improve most firms' real risk profile.

Despite its reputation as a panacea for raising the bar on business governance, SOX is essentially a quality-control mechanism piggybacking on financial reporting systems. It does little to protect the primary strategic and operational elements that, according to our survey, are the primary cause of shareholder value destruction. Because of this, the impact of SOX on management reforms intended to improve corporate performance has been disappointing: To insulate their boards and senior executives from extensive scrutiny, firms have ended up sacrificing growth and innovation for regulatory acquiescence.

In reacting to Sarbanes-Oxley with an exaggerated fear of risk exposure, many companies are tempted to reduce risk management to an expensive "box-checking exercise" in regulatory compliance. However, companies need to do much more: They must be proactive in addressing risk by understanding and anticipating the full range of threats to their businesses. And they must embed risk management in strategic planning. These two processes are interdependent: Only when companies develop a risk management program that protects *and* enhances shareholder value can they eliminate unwanted earnings surprises and foster growth.

Recognizing that companies have to deal with SOX and manage for growth, executives must design a more robust and integrated strategic

planning process built on a broad understanding of all risks to the business. Board directors and senior managers need to look beyond traditional risks — typically, capital credit and physical security — and anticipate earnings-driver risks and cultural risks, too. The specifics of such an ambitious risk management agenda will vary from company to company, but we have identified five components of an effective program:

- **Define what constitutes “risk” and develop early-sensing mechanisms.** Most companies need to expand their definition of risk beyond market, legal, and natural

met with weak capabilities. This risk agenda can be used to align the actions of various company stakeholders, such as the risk committee, office of the chairman, and business or functional management.

- **Build and adapt the risk management architecture.** This architecture must reflect the risk agenda and encompass corporate processes, organization, information tools, and culture. For example, a company that depends on a nimble, decentralized organization to succeed in its markets should consider having a risk management architecture that manages activities and accounta-

## Companies need to expand their definition of risk beyond market, legal, and natural hazards.

hazards. They need to consider threats that could have a long-term influence on company performance, such as customer churn, price pressure, and brand impairment. They also need to address weaknesses in organizational behavior, and the management and cultural factors that influence it, such as misaligned incentives, unethical conduct, and communications breakdowns. Companies also need to institutionalize sensing mechanisms to anticipate emerging risks. An earnings-driver risk assessment, for example, identifies and sets priorities around key demand and supply-side risks.

- **Determine the risk agenda.** After defining, identifying, and ordering risks, management needs to assess how capable the organization is of mitigating the most serious risks. Companies can establish an effective risk agenda by determining where high-priority risks are

bility in a decentralized fashion, but is also supported by diligent central monitoring of results.

- **Integrate risk management with strategic planning.** Companies must incorporate their risk management capabilities — such as better business intelligence and scenario planning — in the strategic process. Fundamentally, the same capabilities that mitigate risk enable a company to capture growth opportunities. For example, when a company identifies a competitor that is posing a specific threat to its strategic position, the tools that will help the company defend itself and enhance revenues and earnings are better market-sensing capabilities, improved product development, and more sophisticated strategic planning activities.

- **Adapt the agenda and architecture to changes in the risk environment.** Any broad risk manage-

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ment system must be flexible. For example, if shifts in customer demand require a change in the company's product mix, a good risk management system will anticipate the change and trigger a reassessment of the capabilities required to manage in the new environment that is implied by the new product mix.

Executing this program requires a shift from a "culture of compliance" to a "culture of confidence." That is, it requires a cultural transition, from an exclusive focus on controls to an atmosphere in which managers can confidently choose, on the basis of robust analysis and

strong corporate values, which strategic risks to take, which to mitigate, and which to avoid. By taking a diagnostic approach, companies not only avoid negative earnings surprises, but also save significant sums by targeting their investment on the central gaps in their strategic risk management capabilities.

Companies that are successful in establishing an effective risk management program are more likely to protect directors and officers against charges of lack of good faith, build stakeholder trust, capture opportunities, and improve corporate performance and shareholder value over the long run. +

countries. These episodes, which were generally caused by a sudden loss of confidence in local economies, led to severe economic downturns as each country attempted extraordinary measures — most importantly, sharp interest-rate hikes — to shore up the value of domestic currencies as the value of dollar reserves dwindled.

When the gross domestic products of the affected countries began to bounce back, their governments took steps to protect themselves from future economic crises. At the top of the list of actions was a decision to accumulate large reserves, particularly U.S. dollars. The conventional wisdom in developing countries is that substantial foreign currency holdings are a signal to nondomestic investors of the strength of the local economy and therefore its protection against a run on the national currency.

As a result, the value of reserves in many developing countries now exceeds 20 percent of GDP. In some cases, such as China, which keeps the yuan pegged to the dollar as an economic defensive measure, that value tops 30 percent. The mix of reserve holdings varies by country, but the dollar is by far the predominant currency.

Reserve holdings always come at a cost (reserves are held in short-term deposits that pay almost no interest), but the price tag will be especially high if the value of foreign currency reserves declines, which is virtually certain to be the case with the dollar, as Federal Reserve Board Chairman Alan Greenspan noted at the end of 2004.

The U.S. current account deficit is running close to \$650 billion annually, or 5.7 percent of GDP. Remarkably, this deficit has

## Are Dollar Reserves Still Safe?

by Dean Baker and Mark Weisbrot

**T**he U.S. dollar is generally thought to be an extremely safe asset to hold, which is why it has been the world's main reserve currency since World War II. Developing country governments, in particular, view plentiful dollar holdings as a hedge against economic crises that might precipitate a run on their own currencies. In some developing countries, such as China and Thailand, dollars represent as much as 60 percent of reserves.

But a strategy that was once considered a source of economic stability is becoming more and more dangerous. The dollar has fallen sharply against other major currencies in the last two years, and because of massive U.S. current account deficits, it is almost certain to fall further in the years ahead. If

that happens, the losses from dollar reserves for some developing countries may exceed 20 percent of their annual budgets.

The damage of a declining dollar could be extensive: If many developing countries were to sharply increase their exports in order to rebuild the value of their reserves, it could lead to a serious drag on world economic growth and possibly prolonged stagnation in much of the developing world. For multinational companies, this would be especially painful because the fastest-growing markets in Asia, Latin America, and Eastern Europe, which they are depending on for their growth, could be stopped cold.

The size of foreign reserves held by developing countries increased substantially after the financial crises of the 1990s, which hit Mexico, Brazil, Russia, and many Asian

continued to increase even though the dollar has already fallen substantially against the euro, the yen, and other major currencies. Already, the net indebtedness of the United States exceeds \$3 trillion. If the current account deficit remains constant as a share of GDP, it would imply that net indebtedness would reach \$10 trillion in less than a decade, approximately the current value of the entire U.S. stock market. Few, if any, economists believe that such a debt level is sustainable.

There are only three ways to make large reductions in the U.S. current account deficit:

- Accelerate rapid growth in the economies of U.S. trading partners.
- Have a severe economic downturn in the United States.
- Experience a sharp decline in the value of the dollar.

Although more rapid growth worldwide would be desirable, there is little reason to expect a major upturn in the near future, and no credible forecasters are predicting sustained high growth. But there are factors that could lead to a sharp downturn in the U.S. economy, most obviously a collapse of an overheating construction and real estate market. Still, the Federal Reserve Board and the Bush administration are not likely to accept a prolonged downturn. They would take aggressive action to provide an economic stimulus if conditions sour.

This leaves a sharp drop in the dollar as the only plausible correction mechanism for the current account deficit. In the third quarter of 2004, we calculated that a drop in the value of the dollar of approximately 22 percent would be needed to bring the U.S. current account deficit down to a sustainable level,

or approximately 3.0 percent of GDP. The longer the decline is delayed, the more dollar depreciation will be needed to reduce the current account deficit. As of December 2004, the deficit was already \$100 billion higher than the figures we used when we ran the above calculation.

A drop in the dollar of 22 percent would mean big losses for countries with large dollar holdings. For example, a country holding reserves equal to 10 percent of GDP would lose 2.2 percent of its GDP; this is more than 10 percent of the annual budgets of most devel-

oping countries. A hit this large could force a substantial economic contraction in most developing countries and could diminish the purchasing power of consumers who drive growth in these countries, and who are a new target market for multinational companies.

This simple arithmetic should demonstrate the urgent need for governments to diversify their reserve holdings away from dollars. As Alan Greenspan said in a slightly different context, anyone holding large numbers of dollars at this point “must be desirous of losing money.” +

## I Want My DTT

by Luigi Pugliese

**D**igital terrestrial television (DTT), which uses the analog infrastructure of traditional broadcast television to deliver digital programming, has the potential to bring interactive TV, multichannel capabilities, and TV-based online shopping, banking, and other services to the hundreds of millions of people who don't have access to cable or satellite systems. In the process, DTT will create an array of new business opportunities that could affect everything from home entertainment to mobile communications.

In the United States, cable and satellite dominate television programming distribution, but in many other markets — Italy, France, Spain, Russia, Brazil, China, South Africa, and Australia, to mention a few — these technologies have had limited penetration to date. Meanwhile, DTT is either already making inroads in these

countries or poised to do so, because of regulatory agency mandates that will require broadcasters to switch from analog to digital terrestrial TV by around 2010.

Because consumers can use conventional TV sets to access DTT and usually don't have to pay a subscription fee to view basic stations, adoption of DTT is generally very rapid in almost every country where it is introduced. In the United Kingdom, more than 4 million households use DTT after only two years in the market. This equals more than 50 percent of the current market penetration of cable and satellite.

Initially, DTT will have its greatest effect in the pay-TV sector, which is, thus far, controlled by cable and satellite companies. Digital terrestrial TV will let broadcasters and premium content providers offer pay-per-view programming relatively inexpensively and efficiently without having to piggyback on costly proprietary systems.

In fact, it's already happening.

In January 2005, two of the leading media companies in Italy, Mediaset SpA and Telecom Italia Media SpA, launched a pay-per-view service that lets customers watch a sporting event or a reality show for a one-time fee charged against their prepaid “smart card.” Because this simple model requires minimal billing and customer service operations,

2005, several broadcasters, including the Korean Broadcasting System, will start airing DTT programs tailored to this phone.

DTT is a far more efficient transmission protocol for mobile entertainment than cellular networks, because it is capable of delivering content to millions of individual connections at once without

DTT is a more universal delivery system than cable or satellite, it has the potential to make interactive advertising more common.

For this to happen, DTT systems would have to be developed so that consumers could interact with show hosts and other participants of shows, especially on opinion shows and news debates in which viewers are invited to respond to surveys and comment on issues. Through these interactive vehicles, DTT content providers could collect data about audience interests, and follow up with highly targeted advertising. This type of two-way sales programming could be enhanced with Web-type shopping via DTT systems so that consumers could immediately purchase products in response to these targeted ads.

The future of DTT comes down to numbers. The terrestrial open platform provides a strong enough signal to reach everyone without the need for a satellite dish or cable lines, and it can potentially offer more than 50 free digital channels, depending on a country's geography and available terrestrial frequencies. Cable and satellite are more powerful — most cable TV systems offer about 150 channels, and satellite TV delivers 500 or more channels — but they are based on proprietary platforms and monthly subscription fees.

Perhaps the more important numbers have to do with investments of time and money. It will be a lot quicker and, over time, a lot less expensive for small content providers to offer high-quality, Internet-age, in-home and mobile programming and applications on DTT than on any other medium. That may just be enough to begin the new revolution in old TV. +

## DTT will bring interactive entertainment to millions without access to satellite or cable.

Mediaset and Telecom Italia can supply shows at a relatively low price to consumers. A comparable cable/satellite offering would require a monthly subscription for basic service plus digital or some other premium service. The content provider would have to maintain complex bookkeeping and customer management systems as well as its vast TV distribution network.

Cellular operators also have something to fear from digital terrestrial TV. Using DTT platforms, media companies will be able to deliver entertainment or information on new dual-mode handsets that recognize both mobile phone and DTT technical standards. In effect, these handsets will let media companies bypass traditional mobile technology. Consequently, cellular companies, which have been counting on new entertainment and data applications to increase revenue, could find that their forecasts and business plans are flawed.

Samsung has already released a cellular phone with DTT and third-generation mobile capabilities for the Korean market. On the heels of this, beginning in the first quarter of

network interference or overload. For instance, tens of thousands of people in a football stadium could simultaneously and reliably access DTT-provided data or entertainment through a mobile device, whereas a cellular network would be too congested to handle a load even 1/1000th that size.

Rather than stubbornly relying on mobile networks as the sole content delivery technology, cellular operators should consider developing plans and partnerships to bundle DTT networks with their own mobile data networks. Under this arrangement, they would offer their usual range of content, along with that of digital terrestrial TV, choosing the most efficient distribution medium depending on the user, location, and network availability. These types of ventures undertaken by cellular companies could forestall a big, and inevitable, push by media companies to earmark the people and funding to build mobile DTT systems.

DTT's most intriguing impact could be on interactive or two-way advertising campaigns, which are still largely experimental. Because

# Correcting a Culture That Breeds Mistakes

by Robert E. Mittelstaedt Jr.

**W**hen a corporation finds itself embroiled in a major crisis and spinning out of control, hindsight usually reveals a series of events leading up to the incident. Whatever the cause — a catastrophic environmental accident, a serious product design defect, a major strategic misreading of a market, or something else — major crises don't just happen. Most are the result of multiple mistakes.

This phenomenon — a chain of events leading to a crisis — has been well documented in physical disasters. Take the accident at the Three Mile Island nuclear plant in 1979. Here a series of procedural mistakes, including judgment errors in performing routine cleaning operations made by incompetent or inattentive operators and system design engineers, led to the core meltdown that ultimately changed the fate of the entire nuclear power industry.

Chains of mistakes often cause colossal operational or strategic missteps in business. Consider the crisis that ensued in 1994 when Intel released a new microprocessor with a design defect. This mistake was followed by denials that a problem existed even after Intel had internally verified that the chip was faulty. Compounding the problem, Intel's reaction to customer complaints was perceived as condescending, unsympathetic, and bureaucratic. In the two months

before Intel authorized a replacement program for the flawed product, the company lost significant market value, and ultimately incurred a \$475 million charge for costs associated with the debacle.

Some firms (which also consistently show up on the lists of best-managed companies) are able to avoid such missteps. My research shows them sharing a belief in six precepts, which are embedded in their cultures and management systems. They:

- Create a system to detect patterns of mistakes early and trust the data.
- Communicate and seek candid advice throughout the organization and from trusted outsiders.
- Don't underestimate potential damage of mistakes.
- Consider the unthinkable.
- Protect the relationship with customers at all costs.
- Are not passive; a bad situation will never go away on its own.

Most, not surprisingly, are blue-chip successes, among them Johnson & Johnson, IBM, Dell, McDonald's, Southwest Airlines, and Toyota.

Such companies have made big mistakes, but they make fewer of them, discover them earlier, and fix them more adeptly and aggressively than other organizations.

Johnson & Johnson's reaction to the Tylenol tampering incident more than 20 years ago is still the most frequently cited example of excellent crisis management. The company's national recall was not

necessary, given the assessment that the problem was local to Chicago. But Johnson & Johnson's famous credo, with its emphasis on consumer safety, guided decision makers. In contrast, advocating for customer welfare did not appear to be a strong cultural value guiding Intel's response to its microprocessor crisis.

Many other well-known organizations have failed to appreciate the effects of multiple mistakes and paid dearly and publicly for it.

The specific high-profile mistakes were all different — accounting illegalities (Enron and Health-South), strategic market blunders (Kodak), design flaws that compromised customer safety (Ford and Firestone). But the cultural factors that so obviously influenced leaders' behavior were the same:

- **Myopia.** "We've always done everything right, and those market changes you see are not real."
- **Hubris.** "We deserve to be rewarded for being so much smarter and better than our competitors; they can't even understand what we do."
- **Egocentricity.** "We'll ask when we want employees' ideas. Do your job and don't speak up because your more experienced superiors know better."

Today, no company can afford these cultural excesses. The ability to listen, learn, take risks, and manage mistakes must be part of every manager's repertoire. Mistakes happen, but they can be caught more quickly if companies detect problems before they multiply — and then truly learn from them. +