How Risky Is Your Company?

by Robert Simons

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How Risky Is Your Company?

Success brings profits, growth, and unbounded optimism. But it also has a way of blinding executives to the many organizational dangers that creep in at the same time. How much internal risk is hiding within your company? Use the risk exposure calculator to find out.

BY ROBERT SIMONS

In good times, it's easy to forget about risk. Optimism abounds when markets are growing and revenue and profits are up. The business is hiring new people, increasing the scale of operations, and searching out new and exciting opportunities for growth. Indeed, in such boom periods, the future looks so bright – to paraphrase the pop song – you have to wear sunglasses.

Yet it's in good times that managers need to be most watchful for signs of impending danger. Such is the paradox of success: it has an uncanny way of setting a company up for trouble, if not outright attack. And not only from outside sources, such as competitors or regulators, but, just as important, from within the organization itself.

Consider how an aggressive, can-do culture often arises when a company's sales and profits soar. Such a culture usually accounts for bold initiatives and satisfied clients, but it also can end up silencing any messenger carrying bad news about

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a company's practices. Success can also require an organization to invest in new computer systems to carry the load of increased orders. That growth is reason to celebrate, except that the all-too-common failure to integrate new technology is a disaster waiting to happen.

Success, in other words, should make executives nervous. Better yet, it should galvanize them to identify their level of internal risk exposure. Not all risk is bad, of course, and in fact, most organizations must take risks in order to make progress. (In some fast-moving industries, such as software and financial services, it is necessary to take on quite a bit of risk just to stay even.) But managers – especially those of successful enterprises – must always be on the lookout for the risk lurking in their organizations. The question is: how can they pinpoint the areas of risk exposure?

Over the past several years, I have developed a tool called the *risk exposure calculator.* The calculator shows the pressure points present in every organization that lead to increased risk, such as the speed of operational expansion and the level of internal competition. Depending on a company's circumstances and management style, the amount of pressure on each point can be low or high. A uniformly low score on these pressure points, it should be noted again, isn't necessarily a virtue. Remember that nothing ventured is nothing gained. But too high a score on too many pressure points can be a strong signal that a company is exposed to dangerous levels of risk. Remedial action may be necessary – and fast.

The risk exposure calculator is not a precise tool like an electronic spreadsheet or a discounted cash-flow analysis; its results are directional. It allows executives to determine if a company's risk level is in the safety, caution, or danger zone. Once executives calibrate and understand a company's risk level, they can align it with the organization's strategy.

The calculator has been tested by managers from hundreds of different companies attending Harvard Business School's executive education programs where I teach. Because the calculator shows the combined effect of risk exposure throughout a company, the typical reaction to the total score is surprise, followed by nagging discomfort. It is not as if these executives don't know that their organizations carry risk. The CEO of a manufacturing company might, for example, be fully cognizant that a new factory has been put on-line too quickly. That single pressure has been worrisome, but not enough to keep him up at night. Using the risk calculator, however, the same CEO might discover that there is enough pressure on other critical pressure points that his company's overall risk exposure has risen to dangerous levels.

The risk exposure calculator also gives executives the opportunity to conduct two illuminating exercises. First, managers can ask people at different levels and in different functions within a company to use the calculator – and then compare scores. In my experience, that process shows that people at the very top of the company are less aware of risk exposure than those closer to the ground. Similarly, the exercise often reveals that people in one division or business unit rate the company's exposure to risk much higher than the rest of the organization. In such cases, it is time for senior executives to find out what one business unit knows that no one else does.

Second, managers can calculate their company's current risk exposure and then calculate what it would have been 24 months ago. Comparing those scores reveals an organization's internal risk-exposure trajectory. One executive who did so found that her organization had somehow managed to soar from the safety to the danger zone. She acted swiftly to alert her senior team, and steps were taken to bring risk back under control.

In dynamic markets, taking risks is an integral part of any successful strategy. But understanding the conditions that create unhealthy levels of risk can go a long way toward preventing failure. It is critical, then, for senior executives to keep track of each pressure point. Later, we'll take a look at the steps managers can take to control those pressures, but first, let's examine the calculator in detail.

The Risk Exposure Calculator, Key by Key

The risk exposure calculator is divided into three types of internal pressures – those due to growth, to culture, and to information management. For each of those pressures, success can increase the level of risk. People subject to them make mistakes in their jobs, inadvertently or not. They skip important steps in a quality-checking process, for instance, or allow new customer service associates to answer phones without adequate training. Another common outcome of internal pressures is that people fail to share important information, especially with their bosses. Either they don't have the inclination, or they don't want to pay the price. And finally, increased pressure can cause inefficiencies or breakdowns, or both, as systems and people become overloaded and undermanaged.

Let's start with the pressure points related to growth, where the exposure to risk begins in many successful companies.

Pressure Points Due to Growth. Fast-growing businesses are often intense and exciting environments. A burgeoning company attracts the interest of employees and the capital markets alike. In pursuing strategies that emphasize growth, executives often set ambitious sales and profit goals. Those who deliver are rewarded for their work; those who fail to meet expectations do not share in the bounty. No wonder, then, that growth can lead to the first pressure point: pressures for performance.

If managed properly, pressure to achieve challenging goals can stimulate innovation, entrepreneurial creativity, and superior financial performance. However, such pressure can also bring unintended risk. Subordinates may fear that failing to meet performance expectations will jeopardize their status or compensation. Accordingly, they may feel intense pressure to succeed at all costs, even if their actions overstep ethical bounds or contravene company policy. They may, for example, accept customers with poor credit ratings or cut quality to accelerate operations. And if pushed hard enough, employees can sometimes misrepresent their true performance to cover up any shortfalls against expectations.

Examples of such behavior are, sad to say, plentiful. Consider what happened in 1997 at the membership club CUC International. The company, which offered its customers discounts on home appliances, travel, dining, and auto parts, was run by managers intent on aggressive revenue and earnings growth. And indeed, the company consistently hit those goals – to the stock market's delight. But shortly after CUC merged with a franchising giant HFS (which franchises Ramada hotels, Coldwell Banker real estate, and Avis rental cars, among others) to

The Risk Exposure Calculator

The risk exposure calculator is a mechanism used to gauge a company's likelihood of being surprised by errors or breakdowns that could threaten the company's franchise or strategy.

Using the calculator is straightforward. For each key, rate the level of pressure in your company, scoring one as low and five as high. At the end, total your scores and interpret the results as shown to the right.

Growth

pressures for performance 1 2 3 4 5 score	+	rate of expansion 1 2 3 4 5 score	+	inexperience of key employees 1 2 3 4 5 score	=	score

Culture

rewards for entrepreneurial risk taking 1 2 3 4 5 score	+	executive resistance to bad news 1 2 3 4 5 score	+	level of internal competition 1 2 3 4 5 score	=	score

Information Management

transaction complexity and velocity 1 2 3 4 5 score	+	gaps in diagnostic performance measures 1 2 3 4 5 score	+	degree of decentralized decision making 1 2 3 4 5 score	=	score

total score =

9 to 20: The Safety Zone

Companies that carry this low level of risk are probably safe from unexpected errors or events that could threaten the health of the business. However, managers of such companies should question whether their risk exposure score is too low. Innovative, successful companies invariably create risk pressure. If your business scores in the safety zone, perhaps it's time to take some calculated gambles.

21 to 34: The Caution Zone

Most companies will find that they fall in this middle zone. But even here, managers should be alert for high scores in any two of the three risk dimensions. For example, if your business scores high on both growth and culture, but the total score falls below 35, there is still reason for concern.

35 to 45: The Danger Zone

If you find that your total score is 35 or above, alarm bells should be ringing and fast action should follow. Use the levers of control: belief systems, boundary systems, diagnostic control systems, and interactive control systems – coupled with traditional internal controls – to protect your business from disaster.

create Cendant, it was revealed that CUC's remarkable results were fake. Employees in 22 business units had falsified accounting records and booked more than $500 million in phony pretax profits. When confronted by investigators, the people who logged the fictitious entries said they felt pressured by their bosses to meet Wall Street's expectations.

How can managers measure their score on this point? They can ask themselves if aggressive stretch goals are set from the top down with little or no input by subordinates. If the answer is yes, then this point merits a high score. So does an environment in which performance-variable pay represents a large percentage of total compensation. High scores are also called for when managers give star performers special attention and recognition. And finally, pressure on this point is invariably high when the capital markets hold high expectations for financial results and traders bid up the stock to prove it.

The second growth-related pressure point is the rate of expansion in operations. Again, this is a good news–bad news story. New production facilities, distribution channels, and product lines are only necessary when business is booming. However, without careful planning and allocation of resources, the infrastructure to support rapid expansion may quickly become overloaded, resulting in sacrifices in quality. In other words, when calculating the pressure on this point, managers should ask themselves, Are operations expanding faster than our capacity to invest in more people and technology?

The answer, clearly, was no at American Express, when in 1987 top management decided to aggressively expand the scope of the company's franchise. In addition to the well-known American Express card, which requires customers to pay outstanding balances in full each month, a new Optima card was launched that encouraged customers to roll over unpaid balances and pay finance charges. The new business was ramped up quickly to accommodate the increased volume. But with little previous experience in consumer credit markets, Optima managers badly misjudged delinquency rates on the new cards. The result: write-offs in excess of $150 million and a quarterly loss for the prestigious Travel Related Services division.

Success can embolden risk takers too much; money is loose, confidence is high.

A high level of inexperience among employees and staff creates the third growth-related pressure point. When large numbers of people come on board quickly, managers sometimes waive background checks or lower performance standards and educational qualifications. As a result, new employees often lack adequate skills and training or don't fully understand their jobs. The fallout of such circumstances is well known: an array of small and large mistakes, from sales clerks who misinform important clients to factory workers who mishandle dangerous equipment. From unhappy customers to endangered staff, the risks posed by inexperienced people can be unnerving. When calculating the pressure on this point, then, managers might ask themselves, What percentage of our jobs are filled with newcomers – people, say, with less than 12 months experience with the company? Other telltale signs that pressure is climbing include increased customer complaints about service, and employees who make too many "stupid" mistakes. Those problems may seem like simple irritants to senior managers of a growing business, but they are important alarm bells.

Inexperience brings with it an additional risk, especially in unstructured, high-innovation businesses. It takes a lot of time for new people to learn, let alone internalize, a company's values. Often they simply don't know what constitutes acceptable behavior – or put another way, what kind of behavior is completely out of bounds. Consider what happened in the late 1980s and early 1990s when Nordstrom, the fashion retailer, sharply increased the number of its stores across the United States and hired scores of new managers to staff them. Even though Nordstrom had always prided itself on being fair – some would say generous – toward its employees, a few overzealous managers intimidated subordinates into underreporting work hours in an attempt to meet sales-per-hour quotas. This miscreant behavior resulted in a series of lawsuits and government actions that absorbed management's attention and damaged Nordstrom's otherwise fine reputation.

Pressure Points Due to Culture. No businesses can survive over the long term – let alone prosper – without the entrepreneurial risk taking that drives innovation and creativity. But success can embolden risk takers too much; money is loose, confidence high. For some, the urge to gamble with the company's assets and reputation – all in the name of greater gains – becomes irresistible. And so very often people in successful enterprises invest in excessively risky deals, forge alliances with people or businesses that may not have the ability to honor their contracts, or make promises to customers that are impossible to fulfill. Again, rewarding entrepreneurial initiative is generally the right thing to do. But as the rewards for entrepreneurial behavior rise, so too does risk exposure.

Consider what happened at Bankers Trust Company, a traditional commercial bank during much of its history. In the early 1990s, senior management transformed the business into an aggressive investment bank that issued innovative financial instruments. Bankers and traders were rewarded for creating and pushing new products as fast as they could. By 1993, based on the success of such entrepreneurial behavior, the company was earning more than $1 billion on revenue of $4.7 billion. In 1995, however, Bankers Trust was sued by several clients, including Procter & Gamble, for misrepresenting the risks associated with these new financial products. The result was over $250 million in fines and customer-reimbursement costs and the ouster of Bankers Trust's CEO and other top executives.

How can managers calculate a score for this pressure point? One way is to determine what percentage of the business is based on new products and services that have been generated by creative, risk-taking employees. The higher the number, the higher the score. Another cause for a high score on this point is an environment in which people are allowed – even urged – to operate like the Lone Ranger, and only return to base when they have captured the "spoils." And finally, an increasing frequency in failed new products or services or unsuccessful deals is a sign that exposure to risk is mounting.

Another cultural pressure point has to do with information – particularly as it flows upward. To their peril, executives running successful organizations often develop a resistance to bad news. They want to be surrounded by people who share their pride in the business and exude confidence about reaching demanding performance goals. People who speak of obstacles, problems, or impending dangers are derided as annoying naysayers and accused of not being team players. Yet it is often these individuals – many of whom communicate daily with frontline employees, customers, and suppliers – who are best able to see risk creeping in. In cultures where the philosophy is "the boss knows best," many learn not to speak out about such risk.

The result? In the worst case, top-level managers are the last to know about critical changes in the competitive environment. At Kmart, for example, managers were reportedly reluctant to tell the leadership team about problems in the business, even as Wal-Mart was quickly overtaking them. While upstart competitor Sam Walton was known for prodding his subordinates to deliver bad news quickly so that they could figure out how to improve, Kmart's CEO Joseph Antonini had a reputation for surrounding himself with people who would not challenge his views. Eventually, in 1995, the shareholders and the board forced him out. Similar stories about senior managers at the "old" IBM and General Motors have been told to explain the companies' spectacular declines from industry preeminence. (New top management, of course, has now reversed their fortunes.)

To calculate the score on this pressure point, managers must ask themselves some difficult questions: How much bad news do I actually hear? Have I surrounded myself with "yes men"? The answer to those questions will help determine their score.

The last explosive ingredient in the mix of cultural pressure points is internal competition. In many organizations, managers believe that they are in a horse race with their peers for promotions and rewards. And often they are right. Senior executives frequently set up such contests to stimulate exceptional effort. However, when employees perceive advancement and promotion as a zero-sum game, internal competition can have unintended side effects. The most common result is a decrease in information sharing. After all, if you know something important about customers or processes that your rival doesn't, why give away your advantage?

To compound the problem, employees feeling the pressures of internal competition may gamble with business assets, potential credit losses, and the company's reputation in their attempts to enhance short-term performance. In such instances, risks and rewards are not evenly distributed. If the gamble succeeds, there is an upside for both the employee and the company. But if the gamble fails, the employee may – at worst – lose his or her job. The organization can also be left with catastrophic losses. That's exactly what happened at Barings Bank in 1995. Nick Leeson executed transactions that at first appeared to create exceptional levels of profit. To win respect and rewards, he was in fact gambling company assets in an attempt to cover ever-mounting losses. When the dust settled, Leeson was in custody on fraud charges. His actions destroyed a 200-year-old institution.

To calculate their score on the internal competition pressure point, managers might simply ask themselves, Do we manage and motivate by horse races here? They could also consider how performance reviews are conducted at their company. Are employees ranked and compared with one another, or are they evaluated on their own merits? If the answer is the former, then the score should be high. Managers might also think about what happens when star performers are promoted. Do other people get fired – or quickly leave – at the same time? Companies with such up-or-out environments have high levels of internal competition and should receive a high score on this point.

Pressure Points Due to Information Management. The final set of pressures in the risk exposure calculator relates to the flow of information within a company. In short, when systems to manage information are inadequate, havoc ensues – and risk exposure mounts.

Success in the marketplace is often accompanied by increasingly sophisticated products, by innovations in the way that customers are served, and by creativity in bundling new products or services. All these changes can increase the complexity of transactions. When that happens, fewer people fully understand the nature of the risks that these transactions create and how to control them. For example, cross-border agreements in international operations, creative financing of customers' purchases, and elaborate consortium arrangements can all produce highly complex contracts. If only a handful of experts in the organization truly grasp the resulting obligations and contingent cash flows, the risks hidden on the balance sheet can become a mystery to the senior managers who need to understand them most. In calculating the pressure on this point, then, ask yourself if you truly understand the complex and sometimes arcane language of the deal-making experts in your company. If the answer is no, score your risk exposure accordingly.

The increase in complexity due to highly leveraged derivative financial products – that is, financial instruments whose value fluctuates based on changes in the values of other underlying assets – has caused more than one well-managed company to sustain substantial losses. A perfect example is Metallgesellschaft Refining & Marketing (MGRM), an American subsidiary of the large German industrial corporation Metallgesellschaft. In the early 1990s, MGRM began selling long-term fixed-price fuel oil contracts. At the same time, as a hedge against price volatility, MGRM bought short-term oil futures on the New York Mercantile Exchange. When oil prices began their precipitous decline in 1993, the business was forced to pay more than $50 million per month to cover margin calls. Managers of the parent company became alarmed and, against the advice of MGRM executives, liquidated the futures positions at a significant loss. The parent board blamed subsidiary managers for lax operational control; subordinate managers claimed that the parent did not fully understand the nature of the futures positions and had overestimated the potential risks. Who was right? Because of the complexity of the transactions, it is hard to say, but losses on the liquidated positions exceeded $1 billion and brought Metallgesellschaft to the edge of bankruptcy.

Success can also mean an increase in the volume and velocity of transactions, which often overloads information systems. The dangers here are obvious. Managers have less opportunity to scrutinize transactions to ensure that they adhere to preapproved policies. Overloaded or inadequate computer systems may not be able to capture the information essential to support growth. That's what happened at People Express – the now defunct low-cost, no-frills airline. As the business took off, it quickly reached a point where its rudimentary information systems lacked the ability to accurately analyze

Pounding the Calculator Keys at One Company

To demonstrate how the risk exposure calculator works, let's show how it might have revealed the risk brewing at Kidder Peabody before its disastrous fall in 1994, when over $350 million of false profits were uncovered and its parent, General Electric, decided to dispose of Kidder Peabody's assets.

In hindsight, it is easy to see that many of the pressure points on the risk exposure calculator were at dangerously high levels. Indeed, the company's score would have been close to straight fives in all categories for a total of 45 – at the very top of the danger zone.

First, consider the growth dimension. Even before General Electric purchased Kidder Peabody, pressure for performance at the company was extremely high – not unlike the pressure at other Wall Street firms. From all accounts, the acquisition heightened the demand for results. The rate of expansion was likewise intense. After all, GE Capital was pouring money into Kidder so that the business could expand aggressively. At the same time, the number of inexperienced people at Kidder was mounting. GE managers sent in to oversee the company after the acquisition – while expert at running an industrial company – did not fully understand the operations or the nature of financial service products. Moreover, Joseph Jett, the trader hired for the fixed-income desk, was young and had no training or experience in buying and selling specialized types of bonds. Pushing this score up even available seat miles so that managers could set the right prices to maximize profit. Six years after its successful launch, the company went bankrupt. More recently, America Online suffered the consequences of inadequate information-processing capacity in the face of increased transaction volume: service shutdowns and blackouts reverberated throughout its system just as many new customers were trying to come on board.

To determine the score on this point, managers should do a rough calculation in their heads. What were the complexity, volume, and velocity of information a year ago? Have they risen, and by how much? The answers to those questions are not precise, but they can give a strong indication of whether the score should be high or low.

Success also puts pressure on the internal reporting systems that measure critical performance variables, such as return on capital employed, same-store sales, order backlogs, and product or service quality. In bad times, managers usually pore over such facts and figures as they try to divine the source of their problems. In good times, however, managers will frequently let this process slide. There are two reasons. First, rapid growth often renders these systems outdated and inadequate to the new demands of the business. And second, it's human nature. If everything is going well and profits are high, there's little reason to plow through mounds of data in order to find anomalies or ways of making small improvements.

How can a manager calculate a score on this pressure point? One signal that a high score is called for is, simply, a feeling of frustration – a sense that it's hard to get the right data at the right time. When there are gaps in diagnostic performance measures, managers end up getting the information they need by making phone calls and walking around. In short, they spend a lot of time doing the work a computer system should be doing.

Another way to calculate the score on this point is to ask, How often do I fight fires? If the answer is

further was the fact that there were few shared values between managers at GE, a carefully managed industrial company, and those at Kidder, a freewheeling financial trading business.

As for culture, GE's and Kidder's senior managers had certainly created an environment that rewarded entrepreneurial risk taking. Those who could find ways to exploit market imperfections or who could create new financial products were well compensated. Thus, Jett, who was ultimately discovered to be booking false profits, had previously been feted by top management as Kidder's "man of the year." His 1994 annual bonus was $9 million. Notwithstanding his outward success, however, several people close to his operation questioned the nature of the profits that he was generating. But there was such executive resistance to bad news – especially given the rewards and accolades that were being showered on the trader – that those with suspicions were quickly quieted. There was also intense internal competition as traders and managers vied for promotion, recognition, and large bonuses.

Finally, consider the quality of information management at Kidder. Transaction complexity and velocity were both increasing rapidly as Jett placed orders to buy and sell billions of dollars worth of bonds. Illogical explanations for complicated trades were not questioned by managers who later claimed ignorance of the real nature of these transactions. Diagnostic performance measures were faulty and incomplete. Jett had stumbled on a glitch in the firm's computer program that allowed him to record huge unrealizable profits. Diagnostic early-warning systems that should have alerted senior managers to the dangers of these outstanding positions were either nonexistent or ignored. Because of a lack of systematic early-warning systems, senior managers at Kidder and GE were never provided with the critical signals that would have alerted them to serious problems.

Finally, Kidder scores high on decentralized decision making. Not only is GE a highly decentralized organization, but Kidder, too, allowed major decisions to be made by employees at the trading desks without direct management oversight. When Jett's supervisor was asked why he didn't watch his people closely, he said that it was not part of his job and that he relied on others to alert him if anything was amiss.

Who was to blame for Kidder's ignorance of its enormous risk exposure? Jett claimed that he was not culpable because he had never hidden his actions from superiors. In turn, his bosses claimed that they were not responsible because they had relied on the company's diagnostic control systems and internal auditors to alert them if anything was wrong. In hindsight, blame must be placed on the shoulders of those managers who failed to appreciate the risk pressures due to growth, culture, and information management that were mounting within the company.

often, then it's likely that your information systems are not providing the right information in a timely fashion. And finally, give yourself a high score if the last time you looked at data on performance was more than a month ago, or if you're unlikely to complain if monthly performance reports are late or missing. This invariably means that you are not using diagnostic controls effectively.

The final information-management pressure point in the risk exposure calculator is decentralized decision making. When companies expand quickly, local managers are often given a great deal of autonomy to make decisions. Indeed, top-level corporate managers are typically involved only in matters of resource allocation, goal setting, and performance reviews. Of course, decentralization yields many advantages. It enables local business units to respond quickly to market demands, allows more creativity and innovation, and it can enhance the motivation and career satisfaction of managers.

But again, these positive effects also have their downsides. First, local managers acting without a larger sense of their organization's corporate strategy may unknowingly take on too much risk. Second, decentralized organizations do not have well-defined information channels for sharing information either sideways or upward. If senior executives are not hearing important information until it's too late, then they need to give themselves a high score on this pressure point. (To see how the risk exposure calculator is actually applied, see the insert "Pounding the Calculator Keys at One Company.")

Now that we've identified all the pressure points that contribute to risk exposure, let's take a look at what managers can do after they've calculated their score.

Five Questions About Risk

Most managers understand the relationship between risk and reward. But a second relationship is equally important: the relationship between risk and awareness. Taking risks is not in itself a problem – but ignorance of the potential consequences is an entirely different matter. Even for the most technical categories of external risk – sovereign risk, counterparty risk, credit risk, market risk – if managers are aware of their nature and magnitude, they can take appropriate steps to avoid the hidden dangers.

The same is true of internal risk exposure. Once managers know where it exists in the organization, and at what levels, they can act. In many cases, however, that's easier said than done. Over the years, I have spoken with many managers who work for companies that fall into the calculator's danger zone. They often say that they have done everything possible within their organizations to control risk. "What actions are left?" they ask.

The answers can be found in a series of questions. These questions correlate with the four "levers of control" that I developed from intensive research over a ten-year period. (For a model of the levers of control, see the exhibit "The Levers of Control.") The levers, simply stated, are the mechanisms managers can adjust to control risk as a company pursues its strategy. There is one question for each of the four levers: belief systems, boundary systems, diagnostic control systems, and interactive control systems. Working together, these four levers give managers the tools to balance profit, growth, and control. Each of them must be carefully aligned with a business's strategy. A fifth and final question relates to what are commonly known as internal controls – the checks and balances designed to safeguard assets and ensure reliable information. Internal controls do not vary with strategy; they are, however, an essential foundation for controlling risk in all organizations.

The managers of many successful companies have implemented the levers-of-control model and in doing so have found a way to drive maximum performance while ensuring adequate safeguards against risk. The following questions are designed to help you do the same.

Question #1: Have senior managers communicated the core values of the business in a way that people understand and embrace? Many of the critical pressure points in the risk calculator measure the likelihood that employees are misconstruing the intentions of senior managers or are taking on unacceptable levels of risk for personal gain. Belief systems – communicated through mission statements, credos, and statements of values – can go a long way toward creating a culture that rewards integrity and makes clear the types of choices that should be made when confronted with temptation or unfamiliar situations. Effective belief systems are an essential safeguard in rapidly growing, high-pressure businesses.

But to effectively communicate core values and beliefs, managers must do more than go through the motions of writing a mission statement. They must reinforce their stated beliefs through visible actions. That is, they must demonstrate that a mission statement or credo is more than a plaque for the wall – they must prove it is a living document. At Johnson & Johnson, top managers periodically meet with all business unit managers to debate and reaffirm the importance of their long-standing credo. Indeed, members of the company's senior team will even meet with small groups of employees and vet the credo word-by-word. Such extraordinary practices demand a great investment of time, but they are worth it for the enormous clarity they bring to questions of policy and practices and for the clear understanding they convey about what is right and wrong.

Question #2: Have managers in your organization clearly identified the specific actions and behaviors that are off-limits? Every business faces the possibility that some employees may step outside the bounds of normally accepted business practices. They may promise customers too much, for instance, or accept a client who has a poor record of paying his bills. Some missteps, however, are more serious than others – they may actually harm the franchise of the business. Therefore, for any given business strategy, managers must determine what behaviors or actions could damage the business's reputation and declare those actions categorically off-limits.

Consultants and auditors, for example, depend on their reputation for trustworthiness as an essential asset for effective competition. Ask yourself how long McKinsey & Company could stay in business if clients suspected that client data were being leaked to competitors. Because of such clear franchise risks, McKinsey and firms like it have explicit codes of conduct that forbid any behavior that could be perceived as compromising the confidentiality of client data. At PricewaterhouseCoopers, the accounting firm responsible for tallying the votes for the Academy Awards, boundaries for business conduct are made clear to anyone associated with the awards: Tell anyone other than your supervisor about the outcome of the votes, and you'll be fired. Establishing unambiguous boundaries is a quick but effective way of reining in risk and protecting a firm's most valuable asset.

The Levers of Control

To control the internal risk that accompanies strategy, managers have levers of control at their disposal. Ask yourself the following questions to see if those levers are being pulled in your organization. The question at the very bottom relates to what are commonly known as internal controls – the checks and balances that safeguard assets and ensure reliable information. Internal controls do not vary with strategy; they are, however, an essential foundation for controlling risk in all organizations.

Belief Systems

Have senior managers communicated the core values of the business in a way that people understand and embrace?

Boundary Systems

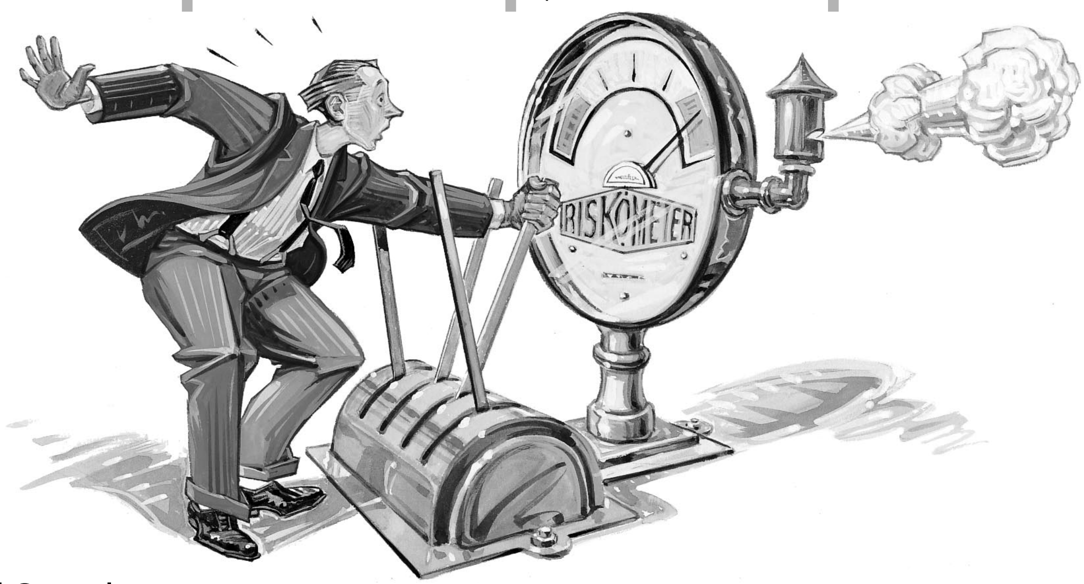
Have managers in your organization clearly identified the specific actions and behaviors that are off-limits?

Diagnostic Control Systems

Are diagnostic control systems adequate at monitoring critical performance variables?

Interactive Control Systems

Are your control systems interactive and designed to stimulate learning?



Internal Controls

Are you paying enough for traditional internal controls?

ARTWORK BY DOUGLAS JONES

Question #3: Are diagnostic control systems adequate at monitoring critical performance variables? Because success makes it so easy to neglect or dismiss diagnostic control systems, managers have to be sure to invest in these systems in boom times and ensure that everyone is focusing on the right critical performance variables. Sometimes existing systems and measures are adequate. In other cases, success calls for new variables. Managers need to determine which performance variables matter most in present circumstances and then design ways to ensure that key managers are regularly informed of those figures. Managers may choose to focus diagnostic measures on operations (such as quality and throughput), on critical balance sheet assets (such as credit loss exposure), or on the competitive environment (such as customer complaints or bids lost to competition). Watching the right numbers can be an important way to find out if the future doesn't look so bright.

Question #4: Are your control systems interactive and designed to stimulate learning? Managers can stay abreast of many critical performance variables by relying on exception-based diagnostic reports, but such documents represent a one-way flow of information. An additional and important way to monitor risk exposure is through certain interactive control systems – that is, systems that force managers to engage in conversations about strategic uncertainties. If used properly, the debate that these control systems trigger can raise important questions about customers, technology, competitors, regulation, markets – anything that might change a company's way of doing business. Any number of systems can be used interactively: profit plans, performance scorecards, technology-monitoring systems, or brand revenue systems. The only requirement is that interactive meetings for discussing the data become routine enough that they don't fall by the wayside. Used as mechanisms to gather information, interactive control systems open information channels from the bottom of the organization to the top, an essential way to combat risk.

Again, Johnson & Johnson provides an illustration of a company that uses an effective risk-controlling device. Its managers use their profit-planning and long-range-planning system in a highly interactive way to continually assess opportunities and threats. As they constantly revise projections, managers are forced to confront three questions: What has changed? Why? and What are we going to do about it? Through such an interactive process, Johnson & Johnson's managers have successfully navigated the shoals of the changing health care industry and have managed to stay, year after year, on the shortlist of America's most admired companies.

Question #5: Are you paying enough for traditional internal controls? In this age of balanced scorecards and enterprisewide information systems, many organizations have relegated internal controls to the dustbin. I'm referring here to time-tested practices such as segregating duties, limiting access to critical information, and adequately staffing key control and risk management positions, such as controllers and internal auditors.

Why have some companies let those controls go? One of the main reasons is the wave of reengineering and downsizing that has occurred over the past decade. On the one hand, these initiatives have successfully refocused and streamlined businesses, making them healthier and more competitive. On the other hand, they have also removed much of the redundancy and middle management oversight that were the traditional backbone of internal control systems.

There is no fixed amount or percentage that a company should be paying for the checks and balances that are the mainstay of internal controls. But there is one rule of thumb. As a company grows, the money invested in such systems should be growing commensurately. It may feel wasteful at the time – especially since success makes risk seem so remote – but it is money well spent. That's a fact, unfortunately, that many managers don't learn until it's too late.

A Calculator and a Magnifying Glass

Attaining success is the reason that many people enter business in the first place. It feels great. And perhaps that's why once you achieve it, the last thing you want to hear is: Watch out – risk looms! But executives running successful enterprises can't let the brightness of the day – or the future – blind them. They need to shed their sunglasses and find a magnifying glass to search their organizations for the risks that may be multiplying within. A pair of binoculars might be called for as well. Sometimes risk creeps into the organization at quite a distance from the top.

The risk exposure calculator won't, in and of itself, decrease an organization's risk. But it will suggest where risk is growing and how fast. With that insight, managers can take the steps they need to protect their success. Not all risk is bad. It's up to you, then, to decide if your business's level of risk calls for mere watchfulness or for strong action.

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