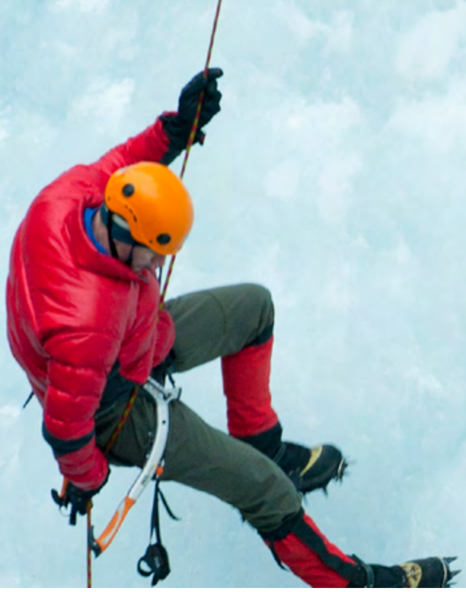

KPMG

Calibrating Strategy Amid Volatility and Uncertainty

KPMG Board Leadership Center

Disruptions in the oil markets, swings in commodity prices and currencies, interest rate uncertainty, and geopolitical hotspots around the world—not to mention technology developments and government regulation—all point to a new level of global volatility and uncertainty impacting corporate business models and strategies.

Indeed, with assumptions about input prices and demand changing rapidly, and with technology advances creating shocks and shifts in the competitive landscape, a key challenge for management teams and boards is to assess the continuing validity of the company's strategy—particularly the critical assumptions at the core of the strategy—and to calibrate or adjust that strategy as appropriate.

KPMG's Fall Roundtable Series gathered over 1,200 directors and senior executives across 17 cities to share their views on the board's role in strategy amid increasing global volatility and uncertainty.

As highlighted at the roundtable series and in recent surveys, the board's role in strategy is evolving from an "annual review and concur with periodic involvement" to a continual dialogue—evaluating strategy options and challenging fundamental assumptions, monitoring execution and engaging with management on an ongoing basis, and helping to connect strategy, risk, and long-term value creation.

"Today, strategy is discussed at every board meeting and sometimes in between," said one director.

"With globalization and economic uncertainty, the risk for any one company is that the fundamental assumptions on which their strategy is based have changed and are no longer valid," Ray Gilmartin, former lead director of Microsoft and General Mills, told KPMG's Board Leadership Center. Read the interview, "Enhancing the Board's Role in Strategy."

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The new global volatility affecting companies

Oftentimes, volatility and uncertainty are reflected in daily fluctuations in the stock and bond markets. But the stock market is not the economy, and uncertainty and volatility go much deeper.

For example:

- Lower oil prices have been a boon to U.S. consumers, as well as manufacturers and transportation companies, but certain emerging market economies are reeling due to their dependence on petroleum-related industries and exports.
- Commodity and currency swings, specifically the strong U.S. dollar and the decline in the dollar-cost of global commodities, has put pressure on profits for U.S. companies selling overseas as well as commodity producers and the economies they support (Australia, Canada, Brazil).
- Interest rate uncertainty is clearing in the U.S., but other global central banks continue to maintain stimulus programs and prolonged low-rate regimes.
- Decelerating growth in China has put even more pressure on commodity producers and global companies with significant sales to Chinese businesses and consumers. "The company must consider strategy on a country-by-country, region-by-region basis," said one roundtable panelist.
- Other strategic risks, including disruptive business models and innovative technologies, are always on the horizon and often the hardest to spot.

Among directors and C-level executives attending the roundtables, 61 percent said that economic uncertainty is having the most significant impact on the company's strategy. Technology/innovation and regulation were also emphasized.

Indeed, as Ram Charan wrote in *The Attacker's Advantage*, we are "in the age of a technology renaissance that is not only disruptive, but destructive."

"Innovation happens very close to the edge of chaos," said one director. "If the company is not occasionally making some mistakes, it's probably not pushing the envelope."

Understanding the company's strategy process

"Strategy" is very broad and may mean different things to different people. It includes strategic thinking, decision making, strategic planning, strategic execution, monitoring strategic execution, monitoring the external environment and the continuing validity of key assumptions underlying the strategy, and adjusting or calibrating strategy as appropriate. The classical style of strategy—analyze, plan, execute—may no longer be adequate.

Roundtable participants observed that:

– Scenario planning is critical. In an uncertain environment, management needs to (i) define "the few vital uncertainties" the company faces (ii) create a set of probability scenarios for how the future might unfold and discussing the threats—and opportunities—these scenarios present (iii) devise a set of strategic options that balance commitment to a course of action with the flexibility to adjust amid different future scenarios, and (iv) identify critical trigger points that signal important changes in the marketplace and trigger a set of actions already foreseen during the scenario planning process. (See "A Strategy for Thriving in Uncertainty," Bain & Co.)

– Monitoring the external environment on a continuous basis is also crucial. The goal of scenario planning is to prod leadership to monitor change on a regular basis and adjust as future states begin to take shape. "What are you trying to accomplish by doing a shock analysis? Testing liquidity, reputation, supply chain, other stress?" asked one director. "You have to keep the scenarios realistic."

– Avoid pegging strategy to "more of the same" assumptions across key factors in the external environment, e.g., input price assumptions, economic growth and demand growth assumptions.

– Beware of deep-seated cognitive biases—such as anchoring, neglecting low-probability events, or over-confidence—that can hamper scenario planning process, according to McKinsey. "The power of the corporate culture to shape what really happens shouldn't be underestimated," said one director.

– Moving faster than the competition as conditions change is also essential to success. "Boards need to continually ask who might be trying to encroach on the company from outside its traditional market," suggested one director.

Thirty-two percent of directors and executives surveyed at the roundtables said that they were "concerned" that management tends to use "more of the same" assumptions in setting strategy, and another 46 percent said they were "somewhat concerned."

Calibrating the company's strategy as needed

A key question for every board is to understand how robust the strategy process is and whether it enables the company to calibrate strategy as needed. Here are a few areas that the board might probe in answering this question:

– Does our monitoring process provide timely signals indicating when a strategic adjustment may be necessary?

– What is the scope of the strategic adjustment?

– Did our scenario planning anticipate this scenario?

– Do we have the operational flexibility to adjust (people, resources, financing, partners, vendors, etc.)?

– Who needs to know when a strategic adjustment is necessary, and what is our plan for communicating it?

Clarifying the role of the board in strategy

As noted in the NACD Blue Ribbon Commission Report on Strategy Development, the board in its traditional "review and concur" role may not sufficiently arm directors with enough information around strategic assumptions, uncertainties, judgments, and alternatives.

Without this context, the board is less likely to recognize when a strategic correction is required. Continual board engagement in strategy and a deep understanding of the business context and the potential forces that could affect the strategy improve the company's ability to adapt to inevitable change.

"A continuous process allows the board to move from a posture of learning about strategy at a year-end retreat to being in a position to evaluate strategy, to have metrics as to how well the strategy is being executed, and, most importantly, to be able to assess whether or not economic value is being created by this strategy," said Gilmartin.

Discussions among roundtable participants emphasized the importance of linking risk and strategy in boardroom discussions, for example, by:

– Reviewing and approving the risk appetite

– Devoting more time to discussion of strategic risks, uncertainties and opportunities

– Improving information flow to the board regarding strategic risks, uncertainties, and opportunities

– Hearing more third party views related to the company, its industry, business model, the operating environment, etc.

As one attendee said, "Have a *red team* designated to challenge the working assumptions. Manufacture the contrarian. Bring in an outsider."

“Boards clearly need to be more deeply engaged on strategy...and that requires having people on the board who can add real value in strategy discussions—particularly when course corrections are needed.“

Adding value with the right people and perspectives

The institutional investor community has been encouraging boards to focus on refresh practices—a term that encompasses attention to diversity of skill sets, backgrounds, and perspectives in the boardroom—when considering director tenure or conducting performance evaluations at the full-board, committee, and individual director levels. Yet, according to recent surveys, many boards view director recruitment from a relatively short-term perspective.

As the recent NACD Blue Ribbon Commission on Long-Term Value Creation recommended, board leaders should “approach board composition and succession planning with long-term needs in mind, based on a map of the director skillsets that will be most relevant to the company’s strategy in three, five, or even 10 years against current board members and anticipated vacancies. This multi-year skills map should inform director recruitment, ongoing director education, and board evaluations.” To align board composition with the current and long-term needs of the business, boards might consider:

- Does the composition of the board reflect the needs of the company’s particular stage of development (e.g., early, fast-growth, mature, restructuring)? As one director noted, “The stage a company is at in its lifecycle makes a big difference.”
- Where do we expect the company to be in three and in five or more years, and what gaps will that create in board composition? Considerations include skills, experience, and/or demographics such as age, gender, nationality, or racial/ethnic background. Sixty-four percent of roundtable survey respondents said that their board had considered future composition in light of strategy.
- Do our board composition and leadership contribute to a culture where open dialogue and constructive challenge (among directors, and between directors and members of management) is encouraged? “Over-collegiality is a real risk. It’s just a step away from group think,” said one director.
- What does the board do to align current directors’ skills and competencies on a continuous basis with the company’s strategic challenges and growth opportunities? Is ongoing director education an expectation for all board members?[1]

“The CEO and senior management are there to provide executive leadership of the company,” noted one director. “But boards clearly need to be more deeply engaged on strategy than ever before, and that requires having people on the board who can add real value in strategy discussions—particularly when course corrections are needed.”

Ten Recommendations for Strategy Engagement

1. Expect change and understand how it may affect the company’s current strategic course, potentially undermining the fundamental assumptions on which the strategy rests.
2. Engage with management on strategy issues on an ongoing basis, including early involvement to improve strategy development, adjustment, and monitoring.
3. Evaluate strategy options and underlying assumptions in good times, as well as in times of crisis.
4. Divide the strategy into elements that are tied to performance drivers and critical assumptions, and revisit those different elements throughout the year.
5. Communicate to the CEO and management the expectation that strategies are brought to the board in the early stages to allow for open discussion and engagement.
6. Establish an effective and collaborative relationship between the board and CEO via the chair or lead director.
7. Consider director experience and expertise in relation to the strategic role of the board as part of the nomination and re-nomination decisions.
8. Develop consensus with management on the forward-looking metrics specific to the company that will be early indicators of the success or failure of a chosen strategy.
9. Hold executive sessions—at a minimum—at the beginning and end of each board meeting to allow independent directors to freely discuss strategy.
10. Establish a relationship with key investors when performance is good. This can ease conversations that may arise during more challenging times.

Source: Report of the NACD Blue Ribbon Commission on Strategy Development

[1] Report of the NACD Blue Ribbon Commission on Board Evaluation: Improving Director Effectiveness, p. 4.

KPMG Roundtable Survey Findings

Which of the following factors are having a significant impact on your company's strategy or the assumptions underlying the strategy? (select all that apply)

61%	*Economic uncertainty*
58%	*Technology and innovation*
57%	*Government regulation*
35%	*Interest rate uncertainty*
32%	*Swings in commodity prices and currencies*
27%	*Disruptions in the oil markets*
14%	*A decelerating China*
11%	*Geopolitical hotspots*

How concerned are you that the high degree of uncertainty and volatility poses a significant threat to your company's strategy?

62%	*Somewhat concerned*
33%	*Very concerned*
5%	*Not concerned*

How concerned are you that management tends to use "more of the same" assumptions—regarding key factors and uncertainties in the external environment—in setting strategy?

46%	*Somewhat concerned*
32%	*Very concerned*
22%	*Not concerned*

Survey responses from 202 directors and C-level executives attending the KPMG Fall Roundtable Series, November/December 2015

Does management at your company create probability scenarios that focus on the critical assumptions at the core of the company's strategy?

51%	*Yes*
40%	*No*
9%	*Not sure*

How satisfied are you that management has an effective process to scan and monitor changes in the external environment on a regular basis in order to test the continuing validity of the critical assumptions at the core of the company's strategy?

49%	*Somewhat satisfied*
38%	*Satisfied*
14%	*Not satisfied*

What steps has your board taken over the past several years to better link risk and strategy in boardroom discussions? (select all that apply)

63%	*Devoting more time to discussion of strategic risks, uncertainties*
58%	*Improving information flow to board regarding strategic risks, uncertainties*
39%	*Review/approve risk appetite*
28%	*Hearing more third-party views*
4%	*Other*

Has your board discussed its composition and succession planning based on skill sets that will be most relevant to the company's strategy in three to five (or more) years?

65%	*Yes*
20%	*No*
15%	*No – but plan to do so*

Fall Roundtable Locations

Atlanta	*Denver*	*Los Angeles*	*Orange County*	*Seattle*	*St. Louis*
Charlotte	*Detroit*	*Minneapolis*	*Philadelphia*	*Short Hills*	*Washington, DC*
Cleveland	*Houston*	*New York*	*Pittsburgh*	*Silicon Valley*	

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About the KPMG Board Leadership Center

The KPMG Board Leadership Center champions outstanding corporate governance to help drive long-term corporate value and enhance investor confidence. The Center engages with directors and business leaders to help articulate their challenges and promote continuous improvement. Drawing on insights from KPMG professionals and governance experts worldwide, the Center delivers actionable thought leadership—on risk and strategy, talent and technology, globalization and compliance, financial reporting and audit quality, and more—all through a board lens. Learn more about the Board Leadership Center's programs, resources, and insights for directors at KPMG.com/BLC.

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