What is on your transformation risk checklist?
Part I

Transformations are inherently risky. There are a number of reasons, perhaps foremost because they are usually undertaken with imperfect and incomplete information, which can lead them to fall short of expectations, destroy value, or entirely fail. But even in the best of circumstances, they often suffer from the unexpected.

The COVID-19 pandemic was one such unexpected event that created significant disruption for many companies. Despite the prospect of depleting resources, many finance leaders had no choice but to begin—or accelerate—key transformation efforts by addressing weak spots in supply chains, virtualizing processes and organizations, upgrading networks and systems, and/or delivering new product service configurations and creating digital offerings to deliver value to customers.

Previous articles in our ongoing *CFO Transformation Leadership Takeaway* series have sought to help finance executives better navigate their roles as co-leaders and sponsors of transformation (see "What changes in a transformation—and why it matters to CFOs," *CFO Insights*, January 2020) and offered guidance around setting both motivating and realistic goals for a transformation effort (see "Crafting your transformation ambition," *CFO Insights*, March 2020). In this and a future issue of *CFO Insights*, we provide a checklist of risk areas for CFOs to consider as they navigate transformation efforts.

Assessing critical transformation risks

In finance transformations, CFOs have a strong chance of identifying and managing related risks. In other types of transformations—for example, moving from traditional automobile manufacturing to developing digitally-equipped and driverless vehicles—there may be new risks that emerge, such as cyberthreats and data privacy breaches. So, in addition to pinpointing the critical risks to consider in any transformation, CFOs also should consider what new types of risk might occur as a result, what risks could threaten the transformation even after it has been completed, and how those risks can be mitigated with appropriate investment.

Our research on transformation risks identified seven key risk areas: 1) making the wrong transformation choices; 2) resource risks; 3) leadership commitment and continuity; 4) third-party or agency risks; 5) ineffective planning and alignment processes; 6) behavioral resistance to change; and 7) black swan and other contextual risks. In addition to discussing these risks, we'll offer practical ways for CFOs to help plan for them in the sections that follow:

1. Wrong assumptions, models, and transformation choices

All transformations rely on assumptions about the future. Using whatever information is available, executives try to develop reasonable expectations of market and business conditions and craft a transformation ambition that can drive realistic and executable outcomes.

> "As CFOs, we need to accept and capitalize on failure. We cannot be 100% sure of where we are going and expect to have 100% of the analysis in order to support an innovation platform."
>
> — CFO, Consumer products industry

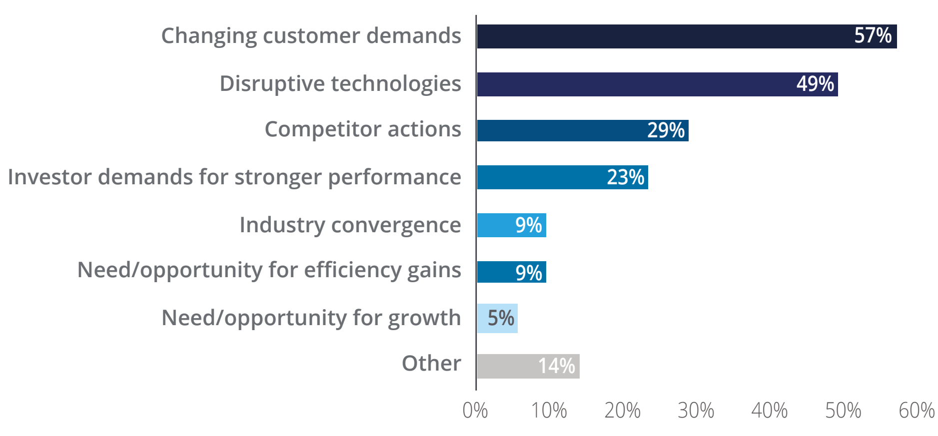
In a transformative acquisition, for example, executives sometimes anchor on assumptions that do not bear fruit after the transaction closes. For instance, Deloitte's recent report on M&A trends found 46% of respondents saying that less than half of their transactions over the past two years have generated the expected value or return on investment.[1] Underlying reasons might include miscalculating the value of the target company or the size of its legal risk and future liabilities. Underestimating the difficulties of integrating cultures and organizations is another often-cited reason for failed mergers and acquisitions. Whatever the reason for falling short of expectations, a transaction could swing from being value accretive to value destructive.

How can you as CFO mitigate against making poor choices? Begin by revisiting the assumptions underlying your company's transformation ambition. For example, they may relate to customers, current and future. Indeed, according to Deloitte's Q1 2020 North American *CFO Signals*™ survey, nearly 60% of CFOs overall reported changing customer demands as a top-two transformation driver. This driver was common for most types of transformation—especially business strategy/model shifts (60% prevalence), growth/integration efforts (40%), process improvement, and technology/systems transformations (both at 38%). See Figure 1.

Figure 1: Drivers of business transformation

What are the primary drivers of the transformation?

Percent of CFOs selecting each driver in their top two (N=128)



Source: *CFO Signals*, Q1 2020, CFO Program, Deloitte LLP; data collected 2/10/20 to 2/21/20

It's also necessary to revisit any assumptions about the markets, the process of transformation, vitally important suppliers (made ever more apparent during the COVID-19 pandemic), and other factors. Consider a worst-case scenario, and adjust assumptions accordingly. The coronavirus pandemic and its impact on economies around the world serves as a reminder of how off-target assumptions can be. In addition, revisiting and challenging assumptions can help you structure your transformation journey in stages, using each phase to gather more information to resolve uncertainties and confirm assumptions before deciding to expend precious resources. The exercise also can help you frame responses to adverse events and fortify resiliency.

2. Resource risks

Transformations require resources: capital, time, talent, as well as data and systems. Deficiencies in any of those areas can impede success.

Capital

A key constraint for many transformation initiatives is a transformation budget that is either inadequate or lacks optionality and adaptability. Funding shortages for the transformation can lead to stress, a diminished degree of change delivered, and dashed stakeholder expectations. It is critical for budgets and expectations to be aligned at the outset to avoid efforts that otherwise could fail because they run out of money. In the increasingly digital world, the typical capital allocation process can stifle a transformation. CFOs may need to consider funding a transformation differently, for example, structuring a separate fund with more flexibility in terms of reviews and measurement.

> "With new technology platforms, ROI can be a little tougher to measure than, for example, a new store. And so, we've had to think through how we allocate capital differently for technology and measure the outcome."
>
> — CFO, Retail industry

Time and workloads

Transformations require time and focus to accommodate increased workloads. One of the most common concerns we hear from executives is that the additional demands on their staff can hinder transformation. Those driving or executing a transformation often have little or no excess capacity and time to undertake another project. Transformations are especially likely to be understaffed when companies are going through a challenging time and when staff cuts have already expanded individual workloads. Thus, it is important to determine what work can be stopped to free up time to execute the various facets of the transformation.

To get and keep key stakeholders' buy-in, it's also important to ensure that new work demands resulting from a change—in a process, system, or other area—are offset by tangible benefits. A process-stakeholder analysis can help diagnose how changes or new processes could impact the work requirements of different stakeholders. Creativity and empathy, especially in difficult times, can also help attract support.

For a transformation to succeed, you may require sponsorship from the top, other senior managers, and possibly the board of directors, to reprioritize others' workloads to move the transformation forward.

Data and systems

Transformations require supporting data and systems to generate information and glean insights. Yet, in our CFO Transition Labs™, we find these areas to be a critical constraint to change in many organizations. Core legacy systems may not be able to provide timely and accurate information and analysis for business decision-making. In cases where organizations have grown inorganically through acquisitions, critical systems and data sets may not be seamlessly integrated to give comprehensive real-time insights on key business issues. Thus, core data and IT infrastructure often must be improved before process and operational changes can be delivered, potentially leading to delays and additional costs. Sometimes we hear from executives that they have to drive a transformation in their IT systems before they can drive the full business model transformation they need.

Talent

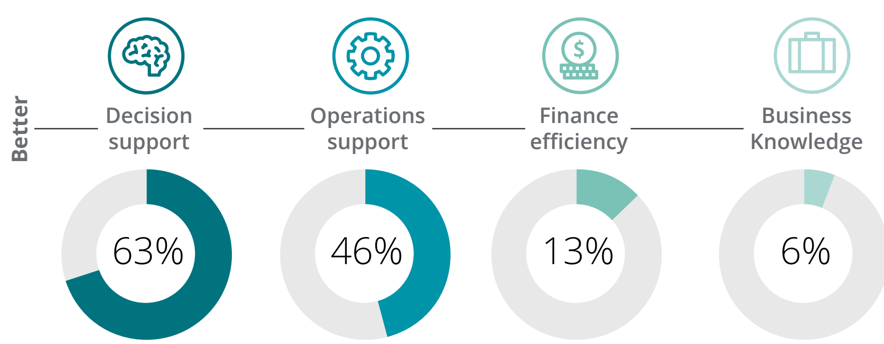
A critical resource for successful transformation is having people with the knowledge, experience, capabilities, and attributes to execute and sustain the many embedded initiatives. To staff a transformation effectively, leaders should consider rotating in high performers and delegating their work to others. In our Q1 2020 *CFO Signals* survey, CFOs were most likely to say their finance teams would need to provide new and/or expanded decision support and stronger operational support in light of their companies' most important enterprise transformations. Meeting these demands is not easy. Imagine that you want to implement a data-mining and analytics capability, but your existing staff has limited analytics skills. Hiring individuals with the skills you seek can be a solution, but recruiting specialized high-quality talent can take as long as a year and require a budget. To make headcount available for new hires, you may have to let people go, which can add to delays.

Leadership talent is especially critical for transformations. Are the people you select to lead projects able to energize others, gain buy-in from critical stakeholders, and communicate progress? Are they able to break projects down into parts and

> "CFO candidates distinguish themselves now by a demonstrated ability to lead—not just support—growth and transformation efforts through the successful implementation of digital solutions throughout the enterprise."
>
> — Clem Johnson, managing director, Crist|Kolder Associates

Figure 2: Implications for finance of business transformation

Deloitte's Q1 2020 CFO Signals *survey found that 63% of CFOs said their finance teams need to provide new/expanded decision support services, specifically calling out better decision speed and quality, stronger data science/analytics expertise, and more predictive/forecasting assistance. Forty-six percent said their finance teams need to provide new/expanded operational support, with particularly high mentions of assistance with establishing and monitoring key metrics. CFOs also specifically called out the need for more ROI analysis and management, automation/robotics expertise, and digital business understanding, particularly for people/organization transformation efforts and business strategy/model shifts.*



Source: *CFO Signals*, Q1 2020, CFO Program, Deloitte LLP; data collected 2/10/20 to 2/21/20

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— Mark Buthman, retired CFO, Kimberly-Clark Corporation

bring them together again? Are they able to create the right level of urgency to get participants to move the project forward without going too fast or making errors, or do they progress too slowly and miss deadlines? Do they have the right level of authority to make key change decisions?

As Mark Buthman, retired CFO, Kimberly-Clark Corporation observed, "It always comes back to leadership, whether leaders can do it, and whether they have commitment from others to get through the tough challenges of a transformation." The wrong leader implementing a complex change initiative is likely to fail.

3. Leadership commitment and continuity

A related risk is leadership commitment and continuity. After all, transformations are usually multi-year efforts. If key leaders are not fully committed to a transformation, or retire or leave a company, that can set back, delay, or harm transformation efforts. Replacement leaders have to ascend a learning curve and get up to speed quickly. Sometimes there may be differences in leadership styles and approaches that lead to conflicts. All of these factors can contribute to execution risk. Understanding leadership risks ahead of time, and having well-considered succession plans for key transition leadership roles, may help mitigate these risks

4. Third-party and agency risks

Third-party and agency risks generally arise when another party behaves in a manner that conceals or uses information for its advantage at your expense or leverages your prior investments and commitments to renegotiate more favorable terms for itself. In agency or transaction cost economics, these are known as the *adverse selection*, *moral hazard*, and *hold-up risks*. Adverse selection occurs when the seller of a product or service knows that it will not likely perform to your needs and expectations. For example, if you are buying a critical piece of second-hand equipment, you may not be able to determine all the defects in the equipment ahead of time without incurring considerable costs. The seller could effectively sell you a "lemon" that breaks down and creates execution risk.

Conversely, in the moral hazard situation, a seller may commit to deliver certain outcomes, but not deliver to the expected level of quality or output, which can drive up costs of execution and compliance to agreements.

Hold-up risks occur when specific commitments are made that cannot easily be reversed. Assume you build a plant in a location close to the source of a specific input. Once the plant is built, the input provider renegotiates the prices to extract more from the arrangement. These kinds of opportunism risks can add to the threats confronting transformation efforts.

Transformation efforts often require third-party vendor support. Determining ways to monitor relationships and structure contracts and pre-define remedies to adverse selection, moral hazard, and hold-up risks can help to mitigate these risks.

The takeaway

Our research interviews and CFO Transition Lab sessions have helped identify seven major risk categories that can impede transformations. Of course, not all risks to a transformation can be controlled, and not all events can be anticipated, but having a process about what to do in a situation that's unexpected is important. In Part I of this series, we have discussed the following four risks: 1) making the wrong transformation choices; 2) resource risks; 3) leadership commitment and continuity; 4) third-party or agency risks. In Part II, we will focus on 5) ineffective planning and alignment processes; 6) behavioral resistance to change; and 7) black swan and other contextual risks. It is important to note that during a transformation, different risks are likely to be salient at different times. At the outset, it may be more important to make the most informed choices as possible and frame a compelling transformation ambition. Later in the process, it may be more important to focus on cultural and behavioral risks that could hinder sustaining the transformation's long-term success.

End note

1. The state of the deal: M&A trends 2020, Deloitte and Touche LLP.

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