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Measuring Value®
Sustainability - Operational and Regulatory Risk

Sustainability is both a critical and popular topic in the media and at most of the world's top tier business conferences. The discussion of sustainability originally centered around energy and environmental issues, in recognition of the finite supply of critical resources that were being consumed in ever increasing quantities and the measurable impacts on our environment, also increasing markedly in impact. The discussion was directly related to globalisation, specifically the expectations that the very large populations in rapidly developing economies around the world would put pressures on both the input and output side of resource and environmental usage that was, simply put, unsustainable.

The global financial crisis brought into focus a broader range of sustainability issues, first and foremost about the imbalances in global financial flows that were both enormous and increasingly unbalanced.

The broader discussion was deeply entwined with the dynamics of globalisation, in particular the lifestyle and spending behaviors in mature economies and the growth drivers and saving behaviors in emerging economies. In fact, the economic relationship that developed over two decades or so between developed and emerging countries was based on powerful, alluring, and dangerous complementarities.

It is now clear that every major executive function in the modern corporation needs be concerned about sustainability, in particular see beyond short-term goals and challenges into the mid-term and long-term potential for the way they are managing their businesses

In one very good example of the new scope of the sustainability discussion, last year, the World Economic Forum completed work on a sustainability report that focused on consumers of the future. Our thinking in this paper owes a debt to that work.

Operational risks and regulatory risks pose a significant challenge to executives managing global businesses that are undergoing material footprint shifts in their value networks, markets, and investments

Recent events highlight two major features of operational and regulatory risk executives face today. First, they are not simply different in scale but in complexity and kind from previous decades. Secondly, they not only potentially threaten the sustainability of desirable levels of business growth; they potentially threaten the sustainability of the corporation itself.

In this issue of *Measuring Value*, we identify four areas of business transformation that are unavoidably related to expanded operational and regulatory risks. These are the evolving relationship between business and governments, intensifying importance of innovation, new models of investment and business, and new supply chain strategies, what we call "value networks" in our Deloitte discussion.

What do we mean by the evolving relationship between business and governments?

We say "governments" because globalising businesses face different if not opposite issues in their relationships with government at home and government abroad, especially in major emerging markets such as the BRICs. We subscribe to a premise that is widely held in discussions of operational and regulatory risk: business is looking at an era that presents two fundamental changes.

There will be new forms of collaboration and cooperation between business and governments, and these will be increasingly critical to get right

Closely related, national and global consolidation is elevating key competition issues from a corporate level to a national level. We are looking at an era where the sustainability of enterprise growth, national economic growth, national financial service agents, and global financial development are intertwined in new and complex ways. Government support for domestic champions through direct and indirect channels in many high growth sectors, like renewable energy, is one side of the story. Government protection of these sectors from foreign competitors is another.

In almost all aspects of sustainability, government, business, and consumers all have a role

There is a lot of discussion of the new partnership between government and business, but that idea is more comfortable in some economies than in others. Governments participate through investment and through regulations, both essential in key areas such as energy conservation and renewable energy development, or transportation and communication infrastructure.

For multinationals, increased regulatory risk has three drivers in this scenario. Government investment requires resources, potentially increasing the burden on enterprises and employees, and in some economies the increased pressure from tax authorities is already being felt. New regulations, related to standardisation, security, and reliability of new technologies, especially in a time of globalisation and rapid change, can have unintended consequences and create new levels of regulatory risk. Finally, the revenue significance of big infrastructure projects in many sectors makes government procurement and compliance with procurement practice a major issue.

Most importantly, the risks inherent in all three of these drivers can be put to the use of protecting domestic enterprises in certain situations

What is the best thinking on new forms of collaboration and cooperation between business and governments to keep government spending in balance and avoid damage to key enterprises through the creation of unproductive regulatory risk? From the enterprise viewpoint, how can the new waves of regulation be appropriately addressed to avoid unnecessary compliance and non-compliance costs? What are the organisational structures and resources best suited to face rapid regulatory change in familiar markets and at the same time master new regulations and even new approaches to enforcement in unfamiliar ones.

What do we mean when we say innovation is the only way forward?

Every economy faces a long-term need to “dematerialise,” shifting from material and resource intensive consumption to new kinds of consumption that are less so. Innovation in this sense can be as simple as creating a strong brand for on-premise coffee that promises both reliable and consistent product and pleasant venues for informal meetings. It might mean new forms of digital media and entertainment, new technologies and devices that drive value and employment creation with reduced levels of resource consumption.

Historically developed economies tend to create more value in services than emerging economies, which tend to create more value in resource development and manufacturing. That has changed somewhat as the time and cost of global communication has shrunk near to zero and service outsourcing on a global scale has enabled emerging economies to create wealth in pure service export. But it has required innovation to develop outsource models that create sustainable value, to drive improvements in efficiency and productivity faster than costs of talent rise.

Failure to innovate increases operational risks in two ways, because enterprises that do not innovate inevitably suffer margin compression under global competitive pressures

This is evident in all sectors, for example, the commoditised end of consumer electronics. This is true whether companies are manufacturing goods or providing services. In the first instance, innovation is essential to protect premium positioning for brand owners capable of maintaining leads and margins in their market realms.

In the second instance, as margins tighten for those less able to protect premium positioning, operational risks increase as a result of survival driven cost management. Increased operational risks may or may not be in the calculus of cost management measures, but intended or not, they need to be recognised and mitigated.

If intense and sustained cost management programmes are not accompanied by robust innovation to mitigate risks associated with cost management measures, operational risks can get out of hand. Obviously, it is better to find more efficient forms of lighting than turn down the lights to save energy. Interestingly, our surveys with major corporations have found that programmes to increase competitiveness through cost management, coupled with commitments to goals like energy conservation, reveal many examples where innovation achieved both goals.

What do we mean by rethink core business models?

MNCs operate in an increasingly complex value network of suppliers of goods and services and customers for goods and services, as well as regulators, competitors and strategic partners for all sorts of contributions to their overall growth sustainability. The quest for the most efficient, value-creating, and sustainable positioning in the sectors they operate creates new levels of dependency on channels partners, suppliers, and customers. At the same time, brand owners and retailers in their customer facing roles face new levels of reputational risk, given the global reach and lightening speed of Internet and Internet-enabled news distribution, blogging, and social networking.

Consumer perception of corporate behaviour has become an important driver of patronage and consumer loyalty

With the efficiency of global communication channels, things like industrial accidents, toxic chemical spills, uncontrolled emissions, employment problems, and excessive energy consumption can explode into reputational disasters on a global scale. Depending on industry, MNCs increasingly need to take into account their impact on food, water, energy, mineral resources, employment, investment returns, and an entire list of ways in which they impact the economic, social, and physical environments in which they operate.

Consumers and regulators together can react strongly to perceived failures of management, either in short-term disaster events or long-term transformation events. Because global brands face these risks on a global scale, they must be managed on a global scale by organisations that are specifically capable to do so.

Identification of risks related to core business models begins with the initial planning and structure of those models. Not only new products but the entire new product development process, for example, needs to take into consideration full life-cycle costs, including disposal and recycle costs of products, energy intensity in their manufacturing and use, and potential adverse impacts on nature and society from many different angles. Done right, this is not a negative but actually a key driver of competitiveness and growth, what we call "The Profit in Green".

Many best practitioners in rethinking core business models are finding important new reputational value and sustainable value network positioning

They do this by broadening their strategic planning and product planning to encompass such considerations and actively promoting their attention to them.

What do we mean by collaborate throughout the value network?

Globalisation drives specialisation, a result of scale and the need to sustain high levels of productivity gain. Value networks are evolving, and successful MNCs identify where in the overall network the most value is created and revenue captured. Some of the world's fastest growing companies achieve growth at historically high rates with historically low commitments of capital for fixed assets and operations through well-planned value network management.

Technology companies that entirely outsource their manufacturing exemplify this trend. They leave manufacturing to a manufacturing specialist, a fab factory or EMS. They focus on design and marketing, brand development, channel management, strategic alliances, intellectual property value, and provision of value-added services. In other industries like automotive, this trend is only now emerging. With more value placed on externalities, a change from a build, buy, bury mentality is inevitable. There will be no "going back to normal" as the relationship between product, service and consumer irreversibly evolves.

Along with the potential for growth uncoupled from high levels of capital investment, the increased diversity and complexity of value chain networks creates new regulatory and operational risks

We have seen examples where environmental and labour compliance issues arose in an outsource manufacturer but impacted seriously the reputation and revenue of brand owners using that manufacturer. We have seen product safety issues arise, contaminated foods and drugs, contaminated toys, and the like, where brand owners and retailers incurred liability for upstream failures difficult to control.

We have seen disputes over liability arise between cooperating parties involved in major operational accidents. Outsourcing steps in the manufacturing or service value chain does not outsource the risk of a regulatory or operational problem. While the location of liability in something like the construction and operation of an oil rig might be spelled out with clarity contractually, in practice it might be anything but clear.

With practice and experience, in every sector undergoing value network transformation, the anticipation and containment of these kinds of operational and regulatory risks are improving.

But change is rapid, and large MNCs are challenged not only to keep up with best practices, but they are challenged even more to learn to anticipate the unexpected

New forms of collaboration that support growth, such as open sourcing, will be required with supply chain partners and consumers and will continue to develop. With them, new forms of risks will emerge.

What does the future look like?

We believe that unprecedented opportunities await well-managed MNCs as the global economy rebalances and grows, as the impact of business on the earth physically and impact on people around the world become an increasing focus of everyone, and as major economies become more interdependent with enhanced communication and transportation technologies.

But executives will be challenged to reach beyond incremental improvements in the way they envision the future, develop strategies, and invest resources. Winners will be companies that find the breakthrough strategies, strategies that weave together all the elements required to sustain growth while managing the kinds of regulatory and operational risks inherent in the growth opportunities of the decade we are entering.

Executives who grasp the importance of these changes and develop powerful strategies to adapt have the opportunity to lead their companies to unprecedented levels of scale and value creation

But as recent events have taught us, they also face unprecedented levels of operational and regulatory risk. And as the world turns, the inconvenient reality is that even the public perception of something like “foreign origin” can lead to a disproportionately damaging public overreaction, not to mention regulator overreaction, to a recall or spill or labour incident in a major market like the USA or China.

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As early as 1917, we opened an office in Shanghai. Backed by our global network, we deliver a full range of audit, tax, consulting and financial advisory services to national, multinational and growth enterprise clients in China.

We have considerable experience in China and have been a significant contributor to the development of China's accounting standards, taxation system and local professional accountants. We also provide services to around one-third of all companies listed on the Stock Exchange of Hong Kong.

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