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Governance and control: Focus risk management on multiple levers of control

Author: Jeremy Hope, Beyond Budgeting Roundtable

Information Management

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Enron. Tyco. WorldCom. Vivendi. Parmalat. Mention any one of them and the response you get is rolling eyes and shaking heads. So what happened? Though you could point to any number of things, excessive risk-taking driven by overly aggressive targets (and accompanying incentives) does seem to have opened the door for unethical behavior, infomanipulation, dishonest reporting, and so on—made even worse by ineffective governance and control mechanisms. Consequent legislated corporate and management accountability standards shouldn't surprise anyone. As you'll see in Jeremy Hope's article below, though the issues are complex, there are a number of common-sense starting points for resolving them.

In this series of six articles, Jeremy Hope explains how organizations use innovative practices to create sustainable improvement in financial and operational performance. The finance teams in the companies highlighted have eliminated many of the barriers preventing the transition from business-as-usual to create—as Jeremy says—a more adaptive, lean, and ethical organization. By grabbing on to new ways of doing business and replacing (not just supplementing) outdated practices and solutions, finance can drive enhanced productivity, performance, and profitability.

Jeremy Hope, Research Director of the Beyond Budgeting Roundtable, is an advisor to the IBM Cognos® Innovation Center for Performance Management. He is also a tireless champion for innovation in performance management theory and practice, believing that business-as-usual is NOT a route to success.

In this sixth and final article in our current series, Jeremy shows how CFOs can set the bar (and the example) for ethical behavior, transparency, information access, risk management, and strategic controls.

Jeff Holker
Associate Vice President
IBM Cognos Innovation Center for Performance Management

Introduction

Most CFOs have been trained in the disciplines of "internal control," which were usually concerned with setting clear authority levels, ensuring correctly managed financial processes, and meeting audit best practices. But this whole subject has exploded onto the corporate agenda in the wake of high-profile governance scandals and the ensuing Sarbanes-Oxley legislation. New descriptive terms have come to the fore including "risk management," "uncertainty management," and – more recently – "enterprise risk management." The knowledge and expertise required of CFOs has expanded dramatically. They are now expected to also be chief compliance- and risk officers rolled into one.

The escalation of risk management up the CFO's agenda has been caused by a wave of corporate governance scandals that started with Enron, WorldCom and Tyco in America, devastated Arthur Andersen, and spread around the world to damage a range of companies from Parmalat in Italy and HIH in Australia to Vivendi in France and Marconi in the UK. It has severely damaged investor confidence, often leaving the CFO's (and the CEO's) reputation in shreds.

These problems have driven governments and regulators around the world to act. The best known example is the Sarbanes-Oxley (SOX) legislation in the USA. SOX has three principal sections that affect internal governance and control:

S302 – Certifying company accounts. CEOs and CFOs must personally certify quarterly and annual financial statements and take responsibility for their accuracy.

S404 – Reporting on internal controls for financial reporting. Companies must state the responsibility of management for establishing and maintaining internal control structures and financial reporting procedure along with an assessment of their effectiveness, which must be accompanied by an external audit report.

S409 – Real-time disclosure. Directors must disclose any material changes in their financial conditions or operations on a "rapid and current basis" (within two working days). Examples include the termination of a customer relationship that constituted a specified amount of revenues; a change in a rating agency's assessment; and modifications to employee benefit, retirement, and stock ownership plans.

These are tough and expensive requirements for organizations to comply with. They focus the spotlight on internal systems, many of which have been found wanting. Most organizations however, have followed the "letter"" rather than the "spirit" of the law. In other words, they have approached the problems from a procedural (or check-box) perspective rather than a management (or cultural) perspective. But the primary problems are not concerned with audit trails, but rather with the causes of excessive risk-taking, malpractice, and greed. The root cause is invariably the setting of aggressive targets, financial incentives, and stock options throughout the organization, which breeds a culture of macho-management and self-interest, and blocks openness and information- sharing.

There is also the question of how organizations deal with uncertainty. Senior managers often demand certainty when discussing investment options, and are unwilling to listen to the myriad caveats that ethical managers would offer if they were encouraged to recognize the uncertainties inherent in their proposals. Most managers are too optimistic, and are easily drawn into justifying their proposals rather than frankly discussing upside- and downside risks. CFOs need to encourage managers to keep open minds about the possible outcomes of their decisionmaking.

This paper will suggest that CFOs should set the highest standards of ethical reporting and behavior, regularly review the key pressure points for excessive risk taking, provide a framework of effective strategic controls, and provide effective feedback controls.

Set the highest ethical standards for reporting and behavior

In 2003, a research team from the International Federation of Accountants (IFAC) looked at 27 companies across the world. They covered a wide range of industries including telecoms, retailing, financial services, energy, and manufacturing from a corporate governance perspective. 16 companies were classed as failures and 11 were deemed successes. The 16 failures included Ahold (Holland), Cable & Wireless (UK), Enron (USA), France Telecom (France), HIH (Australia), Livent Inc (Canada), Marconi (UK), Marks & Spencer (UK), Nortel Networks (Canada), Peregrine Investments (Hong Kong), Saskatchewan Wheat Pool (Canada), D. Tripcovich (Italy), Vivendi (France), WorldCom (USA), Xerox (USA), and YBM Magnex (Canada). The IFAC report concluded that these were the most common problems:

- Poor ethical standards at the top
- Aggressive targets and earnings management
- Misaligned incentives
- A CEO too dominant and charismatic
- Weak board of directors (too cozy with CEO)
- Weak internal controls (e.g., poor resource management)
- A CFO too involved in aggressive merger and acquisitions (M&A) strategies
- Poor choice of strategy and lack of clarity
- Poor execution (especially unsuccessful mergers and acquisitions)
- Failure to respond to change quickly enough

The real worry is that these difficulties are more prevalent than many of us realize. The pressure to hit the numbers at every level of the organization is causing people to compromise professional ethics in order, in some cases, to keep their jobs. Despite a forest of mission and value statements, it is what leaders *do*, not what they *say* that sets moral and ethical standards throughout the organization.

Be uncompromising about ethical reporting

Few finance executives have much confidence in the numbers that most public companies produce. According to a 2004 survey, only 27 percent of executives surveyed said that if they were investing their own money they would feel "very confident" about the quality and completeness of information about public companies.[1] A 2004 analysis of financial filings by more than 120 companies—representing close to 40 percent of the S&P 500 market capitalization—revealed that obfuscation in financial reports remains pervasive in corporate America (approximately one-third of companies filing statements do not truly represent their financial position). Among the alarming trends are off-balance-sheet financing (used by 75 percent of companies), unrealistic pension assumptions (64 percent), and aggressive revenue recognition (28 percent).[2]

Many accountants see the "sexing up" of accounts as a perfectly legitimate practice (provided they stay within some defensible interpretation of generally accepted accounting principles). Indeed, it is one of their most prized skills. As most experienced accountants are aware, you can make profit statements and balance sheets sing and dance to different tunes at different times, depending on your purposes. The effects of fudging, manipulating, and spinning the numbers, like an addictive drug, can give managers a temporary fix (they can even be convinced that they change reality), but the problems quickly return as the next reporting period comes around.

Aggressive performance contracts reinforced by financial incentives are probably the number-one cause of over zealous risk-taking and unethical financial reporting in organizations today. One accounting professor described the Fannie Mae debacle as, "the kind of thing that shakes your confidence in financial statements."[3] The lesson is that setting unrealistic earnings targets and then resorting to every conceivable means (fair or foul) to meet them is likely to end in tears, as it has for thousands of shareholders and employees in companies destroyed by such actions.

Provide an independent internal audit function reporting to the board

Sarbanes-Oxley 404 has encouraged organizations to compare their internal controls against a model. The most popular model is "COSO" which stands for the "Committee of Sponsoring Organizations" of the Treadway Commission. This committee, established in 1997, included the principal accounting institutes in America. It has enabled internal audit teams to look beyond subjective judgments about internal control systems. Instead, they can now compare controls with a model and check whether they comply, which has simplified the task of the internal audit group. However, these controls focus primarily on bookkeeping rather than risk management in its wider context.

Sarbanes-Oxley has also given the audit committee more teeth. As Professor Charles Elson has noted: "Whereas the CFO and the audit committee of the board once worked together collegially, it has now become an oversight relationship, with power moving to the audit committee."[4] The board is also responsible not only for setting up systems of internal control that adequately address the risks facing the organization, but also for establishing a professional, wellresourced internal audit function. The problem is that as finance and internal control departments have been subject to relentless benchmarking, they have cut costs and valuable resources. The accounting profession has indeed observed a substantial increase in control failures in recent years as firms downsize and cut out many previous checks and balances.[5]

However, in leading-edge organizations, the internal audit function doesn't drive the risk management agenda: It is driven by the executive management agenda. In other words, managers focus on *managing uncertainty first* and complying with rules second. Internal audit supports this role, but also audits what managers do. It is both proactive and reactive. In its proactive role, it will examine important forecasts, material risk exposure, and insurance cover. It will comment on plans and decisions. It is part of the management team rather than a detached inspectorate. That is not to say its views are compromised; it remains an independent force inside the organization reporting directly to the board.

Regularly review the key pressure points for excessive risk-taking

Many CFOs are re-thinking their own control systems and risk management policies and practices. But just making a list of risks and writing controls against each one is not the right way forward. The risk profile of any business is constantly changing, and managers must use all their knowledge and skill to keep on top of things. However, there are a number of pressure points in most organizations that provide fertile ground for risk assessment.

Be wary of aggressive targets and incentives

Aggressive targets often go hand-in-hand with huge financial rewards. These are likely to increase the pressure to take short-term risks. In other words, as the rewards for entrepreneurial behavior rise, so do the risks. Derivatives traders on huge bonuses, for example, are more likely to take excessive risks. Ex-CEO of Worldcom, Bernie Ebbers, borrowed hundreds of millions of dollars to support his personal share purchases in the company's stock. But when the company's performance went into to rapid decline, Ebbers went into denial. He and his CFO lieutenant put pressure on the finance team to cook the books so the company could show that it was meeting its targets, which in turn ensured that the share price was protected. But time eventually ran out.

The link between incentives and performance is tenuous at best and misleading at worst. In 2002, CEO total annual compensation (salary plus bonus) rose by 10 percent, while total return as measured by the S&P 500 fell by 24 percent. In the same year, CFO bonuses rose by 17.5 percent.[6] Over the past decade, according to Charles Handy, "[I]ncentives ended up consuming all the extra wealth they were supposed to generate."[7] One study undertaken by McKinsey & Co suggests that there is an inverse correlation between top executives' pay and corporate innovation. They suggest that "[T]he secret of persuading people to focus simultaneously on developing new businesses and managing current operations may be to rely less on pay for performance."[8] Another study—in the American baseball leagues—suggests that the greater the difference between the pay of the stars and that of the rest of the team, the less impressive the performance of the stars and the team as a whole.[9]

Well-governed organizations have either neutralized or abandoned the fixed performance contract with its emphasis on meeting numbers. Instead they have moved to a performance measurement system based on fair and consistent criteria featuring relative measures. So there is no "number" to meet. Managers don't know how well they've done until they see the results of their peers. They have no option but simply to do their best right up to the end of the period.

Be wary of a culture of resisting bad news

Another problem is resistance to bad news. In some organizations, bad news is not disclosed quickly. Managers prefer to deal with the problem at a local level and try to turn the problem around. The problem compounds itself the longer it takes to react as response options begin to fade and profit impacts worsen. If managers can see the early warning signals (e.g. market downturn, competitor actions, customer dissatisfaction) and act quickly upon them, then the chances are that they can maximize opportunities and avoid emerging threats. The benefits to the bottom line are incalculable.

Well-governed organizations assimilate bad news quickly and deal with it as a team. By doing this, local managers are not afraid of building the results of such bad news into their forecasts—the sting having already been taken out of them. Bill Gates offers some good advice: "A change in corporate attitude, encouraging and listening to bad news, has to come from the top. The CEO and the other senior executives have to insist on getting bad news, and they have to create an appetite for bad news throughout their organizations. The bearer of bad tidings should be rewarded, not punished. Business leaders have to want to listen to alerts from salespeople, product developers, and customers. You can't just turn off the alarm and go back to sleep. Not if you want your company to survive."[10]

Handelsbanken managers share bad news immediately. For example, if one branch loses a customer, they need to either try to rectify the situation and seek help from those having relevant knowledge, or they need to replace the lost business, in which case they might solicit the help of regional managers.

Be wary of a 'silo' mentality toward information management

Many leaders believe that information should only reach those people authorized to see it. But each person's interpretation is different, and by restricting information dissemination in this way we are denying the organization the richness of differing views. Also, the checks and balances inherent in transparent information systems would be lost. It is doubtful that the Enron debacle could have happened with truly transparent information systems.

Well-governed organizations know that a small percentage of people in every organization will abuse freedom of information (some will abuse any system), but they judge that the risk of abuse is worth taking, realizing that the benefit of universal access to information whenever it's needed far outweighs any downside risks. Trust is the key issue. [Strict conformance with the plan assumes an absence of trust.] Effective leaders take an optimistic view of human nature. They set rules for trust, but are absolutely ruthless if the rules are violated.

Organizations like Handelsbanken, Southwest Airlines, and Ahlsell have promoted information flows to new levels of openness and transparency. They have given their people access to the sort of strategic, competitive, and market-based information that was once the preserve of senior executives. And they have understood that all the numbers within the organization should stick to "one truth."

Provide a framework of strategic controls

As CFOs grapple with one unpredictable event after another, they are reminded that business threats can come from anywhere at any time. These include not only terrorist acts or financial disasters, but also strategic risks such as the emergence of a new competitor, a new technology, or a failure to predict marketplace shifts. But many of the major threats are rarely measured or monitored.

To manage risk, most CFOs realize that they need a more comprehensive system for doing so. Such efforts have variously been called "strategic controls" or more recently, "enterprise risk management" (ERM), which involve uniform mapping all of a company's risks and applying a cross-functional approach to managing them.

ERM represents a shift from managing risk in functional "silos" to managing risk consistently across the organization. This gives senior management a better view of risks, and enables a portfolio approach. The more unified a risk-management process is across the company, the more satisfied CFOs are with it. Likewise, the more closely risk management is tied to the strategic planning process, the more effective CFOs believe it is.

Some finance executives believe risk management can create competitive advantage in several ways. First, a company that can manage its industry's key risks better than its peers is in a stronger position to make or sustain a superior profit over time. Second, an ERM system helps CEOs and CFOs evaluate project risks more thoroughly. Understanding the company's overall risk level and knowing how much aggregate risk it can bear makes it easier to recognize investments that fit the corporate risk profile. Without this knowledge, executives may not take a chance on innovation. Third, integrating risk management and planning can help to identify projects that reduce the company's overall risk and thereby improve its performance.

There is also an increasing realization that the most effective control systems by far are those that prevent poor decision-making. That is why, increasingly, many organizations are using strategic controls to hold managers accountable for their performance. This means agreeing with managers what their strategic goals are, and then engaging in a continuous process of challenging plans and actions geared to achieving them.

Some organizations have a culture of suppressing uncertainty in decision-making. Sometimes it is done unwittingly, other times it is done knowingly. Either way, it is hard to detect, because it usually happens in private. Most managers believe, for example, that "selling" project ideas is a skill, and they cultivate it even to the point of distorting the truth. Another problem is that some managers will do anything to avoid taking responsibility for risks that are difficult to assess. The temptation is to ignore risk rather than deal with it explicitly.

Provide effective feedback controls

A thermostat is a negative feedback control loop. You simply set the temperature you want and the device compares the actual temperature with the target to decide on an action to reduce the difference. Many so-called smart software systems work this way. They set predetermined parameters that, if exceeded, will sound alarm bells in the system. Alarms can be transmitted instantly to managers through email alerts, pagers, and mobile phones. In this view of control, all managers need to do is set clear targets, fix them for a period of time, and tell employees to keep on track. Negative feedback control loops have been used as a way of managing uncertainty for decades, but they can have undesirable outcomes if the future is unpredictable. That's why some leading-edge organizations use a range of feedback controls, including fast results (compared with prior periods or peer groups), key performance indicators, and near-term forecasts.

Produce fast financial results

Actual financial results tend to be summarized and shown as trends and moving averages. They are also compared with prior periods. The analysis and presentation of financial information needs to be fast and relevant. The objective is to have a real-time, perpetually up-to-date accounting system. Restricting accounting data to relevant (usually high-level) figures, along with the absence of budgets and variance analyses, lightens the reporting load. Many organizations now produce results on-line, putting their managers in control of what's happening right now. This enables swift response to any abnormalities or spikes in the trends.

Use a few key metrics

Key metrics provide two levers of control. One is based on performance today or this week. These key performance indicators (KPIs) represent the management radar screen. They provide the early warning signals that something might be going awry. They should be few in number and appropriate to the management level having access to them. Taken together, they provide a performance picture that tells managers what is happening now and likely to happen in the near future. Some organizations use measurement ranges to keep managers within agreed performance bands rather than fixed targets and budgets. They don't need huge amounts of detail that only confuse key issues.

Use near-term forecasts

Near-term (usually rolling) forecasting is another control system that provides a fast, high-level view of likely future performance. But there is often a huge gap between the rhetoric and the reality when it comes to forecasting, because there is often great pressure on managers to "tell bosses what they want to hear" and "justify" their conclusions with "the numbers." Most organizations prepare forecasts on the basis of single-point estimates of future outcomes, and usually simple extrapolations of existing trends. The problem is that executives often demand "a number." This implies certainty in the forecast and invariably ends up being an average of past periods. The trouble is that averages are usually wrong. And averages added to averages are even more wrong, especially if other assumptions are dependent on them.

One CFO explains how his company has become more responsive to emerging issues: "By the third week of January 2005, we have forecasts for the first quarter. So if there are any areas where we see a weakness, we have a dialogue with those businesses about how we can address that weakness. Under the old system, we wouldn't have got to that point until the middle of February, so we're three weeks ahead of the game. We have fortnightly management calls around the group based on current forecasts. The benefits are tangible. All the business teams are now focused on delivering their strategy and dealing with threats and opportunities as they arise. It has made us a much more dynamic organization."

Despite all the money spent on updating internal control systems over recent years, there are still many ways to cheat systems if people are determined enough. The ultimate shield against excessive risktaking and poor decision-making is cultural: setting the highest performance and ethical standards and abandoning the worst aspects of the fixed performance contract. It also means looking at the whole picture, and not just focusing on a few problems.

About the author

Jeremy Hope is research director with the Beyond Budgeting Roundtable, a members-based consortium of organizations dedicated to finding better ways to manage performance. He has co-authored three books – *Transforming the Bottom Line* (1995) and *Competing in the Third Wave* (1997) with Tony Hope and *Beyond Budgeting* (2003) with Robin Fraser – all published by Harvard Business School Press. His latest book *Reinventing the CFO* will also be published by Harvard Business School Press in late 2005. He is also an advisor to the IBM Cognos Innovation Center for Performance Management.

About the BBRT

The Beyond Budgeting Roundtable is an independent international research collaborative that supports a global network of BBRT regions and members that share knowledge for mutual benefit, and searches for ways to build lean, adaptive, and ethical organizations. The BBRT is dedicated to helping organizations improve bottom-line performance by introducing simple adaptive control principles and continuous planning techniques.

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3755 Riverside Drive
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Endnotes

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