Enterprise Governance – A CIMA discussion paper

Enterprise Governance is an emerging term that CIMA and others use to describe a framework that covers both the corporate governance and the business management aspects of the organisation. Achieving a panacea of good corporate governance that is linked strategically with performance metrics will enable companies to focus all their energies on the key drivers that move their business forward. However, this is a huge challenge as well as a huge opportunity.

Much work has been carried out recently on corporate governance[1]. But the performance aspects of governance have not received so much attention. Enterprise governance considers the whole picture to ensure that strategic goals are aligned and good management is achieved.

What is enterprise governance?

Research has revealed a number of possible definitions of enterprise governance. These include:

- A definition based on the type of organisation. ‘Enterprise governance’ is used to reflect the fact that the concept of governance does not just apply to large listed companies, but also to state-owned enterprises. This usage is common in academic literature.

- A definition based on the boundaries of the organisation. This definition is based on the idea that with strategic alliances, joint ventures etc, the single-company view of corporate governance is too narrow.

- A definition that expands the definition of stakeholders beyond shareholders to others, e.g. employees, society etc. However, the 1999 OECD definition of corporate governance, which is widely quoted and accepted, allows for a range of stakeholders (OECD, 1999).

- A definition that was developed by the Information Systems Audit and Control Foundation and defines enterprise governance as “the set of responsibilities and practices exercised by the board and executive management with the goal of providing strategic direction, ensuring that objectives are achieved, ascertaining that risks are managed appropriately and verifying that the organisation’s resources are used responsibly” (quoted in Stacey Hamaker, 2003). This is the definition that CIMA is basing its work on.

This holistic definition has several benefits:

- It reflects the dual role of the Board of Directors in both monitoring and strategy, and acknowledges the inherent short and long term tensions between governance and value creation.

- It emphasises the role of the executive management team.

- It covers the internal workings of the organisation as well as the outward facing aspects.

- It may help to demonstrate the importance of the different emphases of the roles of the chairman and CEO - and therefore why they need to be split.

- It helps to illustrate the role of the accountant.

- It can demonstrate the importance of substance over form.

- It can accommodate the different governance models across the world.

[1] Examples include the Sarbanes-Oxley Act in the US, the Higgs and Smith Reports in the UK and the Winter Report in Europe.

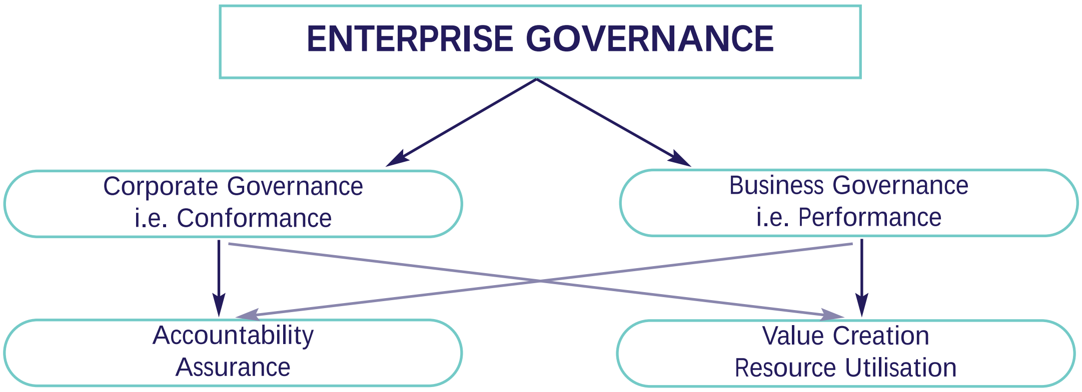

Figure 1: The Enterprise Governance Framework

Figure 1, above, illustrates the reach of enterprise governance – it constitutes the entire accountability framework of an organisation. There are two dimensions of enterprise governance – conformance and performance. In general, the conformance dimension takes an historic view while the performance view is forward-looking.

The diagram is similar to the one that illustrates the domain of the finance function in a recent comprehensive study on competencies (FMAC, 2002). The lines show that, although conformance feeds directly to accountability and performance to value creation, conformance can also feed to value creation while performance can feed to assurance.

The conformance dimension sits on the left hand side of the illustration which seems highly appropriate given that this is the side of the brain that governs our logical, orderly and analytical functions while right brain thinking tends to be intuitive, holistic and creative!

The conformance dimension

The conformance dimension of enterprise governance has had significant coverage in recent years and, in particular, in the last 12 months following the various corporate scandals.

It is what is normally understood by "corporate governance" and covers issues such as:

- the roles of the chairman and CEO
- the board of directors, e.g. composition, non executive directors, training etc
- board committees, e.g. audit, remuneration and nominations committees
- risk management and internal audit.

It is well covered in the literature and there will continue to be developments in this area. Codes and/or standards can generally address this dimension with compliance being subject to assurance/audit.

Within the conformance dimension, the role of the professional accountant in business is that of control to ensure accountability and of internal audit to provide assurance that the controls are effective.

The primary role of the external auditors is to give an independent opinion on the truth and fairness of the financial statements of the enterprise. Depending on the jurisdiction in which the enterprise is based, they may also be required to give an independent opinion on the enterprise's compliance with certain requirements of the law and regulations. In fulfilling their role, the external auditors will work closely with those charged with the governance of the enterprise; in particular with the audit committee, where one exists.

There are also well established oversight mechanisms for the Board to ensure that good corporate governance processes are effective e.g. committees mainly or wholly composed of independent (non-executive) directors and, in particular, the Audit Committee. Other similar mechanisms are in place in countries where a separate Audit Committee does not exist.

The performance dimension

In contrast, the performance dimension does not lend itself as easily to a regime of standards and audit. Instead, it is desirable to develop a range of best practice tools and techniques that need to be applied intelligently to different types of organisation. These tools and techniques are very much the domain of the professional accountant in business.

The focus here is on helping the board to make strategic decisions, understand its appetite for risk and its key drivers of performance. Implementation of strategy and its ongoing relevance and success must then be assessed on a regular basis. This has been the focus of a CIMA Round Table on Strategic Enterprise Management[2].

Unlike the conformance dimension and its audit committee, there are few companies which have a strategy committee and where this does not exist, there is no oversight committee that can oversee strategy independently e.g. by reviewing the strategy development and implementation process, challenging the information provided, assessing which are the key business drivers etc.

There are a range of tools and techniques e.g. scorecards, continuous improvement, strategic enterprise systems, which can help boards to focus on strategic direction and its implications for all areas of the business, but these are not often dealt with as a coherent whole by the board.

One of the proposals of the Enterprise Governance project is to address this "oversight gap" by developing a "strategic scorecard" for the board to ensure that good governance applies equally to the performance aspects of the business. This should be forward looking and reflect the issues that are truly critical to company success. The scorecard should embrace the strategic objectives of the enterprise, the value drivers, the milestones, the timing of intended achievements and the risks that need to be managed.

The quality of information underpinning such a scorecard is fundamental in terms of integrity and relevance but also in terms of being neutral and even handed. This same information, albeit in summarised form, also serves investors through channels of communication such as the Operating and Financial Review (OFR) and Management's Discussion and Analysis of Financial Condition and Results of Operations (MD&A) - which have to be devoid of 'spin'.

Ensuring the quality of information is the domain of the finance function and the professional accountant in business, abiding by a code of ethics. In addition, in public interest companies, which are in the "public eye" on account of type of stakeholder, size or the nature of the product or service provided (e.g. listed companies, public sector organisations, credit institutions, insurance companies and large charitable organisations and trusts), the quality of information would typically be subject to assurance from an independent internal audit or business assurance audit function. The aim is to give the Board comfort that it is seeing a true and fair reflection of strategic progress and strategic options. With regard to external disclosure, the process of preparation of, and/or the information itself, will also be subject to review/audit by the external auditors.

Why is Enterprise Governance important?

We need to have a better understanding of what goes wrong in companies and what must be done to get things right.

Following recent scandals e.g. Enron, Worldcom etc, the emphasis has been on "traditional" corporate governance issues – what we have termed the conformance dimension. Recent problems have led to demands for greater transparency and board oversight to protect shareholders against improper and even fraudulent management (B Burwell and MC Mankins, Marakon Associates, 2002).

It is critical to consider such issues – after all, the aforementioned US failures were failures of control and ethics.

However, it is also important to adopt an integrated approach and not over-emphasise control – recent UK corporate problems such as those at Marconi have typically been strategic failures. As Burwell and Mankins have argued, "overlooking management improprieties is not the only way boards have let down shareholders in recent years". They cite a number of examples e.g. Ford, Kmart, Vivendi and Nortel where boards have failed to steer management away from decisions that damaged long-term shareholder value.

[2] See www.cimasem.com.

They distinguish between the internal and external aspects of corporate governance where the external dimension focuses on the board while the internal dimension focuses on the role of the CEO and executive management team and their relationship with the rest of the organisation in driving value growth (ibid.)

This view is consistent with the framework of Enterprise Governance. Companies need to be successful in creating value. As concluded in a recent Economist Intelligence Unit survey, "regulations are only part of the answer to corporate governance" (Economist Intelligence Unit, 2002). Substance has to matter more than form. This is not just about ensuring that the board works well, but that the company's strategy is the right one and is implemented well. Superior performance will not arise from making the right decisions about the wrong issues.

The Economist Intelligence Unit (EIU) surveyed 115 international executives in July 2002 in the light of Enron. One of the questions posed was "which of the following pose the greatest threat to the share price of your organisation?". The greatest threats were perceived as market risk (downturns), reputational risk, shortage of top-quality management talent and a failure to innovate (ibid).

Ernst & Young recently published a study (Ernst & Young, 2002) which analysed the major positive and negative shifts in the share price of the Global 1000 businesses over the five year period up to August 2001. After adjusting for market and sector movements, the study concluded that two thirds of all radical share price movements – up or down – are a direct consequence of strategic issues. Financial and operational risks account for only one third between them.

In this context, it is worth noting that the critical assurance role of an independent internal audit function features in the dimensions of both conformance and performance with an objective to evaluate and improve the effectiveness of the risk management, control and governance processes.

Next steps

Bill Connell FCMA will be leading this project forward as Chair of CIMA's Technical Committee and as Chair of the Finance and Management Accounting Committee of IFAC.

Bill Connell said "CIMA undertook initial research in this exciting and evolving area and this was presented to the IFAC Board in March and the FMAC April meeting in Rome. It has now been established as a FMAC collaborative research project with participating member bodies from the UK, France, Italy, Hong Kong and the US.

Areas to be investigated include development of a 'strategic scorecard' as part of the tools and techniques of performance and evaluating why corporate failures have occurred against the wider and all encompassing framework of enterprise governance."

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