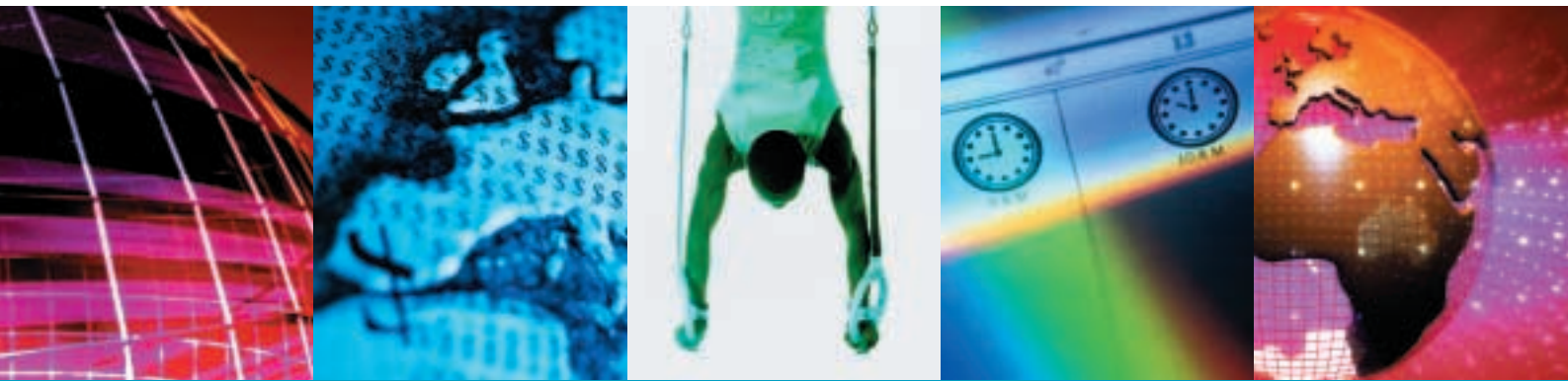


CIMA



**International Federation
of Accountants**



**Enterprise Governance
Getting the Balance Right
Executive Summary**

Introduction

The Professional Accountants in Business Committee (PAIB) of IFAC was asked by the IFAC Board in October 2002 to explore the emerging concept of enterprise governance. A particular focus of the project was to consider why corporate governance often fails in companies and, more importantly, what must be done to ensure that things go right.

Enterprise governance defined

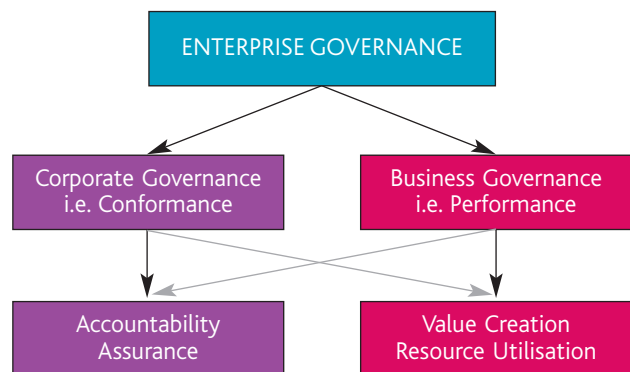
This report defines enterprise governance as “the set of responsibilities and practices exercised by the board and executive management with the goal of providing strategic direction, ensuring that objectives are achieved, ascertaining that risks are managed appropriately and verifying that the organisation’s resources are used responsibly” (Information Systems Audit and Control Foundation, 2001).

Enterprise governance constitutes the entire accountability framework of the organisation. There are two dimensions of enterprise governance – conformance and performance, that need to be in balance.

Figure 1 illustrates the reach of enterprise governance. In general, the conformance dimension takes an historic view while the performance view is forward-looking. It makes it clear that good corporate governance is only part of the story – strategy is also important.

Conformance is also called “corporate governance”. It covers issues such as board structures and roles and executive remuneration. Recent high-profile cases of corporate failure such as Enron, HIH, Tyco, Vivendi, Royal Ahold and, most recently, Parmalat, have brought corporate governance to the top of the business and political agenda. This has led to a number of reviews at national and international level. Codes and/or standards can generally address this dimension with compliance being subject to assurance/audit. There are also well-established oversight mechanisms for the board to use to ensure that good corporate governance processes are effective eg, audit committees.

Figure 1: The enterprise governance framework



The performance dimension focuses on strategy and value creation. The focus is on helping the board to: make strategic decisions; understand its appetite for risk and its key drivers of performance, and; identify its key points of decision-making.

This dimension does not lend itself easily to a regime of standards and audit. Instead, it is desirable to develop a range of best practice tools and techniques, such as scorecards and strategic enterprise systems, that can be applied intelligently within different types of organisation. These 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, what we would term an “oversight gap”. In this project we explored whether this was a significant issue.

At the heart of enterprise governance is the argument that good corporate governance on its own cannot make a company successful. Achieving a panacea of good corporate governance that is linked strategically with performance management will enable companies to focus on the key drivers that move their business forward. This is both a challenge and an opportunity.

Case studies

In order to test the enterprise governance framework and to explore what goes right or wrong in companies, we chose to undertake a series of 27 short international case studies. These were drawn from Australia, Canada, France, Hong Kong, Italy, Malaysia, the Netherlands, Thailand, the United Kingdom and the United States. A wide range of industries was covered including telecoms, retailing, financial services, energy and manufacturing.

The aim was to provide summaries of the causes of corporate successes and failures (as defined by total collapse of the company or severe difficulties resulting in sharp declines in share price and profits, adverse publicity etc). Of the 27 case studies, 11 were "successes" and 16 were "failures".

Each case study focused on corporate governance practices and strategic issues such as the process of strategy development and the resulting choice of strategy. Material was drawn from published sources. Our approach was to develop case studies that were sufficient to generate broad conclusions. The case studies are not intended to be detailed, rigorous pieces of academic research.

These were then analysed in terms of two categories, each with two subsets as follows:

Corporate governance – what went wrong in failure and what went right in success eg,

- the role of the chief executive
- the role of the board of directors
- executive remuneration
- ethics, culture and tone at the top

Strategy – what went wrong in failure and what went right in success eg,

- mergers and acquisitions
- responsiveness and information flows
- risk management
- strategy execution

A number of key themes emerged from our analysis. An example is shown in Table 1 overleaf.

From our findings, we identified priority areas for further work and then focused on developing a series of frameworks and approaches to address these areas. Our aim was to provide guidelines that would help companies to be more efficient in their responsibilities for conformance and with value creation and use of resources (performance).

Principal findings from the case studies

There were four key corporate governance issues that underpinned both success and failure. These were:

- culture and tone at the top;
- the chief executive;
- the board of directors;
- internal controls.

For example: *"Enron didn't fail just because of improper accounting or alleged corruption at the top. It also failed because of its entrepreneurial culture ... The unrelenting emphasis on earnings growth and individual initiative, coupled with a shocking absence of the usual corporate checks and balances, tipped the culture from one that rewarded aggressive strategy to one that increasingly relied on unethical corner-cutting."*

(Business Week online, 25 February 2002).

"Williams was, in reality, chief executive [of HIH] from the inception of the business until he stepped aside in October 2000. No one rivalled him in terms of authority or influence. Even as his business judgment faltered in the second half of the 1990s he remained unchallenged. No one else in senior management was equipped to grasp what was happening and to bring about a change of direction for the group. There was a lack of accountability among senior management and the board of directors, and there was a singular failure to assess performance in the context of deteriorating financial results" (Report of the HIH Royal Commission, 2003).



Table 1 – What went wrong?– corporate governance issues

	Ethics/culture/ tone at the top	CEO	Board of directors	Internal control/ compliance/ risk management	Aggressive earnings management
Ahold (Netherlands)	••	•••	•	•••	•••
Enron (US)	•••	•••	•••	•••	•••
WorldCom (US)	•••	•••	•••	•••	•••
Xerox (US)	•••	•••		•••	•••
Vivendi (France)		•••	••	•••	
Cable & Wireless (UK)		••	•••	•••	
D Tripovich (Italy)			•••	••	
France Telecom (France)	••	••	••	••	

- = issue had relatively minor significance in the case study
- = issue was of moderate significance
- = issue was of major significance

The four key corporate governance factors underlying failure were interrelated – no single issue dominated. It was also apparent that poorly-designed executive remuneration packages distorted behaviour in the direction of aggressive earnings management. In extreme cases, when aggressive earnings targets were not met, fraudulent accounting tended to occur such as in the cases of Enron, WorldCom, Xerox and Ahold.

In the cases of success, a virtuous circle emerged based on a conscious decision to take good governance seriously because it was good for the company rather than required by law or formal codes of best practice.

However, in some cases good governance did not feature strongly as a key factor of success. This does not imply that

corporate governance is unimportant for success. Instead, it shows that good corporate governance is a necessary, but not sufficient, foundation for success. In other words, bad governance can ruin a company, but cannot, on its own, ensure its success. Enterprise governance, with its focus on both the conformance and performance aspects of business, ensures that companies do not lose sight of this.

Similarly, there were four key strategic issues underlying success and failure:

- choice and clarity of strategy;
- strategy execution;
- ability to respond to abrupt changes and/or fast-moving market conditions;
- ability to undertake successful mergers and acquisitions (M&A). Unsuccessful M&A were *the* most significant issue in strategy-related failure.

Strategic oversight

Based on the findings of the case studies, we explored the issue of strategic oversight in more detail. There is no equivalent mechanism to the Audit Committee in the conformance dimension to ensure adequate oversight of the performance or business dimension. This was supported by the findings of the case studies where strategic failure was the major issue.

A particular danger point is at times of transformational change when incremental changes in strategy fail to match the pace of change in the environment. Organisations can become reactive to the environment and fail to question or challenge what is happening. In the end, an even more aggressive transformational change may be required – often when the health of the underlying business has deteriorated considerably.

This is in line with the “abrupt change” identified as being a contributory factor in a number of the strategic failures covered in the case studies. Consequently, there is a real need for directors to have a true and fair view of the strategic position of the company.

One possible way of addressing the strategic oversight gap is through the establishment of a strategy committee which would undertake regular reviews of strategy and have the right to access external advice if necessary. It should be emphasised that such a committee could only be a “preparatory committee” for the full board which would still be responsible for major strategic decisions. The ultimate aim of such a committee would be to better inform the full board’s deliberations over strategic decisions.

We also concluded that the balanced scorecard, which is a respected performance management tool, could not be used to fill the strategic oversight gap. Although it is invaluable in helping businesses to translate agreed strategy into action and/or to bring non-financial key performance indicators into better focus, it is less successful in addressing the

ambiguous, uncertain, complex decisions required to formulate the strategy at times of transformational change, or during major external disruption.

The CIMA Strategic Scorecard

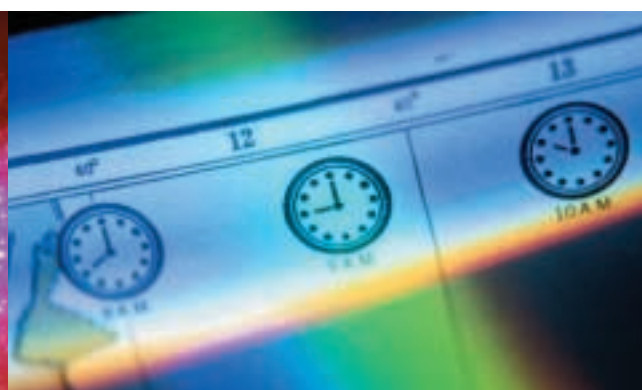
As a pragmatic means of addressing the strategic oversight gap, we propose a Strategic Scorecard. This falls somewhere between the perhaps controversial establishment of a strategy committee and the possibly inappropriate reliance on the balanced scorecard for transformational change. The Strategic Scorecard is complementary to both these approaches.

The fundamental objectives of the ‘Strategic Scorecard’ are that it:

- assists the board, particularly the independent directors, in the oversight of a company’s strategic process;
- is able to deal with strategic choice and transformational change;
- gives a true and fair view of a company’s strategic position and progress;
- tracks actions in, and outputs from, the strategic process – *not the detailed content*;
- highlights the decision points when the board needs to be involved.

The Strategic Scorecard is not a detailed strategic plan. It is aimed at helping the board ensure that all the aspects of the strategic process have been completed thoroughly. It helps the board to identify the key decision points and then the timing of strategic options, milestones in strategic implementation together with the identification and mitigation of strategic risks. The management team would need to give an adequate description of the activity being undertaken and cover when the last relevant information was put before the board and when the next is due.

The scorecard has four basic elements, linked to the four key aspects of the strategic process. The scorecard is covered in more detail in the full report.



Strategic Scorecard



Best practice continued

In addition to strategic oversight, we explored a number of complementary issues that would guide companies towards achieving robust corporate governance (conformance) and strategic success (performance). These are:

- enterprise risk management;
- the acquisition process;
- board performance.

Enterprise risk management

The role of risk management has historically been a peripheral one in many organisations. However, some organisations have recognised that the modern business environment, characterised by an ever-increasing pace of change, necessitates a more performance-focused approach to risk management. In the past, risk has been approached informally, and often, unconsciously.

It is this recognition of a performance-driven approach that has given rise to the concept of enterprise risk management. This reconciles both:

- the assurance requirements of the board and external stakeholders ie that the business understands its risks and is managing them actively – conformance – and;
- the need to better integrate risk management in decision-making activity at all levels – performance.

A practical framework is presented which pulls together all the elements required to integrate the management and consideration of risk with the management of the business. This is discussed in more detail in the full report.

The acquisition process

Because mergers and acquisitions are notoriously risky as highlighted by the case studies, particular attention was also given to this topic. Having considered why mergers and acquisitions are different and why they need to be linked to strategy, an eight-stage process map. A summary is provided below, more detailed discussion can be found in the full report.

Stage 1 – initiation and project team

This occurs at the very earliest stage and should ensure that the right resource is allocated to the project covering both in-house and external resources.

Stage 2 – target valuation

There are a number of techniques available including price to earnings or cash flow ratios; return on investment; discounted cash flows; and net asset backing. It is advisable to use several techniques rather than rely on one alone.

Stage 3 – identification of key risks

There are many risks in an acquisition, such as the risk of failing to integrate the acquisition successfully. It is therefore critical to manage all of the risks at the earliest stage possible.

Stage 4 – business case

The valuation (stage 2) must not take place as a numerical exercise in isolation. The acquisition, even if somewhat opportunistic, should align with the company's strategic objectives.

Stage 5 – due diligence

Full checklists are required for due diligence with the person responsible for carrying out the work and the manager responsible for signing off the opinion/result clearly identified for each of the items on the list.

Stage 6 – finalise the deal

There is a need for a formal sign off before the deal is finalised. This can take the form of a sponsor's note which provides a final summary of the key points.



Stage 7 – integration and implementation

A workshop format is the best way to prioritise the key risks and to ensure a successful integration. Best practice is to carry out this exercise as soon as possible after the deal is finalised. (Note that an integration plan is required for the business case – stage 4).

In the critical early stages of the acquisition, successful integration will include early planning, swift completion of tasks and clear communication.

Stage 8 – post audit

Often regarded as an exercise to analyse why parts of the acquisition failed and requested infrequently by boards who are concerned about the results of a previous acquisition. It is recommended that a formal process is carried out one year after the original bid to act as a learning experience for future action.

Acquisitions summary

Successful acquisitions should occur as part of a planned strategy. The strategy should identify target businesses in targeted markets. Rarely do successful acquisitions come out of opportunistic approaches by buyers or sellers where it is then rationalised as a strategic fit. The fundamental questions to be asked are “why are we buying?” and “why are they selling?” Answers to these, well articulated, are early indications of a successful deal.

The following are identified as the key requirements for success:

- effective, experienced, full-time project management;
- rigorous evaluation of synergies and ruthless implementation;
- effective due diligence;
- experienced specialists with recent deal experience;
- early identification of risks with appropriate mitigating action;
- the deal reflects the business case;
- there is a clear integration plan.

Board performance

The final area for detailed consideration relates to board performance. New measures that have been introduced in various countries to strengthen corporate governance have tended to focus on corporate board structures. However, although valuable, such measures do not necessarily guarantee more effective board performance. Consequently, attention is given to issues such as:

- performance evaluation for boards including the use of performance measurement systems;
- board dynamics;
- board design.

The CIMA Strategic Scorecard could provide a useful tool for boards as they seek to evaluate their performance.

In general, boards need to ensure that they are making the most effective use of limited time and knowledge in order to achieve their stated objectives rather than simply complying with the letter of corporate governance codes.

Conclusion

We believe that the enterprise governance framework provides a timely reminder to organisations to balance conformance requirements with the need to deliver long-term strategic success through performance.

We do not pretend to present a guaranteed formula for business success. However, the case studies highlighted a number of recurrent themes underlying both success and failure and there is great value, therefore, in presenting a number of tools and techniques to address the more problematic areas. Greater attention to strategic oversight (through the use of the Strategic Scorecard), enterprise risk management, the acquisition process and board performance will go some way towards ensuring effective conformance and performance.



IFAC is the global organisation for the accountancy profession. It works with its 159 member organisations in 118 countries to protect the public interest by encouraging high quality practices by the world's accountants. IFAC members represent 2.5 million accountants employed in public practice, industry and commerce, government, and academe.

IFAC's overall mission is to serve the public interest, strengthen the worldwide accountancy profession, and contribute to the development of strong international economies.

This executive summary has been extracted from the full report *Enterprise Governance – Getting the Balance Right*, which was prepared by the Professional Accountants in Business Committee (PAIB) of IFAC. The PAIB Committee serves IFAC member bodies and the more than one million professional accountants worldwide who work in commerce, industry, the public sector, education, and the not-for-profit sector. Its aim is to enhance the profession by encouraging and facilitating the global development and exchange of knowledge and best practices. It also works to build public awareness of the value of professional accountants. The PAIB Committee was formerly called the Financial and Management Accounting Committee.

Copies of this executive summary, as well as the full report, may be downloaded free of charge from the IFAC website at www.ifac.org.

The Chartered Institute of Management Accountants
26 Chapter Street
London SW1P 4NP
United Kingdom

T +44 (0)20 7663 5441
W www.cimaglobal.com



International Federation of Accountants

545 Fifth Avenue, 14th Floor, New York, NY 10017 USA
Tel +1 (212) 286-9344 Fax +1 (212) 286-9570 www.ifac.org

Copyright © February 2004 by the International Federation of Accountants. All rights reserved. With the exception of IFAC member bodies, no part of this publication may be reproduced, stored in a retrieval system, or transmitted, in any form or by any means, electronic, mechanical, photocopying, recording, or otherwise without the prior written permission of the International Federation of Accountants. Translation requests should be submitted to IFAC.