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International Federation
of Accountants

Enterprise Governance
Getting the Balance Right

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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 booklet 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.

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Introduction

The Professional Accountants in Business Committee (PAIB) of the International Federation of Accountants (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.

This report complements an earlier IFAC report, *Rebuilding Public Confidence in Financial Reporting: An International Perspective* which looked at ways of restoring the credibility of financial reporting and corporate disclosure. The international perspective distinguishes both these reports from other literature in this field.

The PAIB established a steering committee comprising representatives from five countries: France, Hong Kong, Italy, the United Kingdom and the United States. The members of the steering committee are listed on page 2. We undertook a series of case studies covering ten countries and ten market sectors. The case studies considered both corporate governance and strategic issues.

Another important feature is that we considered success stories and well-known failures such as Enron and WorldCom. It became very apparent to us that while the heavy emphasis on corporate governance issues has been necessary in the light of recent scandals, it is important to remember that good governance on its own cannot make a company successful. Companies need to balance conformance with performance. This is a fundamental component of enterprise governance.

This report:
- defines and explains the concept of enterprise governance;
- provides a brief summary of the case study findings and identifies key areas for attention;
- proposes ways of addressing these priority areas and;
- introduces the concept of a strategic scorecard.

We focus on what goes right and wrong in listed companies. However, most of our recommendations are relevant to other public-interest entities and small and medium-sized enterprises.

The focus is on the processes inside a company. External processes such as external audit and regulatory compliance are important but they are not covered in this report.

In developing this report, we have drawn on a considerable body of earlier work, particularly in the field of corporate governance. We have not duplicated this work, but built on it. We emphasise that it is important to balance good corporate governance with the creation of sustainable value. A summary of key corporate governance developments is provided in Appendix 2.

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.

The steering committee is grateful to all those in IFAC's member bodies who assisted in researching and preparing the case studies and in particular to Jasmin Harvey, Gillian Lees and Richard Mallett in the technical department of the Chartered Institute of Management Accountants (CIMA) who provided invaluable project management support. Particular thanks also go to Richard Sharman and David Smith of KPMG who prepared the section on enterprise risk management.

This report reflects the personal views of the members of the PAIB steering committee and not necessarily the views of the organisations of which they are members.

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February 2004

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Executive Summary

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.

Scope and focus of work

The scope of our work involved researching the emerging concept of enterprise governance and developing guidelines to explain the many facets of this concept. As part of this work, we also reviewed recent developments in corporate governance as well as analysis of what makes strategies successful in companies.

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.

Conformance is also called "corporate governance". It covers issues such as board structures and roles and executive remuneration. It has had significant coverage in recent years following the various corporate governance scandals 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. There are also well-established oversight mechanisms for the board to use to ensure that good corporate governance processes are effective eg, audit committees.

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 that can be applied intelligently within different types of organisation. Unlike the conformance dimension, there are, typically, no dedicated oversight mechanisms such as audit committees. In this project we explored whether this "oversight gap" 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. Companies must balance conformance with performance.

Case studies

In order to test the 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.

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.

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.

The material from the case studies was 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.
- Strategy – what went wrong in failure and what went right in success.

A number of key themes emerged from our analysis.

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.

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 was *the* most significant issue in strategy-related failure.

Based on the findings of the case studies, we explored the issue of strategic oversight in more detail. We also identified and considered best practice in the following areas, all of which featured strongly in the case studies:
- enterprise risk management;
- the acquisition process;
- board performance.

We felt that these were the key priority areas for attention.

Strategic oversight

As indicated above, 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.

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.

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*.

The scorecard has four basic elements as shown below:

Strategic Scorecard

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.

We then 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
A key element of the Strategic Scorecard is consideration of strategic risks and this was explored in more detail within the framework of 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.

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. In using the best practice framework, a number of key insights have emerged:
- ignore the change management aspects of risk management at your peril;
- understand what you have and what you need;
- risk assessment is a good introduction to risk management;
- leaders need to lead and to be seen to lead;
- business strategy and risk strategy need to be aligned.

An efficient and effective risk management framework will provide the board with the information they need to discharge both conformance and performance duties. It will give them:
- increased confidence in the organisation's risk management capability;
- improved ability at board level to challenge management;
- improved ability to increase stakeholder confidence that the organisation is taking risk management seriously.

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, a detailed eight-stage process map is presented with guidance for each stage. Particular attention is also given to risk management within the acquisition process and to the identification of the responsibilities of the risk management function. A summary of the tools and techniques to be used by risk professionals is provided. 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.

A key element of the Strategic Scorecard was consideration of strategic risks and this was explored in more detail within the framework of enterprise risk management.

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.

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.

1 Context and Background

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. Appendix 2 provides a synopsis of recent international developments in corporate governance.

There remains the challenge of ensuring a high minimum standard of corporate governance internationally. This is being addressed by the OECD.

The recent IFAC publication, *Rebuilding Public Confidence in Financial Reporting: An International Perspective* discusses how the scandals have led to a loss of credibility in financial reporting and why it is important to restore this credibility. As the report points out: *"Reduced confidence in financial information and corporate disclosure produces an investor retreat and results in an increased cost of capital. This reduces the economy's productivity"*. The report considers ways in which confidence can be restored and sets out ten recommendations covering issues such as ethics, audit effectiveness and accounting and audit standards. These recommendations are included in Appendix 2.

A recent survey from the Economist Intelligence Unit, shows that two years after the collapse of Enron, the attention being given to the corporate governance issue is not diminishing. Over 300 senior managers from around the world reported that top management is spending more time on governance now than it did in the previous year and expect that more time will be devoted to the issue in future. This is in spite of the fact that respondents were unable to say whether companies are now better governed and that 80 per cent felt that governance changes had had no impact on revenues. Still, if asked, all the executives would surely agree that every effort must be made to prevent the type of corporate governance disasters that brought about the collapse of Enron and WorldCom.

It is critical that corporate governance failure is addressed properly. But there have been other examples of companies falling into difficulties as a consequence of their strategic choices. The effects of such strategic failure can be just as serious for shareholders and for stakeholders in terms of lost jobs, pensions and savings. There is a danger that in the laudable attempt to improve standards of control and ethics, insufficient attention is paid to the need for companies to create wealth and to ensure that they are pursuing the right strategies to achieve this.

Burwell and Mankins have argued that "overlooking management improprieties is not the only way boards have let down shareholders in recent years". They cite a number of examples including Ford, Kmart, Vivendi and Nortel where boards have failed to steer management away from decisions that damaged long-term shareholder value.

There is a growing body of popular business literature that attempts to discover the secrets of sustainable business success. Recent examples include *Good to Great* by Jim Collins and *What Really Works* by William Joyce, Nitin Nohria and Bruce Roberson. Both devote considerable attention to strategic issues but give only brief consideration of traditional corporate governance. There is little coverage of the potentially conflicting demands on boards to ensure that both the conformance and performance aspects of running the business are addressed adequately and that there is a healthy balance between the two.

There is a gulf between the corporate governance agenda and the "business success" literature and a framework is required to bring these two together. This framework is enterprise governance.

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.

2 Principles of Enterprise Governance

Enterprise governance is an emerging term which describes a framework covering both the corporate governance and the business governance aspects of an organisation. 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.

As indicated in Appendix 2, much work has been carried out recently on corporate governance. 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.

The definition chosen by this report as its starting point 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).

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 emphasis of the roles of the chairman and chief executive officer (CEO) – and therefore why they need to be split.
- It helps to illustrate the multiple roles of the accountant.
- It can demonstrate the importance of substance over form.
- It can accommodate the different governance models across the world.

Figure 1: The enterprise governance framework

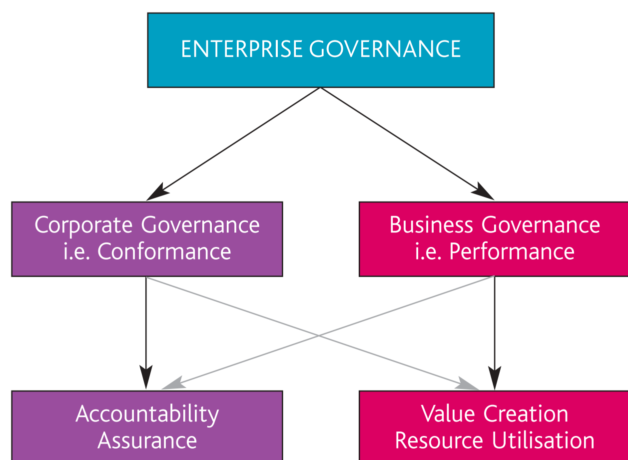


Figure 1, above, illustrates the reach of enterprise governance – it constitutes the entire accountability framework of an organisation. In general, the conformance dimension takes an historic view while the performance view is forward-looking. It makes it clear that good corporate governance is only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

Enterprise governance considers the whole picture to ensure that strategic goals are aligned and good management is achieved.

The diagram is similar to the one that illustrates the domain of the finance function in a recent comprehensive study on competencies (PAIB, 2002). This indicated that the overall domain of the finance function incorporated corporate governance responsibilities and making a contribution to value creation and business success. 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 two years following the various corporate scandals.

It is normally called "corporate governance" and covers issues such as:

- the roles of the chairman and CEO;
- the board of directors, eg, composition, non-executive directors, training etc;
- board committees eg, audit, remuneration and nominations committees;
- internal controls in an organisation;
- risk management and internal audit;
- executive remuneration.

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 assure 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 well-established oversight mechanisms for the board to ensure that good corporate governance processes are effective, eg, committees mainly or wholly composed of independent (non-executive) directors and, in particular, the audit committee. Similar mechanisms are typically in place in countries where a separate audit committee does not exist.

The performance dimension

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 within 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, and;
- identify the critical points at which it needs to make decisions.

Implementation of strategy and its ongoing relevance and success must then be assessed on a regular basis.

It is widely recognised that strategy is the responsibility of the full board. There are, however, a number of companies that have a strategy committee which reviews the strategy development and implementation process, challenges the information provided and assesses the key business drivers.

There are a range of tools and techniques – eg, scorecards, continuous improvement, strategic enterprise systems, investment committees – 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. In other words, there could be what we would term an "oversight gap". We explored whether this was an issue in the case studies.

3 Case Studies

A key aspect of the project was to explore what causes corporate failures against the evolving framework of enterprise governance. This involved focusing as much, if not more, on reasons of strategic failure as on corporate governance failure and fraud.

In order to test the enterprise governance framework, we undertook a series of 27 case studies. These were drawn from 10 countries: Australia, Canada, France, Hong Kong, Italy, Malaysia, the Netherlands, Thailand, the United Kingdom and the United States. 10 industries were covered including telecoms, retailing, financial services, energy and manufacturing. A full list of the case studies is included in Appendix 3.

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".

The case studies were based on published material and covered corporate governance facts about the company including:

- whether the role of the chairman and chief executive was split;
- how long the chairman, chief executive and the financial director had been in post and where they had been recruited from;
- the executive remuneration package;
- the composition and background of the board;

together with details of:

- information about mergers and acquisitions;
- strategy development and implementation;
- the use of complex financial engineering techniques.

Given the approach taken in the project, the case studies are intended to be sufficient to draw broad conclusions rather than rigorous academic research.

The material from the case studies was then analysed to identify recurring themes. Two categories were produced, each with two subsets, as follows:

- Fraud and corporate governance issues – what went wrong and what went right?
- Strategic issues – what went wrong and what went right?

For corporate governance, we asked whether the following had been significant factors in the success or failure of the organisation:

- the role of the chief executive;
- aggressive earnings management;
- executive remuneration;
- the role of the board of directors;
- succession planning;
- internal control, compliance and risk management;
- ethics, culture and tone at the top.

The following were the main areas looked at in the analysis of the significance of strategic issues to the organisation's success or failure:

- mergers and acquisitions;
- market conditions;
- responsiveness and information flows;
- choice and clarity of strategy;
- strategy execution;
- abrupt changes;
- risk management.

A key aspect of the project was to explore what causes corporate failures against the evolving framework of enterprise governance.

It became apparent that key themes tended to occur in combination. Summaries of the case study matrices showing the key themes are shown in Appendix 4. An example is shown below:

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 Tripcovich (Italy)			●●●	●●	
France Telecom (France)	●●	●●	●●	●●	

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

Corporate governance

Key issues of failure
The key corporate governance issues underlying company failures were:

Culture and tone at the top
This means that those at the top of the company, by their own poor example and failure to uphold high ethical standards, allowed a culture to flourish in which secrecy, rule-breaking and fraudulent behaviour became acceptable or, at best, ignored. In some cases, performance incentives created a climate where employees would seek to generate profit at the expense of the company's stated standards of ethics and strategic goals.

The case of Enron in the US illustrates this very clearly. The assessment of performance was ostensibly based on Enron's stated values of respect, integrity, communication and excellence. But employees soon learned that the only real performance measure was the amount of profits that they could produce.

"To the outside world, Enron looked like a dependable, highly ethical, honorable and responsible corporate citizen … Unfortunately, for not only Enron's investors, but also its employees, Enron's ethical performance appears to have fallen far short of the image it projected to the world. Sadly, it appears that the core values Enron actually practiced included deception, arrogance, concealment and self-interest rather than the values of integrity, communication and respect for others that it proclaimed to the world"
(Strategic Finance, February 2002).

"… when the code [of ethics] got in the way of doing what management wanted done, Enron's board was easily persuaded to lay aside certain provisions of that code"
(Financial Executive, July/August 2002).

Similarly, the culture of WorldCom was such that employees knew about fraud, but were afraid to report it. Mid-level accountants who had originally objected to the questionable use of reserves were persuaded, with promotions and salary increases, to go along with subsequent accounting frauds.

In the case of HIH in Australia:

"The problematic aspects of the corporate culture of HIH…can be summarised succinctly. There was blind faith in a leadership that was ill-equipped for the task. There was insufficient ability and independence of mind in and associated with the organisation to see what had to be done and what had to be stopped or avoided. Risks were not properly identified and managed. Unpleasant information was hidden, filtered or sanitised. And there was a lack of sceptical questioning and analysis when and where it mattered"
(Report of the HIH Royal Commission, 2003).

The chief executive

There were numerous examples of dominant, charismatic chief executives who were able to wield unchallenged influence and authority over the other senior executives and board directors.

For example:

"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).

Bernie Ebbers, the chief executive of WorldCom was so dominant that few directors would dare to argue with him. He is reported to have belittled any director who dared to question him and cemented the other directors' loyalty through perks and awards of WorldCom stock.

Vivendi's chief executive, Jean-Marie Messier, was able to pursue his grandiose ambitions of building a "Hollywood-to-mobile-phones conglomerate" on the back of a French water utility. In the process, he adopted a celebrity lifestyle and left Vivendi on the verge of collapse with debts of €19bn.

There is no second chance for chief executives who preside over failure. It was invariably the case that the chief executive was too closely associated with the disaster to be given the opportunity to repair the damage and was forced out of his job. In the 16 case studies on corporate governance failure, 15 chief executives lost their jobs although in three of the cases, this was due to the liquidation of the company.

The board of directors
A recent book on the problems at Vivendi blames not only Jean-Marie Messier, but the directors who enables him to get away with it (M Orange and J Johnson, 2003). We have also seen how the WorldCom and the HIH directors failed to exercise sufficient oversight over their chief executive. Similarly, the Cable & Wireless board has been criticised for being too slow to remove the previous chief executive and for being "unusually cosy". Questions have been raised over how rigorously it challenged the chief executive.

Board weakness goes beyond simple failure to challenge the chief executive. It can extend to a failure to adopt a generally questioning and independent approach to all the material presented by management. This was illustrated by the case of HIH:

"... the board had such a degree of respect for management that the recommendations of management were assumed to have been carefully thought out and therefore to be correct. The board was heavily dependent on the advice of senior management: there were very few occasions when the board either rejected or materially changed a proposal put forward by management.

The board's independence was compromised by the influence of management in relation to its deliberations. I do not doubt that from time to time things were debated. There was at least one instance – the Allianz transaction – where a director asked that management carry out further analysis of proposals that had been put before the board. But the fact that debate occurred does not necessarily mean the independence and rigour of analysis that is required of a board was practised. Generally speaking, the board was too ready to accept what management was saying without testing the matter by appropriate analysis."
(Report of the HIH Royal Commission, 2003).

Board failure could also manifest itself in a failure to take necessary action on a timely basis. For example, the board of Marks and Spencer in the UK was well aware that it needed to split the roles of chairman and chief executive as recommended by UK corporate governance best practice. However, there was no obvious candidate for the post of chief executive. At this point, the board failed to ensure that appropriate steps were taken to groom an internal executive or to search outside the company. The failure to act created the conditions where factionalism and a damaging boardroom coup became inevitable.

Internal controls
It could be argued that internal control weakness is a logical outcome of the above three factors and this was certainly borne out by the cases that we considered. For example, Enron's emphasis on earnings growth and individual initiative meant that inexperienced managers were given too much leeway without the necessary controls to minimise failures.

Another crucial aspect is the role of the chief financial officer (CFO) who should take an independent and unbiased view of key business decisions. However, the case of Ahold in the Netherlands shows how this role may be compromised. The chief executive and the CFO were generally seen as the architects of the strong acquisition-driven growth that the company went through. It is difficult to see how the CFO could challenge business decisions and take an independent role in enforcing good internal corporate governance while being the co-driver of the company's expansion.

We have seen that the four key corporate governance factors underlying failure are interrelated. This was reflected in the case studies where no single issue dominated. Failure is caused by a combination of interrelated issues.

While the above four factors appeared to be the major factors in corporate governance failure, it is important not to overlook the supporting role played by executive remuneration. In particular, a poorly-designed rewards package, including, for example, excessive use of share options can distort executive behaviour in the direction of aggressive earnings management so that the long-term interests of shareholders are compromised. Furthermore, as evidenced by recent media outcry over severance packages, there have been many instances where executives have, in effect, been rewarded for failure.

At the extreme, when aggressive earnings targets were not met, fraudulent accounting tended to occur. This was very apparent in the three US cases of Enron, WorldCom and Xerox as well as Ahold in the Netherlands.

"In mid-2000, with the telecommunications industry in a severe slump, WorldCom announced that the company's results for the second half of the year might fall below expectations...Thus began the process of managing earnings. In order to hit the 2000 year-end profit target, reserves were used to cover line charges. The establishment of these reserves had been questionable at best, and the use of reserves to cover current expenses was in clear violation of accounting rules. When mid-level accounting personnel raised objections to this strategy, the CFO assured them that this was a one-time event that would help WorldCom over a rough place in the road"
(WorldCom case study).

"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).

"Pressure on management to realise ambitious sales targets is cited as one driver for the accounting irregularities [of Ahold]."
(Het Financieele Dagblad, 1 March 2003).

Key issues of success

The four key corporate governance issues underpinning corporate failure were also significant in the cases of corporate success albeit in the opposite direction. They were:

- a positive culture and tone from the top;
- an effective board of directors;
- an effective chief executive;
- effective internal controls.

What does success look like?

A virtuous circle emerges based on a conscious decision to take good governance seriously because it is good for the company rather than required to comply with legislation or formal codes of best practice. A good example of this was illustrated by the case of the Bangkok Mass Transit System in Thailand.

"The case of the Bangkok Mass Transit System is one where, through the awareness of the professional management and the self-discipline of the shareholders, key principles of good corporate governance were established well before the subject was widely discussed in Europe, America or Asia. It is through this early awareness of the importance of corporate governance that the company gained trust and confidence from investors and lenders and hence was able to weather the financial dark years of Thailand"
(Bangkok Mass Transit System case study).

In terms of a positive corporate culture, Southwest Airlines in the US makes a priority of valuing both customers and employees equally.

"You have to treat your employees like your customers. When you treat them right, then they treat your customers right"
(Fortune, 28 May 2001).

Unlike Enron, the company appears to practise its stated values of honesty and integrity.

Good succession planning also featured strongly in some cases. For example, the UK supermarket retailer, Tesco convened a small team to consider the future composition of the senior management team, including the chief executive, more than two years before the then incumbent was due to leave.

Although good corporate governance did distinguish the successes from the failures, governance issues did not feature as strongly in the "successes". Strategic factors seemed to be more dominant. 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.

Strategy

Key issues of failure
The following were recurring themes:
- poor choice and lack of clarity of strategy;
- poor strategy execution;
- failure to respond to abrupt changes or fast-moving market conditions.

The latter was very apparent in the cases of all the telecoms companies that were studied, including Nortel, Cable and Wireless, Marconi, France Telecom and Vivendi.

"The conventional wisdom in the [telecoms] boom was that the future lay in providing high-speed data connections on a global scale. So Cable & Wireless duly sold its local access firms ... and invested the proceeds in long-haul data capacity and related services for large companies. It bought an American network, built a European one and beefed up its undersea cable network. The problem was that many other firms were doing exactly the same thing, resulting in a capacity glut and tumbling prices."
(The Economist, 14 December 2002)

However, the most significant issue in strategic failure was unsuccessful mergers and acquisitions activity.

"In spite of some successes, France Telecom invested so badly between 1999 and 2001 that all its equity disappeared under huge losses. The collapse was only due to bad acquisitions made in consequence of a strategy to expand globally"
(France Telecom case study).

In all the case studies on strategic failure, there was an acquisition that was poorly executed or which failed.

Key issues of success
The following were the most important factors:
- choice and clarity of strategy;
- effective strategy execution;
- competency in mergers and acquisitions;
- responsiveness to information flows;
- effective risk management.

A striking feature of Tesco is the clarity of its strategy, which has four key strands. *"The determination to focus on a limited number of strategic goals was very apparent when I spoke to the CEO in mid-2000."* (The Grocers: the rise and rise of the supermarket chains, 2001). It is notable that the directors all consistently emphasise the four-part strategy in interviews, articles and other publications.

Competency in mergers and acquisitions could be achieved in an unexpected way as illustrated by the Hewlett-Packard merger with Compaq. Opposition to the proposed merger was so great from some quarters that the pros and cons had to be thoroughly considered and management had to go to great lengths to develop a detailed integration plan. It has been suggested that this planning reduced the risks of the merger.

The example of Unicredit Group in Italy shows how companies can create value through competency in merger activity. It has radically reformed the structure of the group away from a network of seven regional banks into three new banks specialising in three different client sectors. However, the success of this restructuring has been based on the previous success of integrating the seven different banks, which shared the same points of strength in professional skills and client relationships.

It also appeared that responsiveness and strategic risk management played a crucial supporting role in terms of a company's ability to read market trends and apply that knowledge successfully. This was the case for the Hong Kong company, Li & Fung, which transformed itself from a middleman between wholesalers and retailers to a manager of complex supply chains. Another related factor was the ability to recognise errors and correct them quickly. This was illustrated by the case of the UK-based supermarket retailer, Tesco, when it tried unsuccessfully to expand into France and, after learning from its mistakes, was then able to develop and implement a successful overseas expansion strategy.

"Li & Fung started as a family-run trading company that acted as a broker between Asian manufacturers and overseas merchants for transactions involving apparel. By the mid-1970s, the company's margins were under pressure. Brokerage fees were being squeezed as the buyers and manufacturers became increasingly comfortable dealing with each other directly. In response, the [Fung] brothers remade the business. Rather than connecting just two levels of the value chain, Li & Fung became a much broader intermediary, connecting and co-ordinating many different links in the chain. It became an orchestrator of a process network. By using its own knowledge of the apparel market to leverage other companies' assets, Li & Fung has been able to achieve impressive growth in the slow-growing apparel industry."
(Leveraged Growth: Expanding sales without sacrificing profits, John Hagel III, Harvard Business Review, October 2002).

In the case of Tesco, not all acquisitions have been successful, eg, the 1994 purchase of 104 Catteau stores in France. However, this failure led to a reassessment of the acquisition strategy to focus on areas that Tesco could dominate. This has led to the purchase of businesses in Central and Eastern Europe as well as the Far East, most recently in Japan. Tesco now has a reputation for managing its acquisitions successfully.

"… in places some incumbents were happy to sell out to Tesco, recognising its commitment and that it had the knowledge to make these new ventures work."
(The Grocers: the rise and rise of the supermarket chains, 2001).

A point of interest was that market sector and conditions appeared to be relatively unimportant given that the case studies featured companies that operate in particularly challenging industries such as airlines, banking and supermarket retailing.

"Since earning its first profit in 1973, Southwest Airlines has not lost a penny. In an industry plagued by fare wars, recessions, oil crises, and most recently terrorism, this is astounding"
(Business Week, February 2003).

A key reason for Southwest Airlines' financial success is its dedication to its original strategy of being a low-fare, on-time, point-to-point airline, using all the same aircraft to simplify training and maintenance.

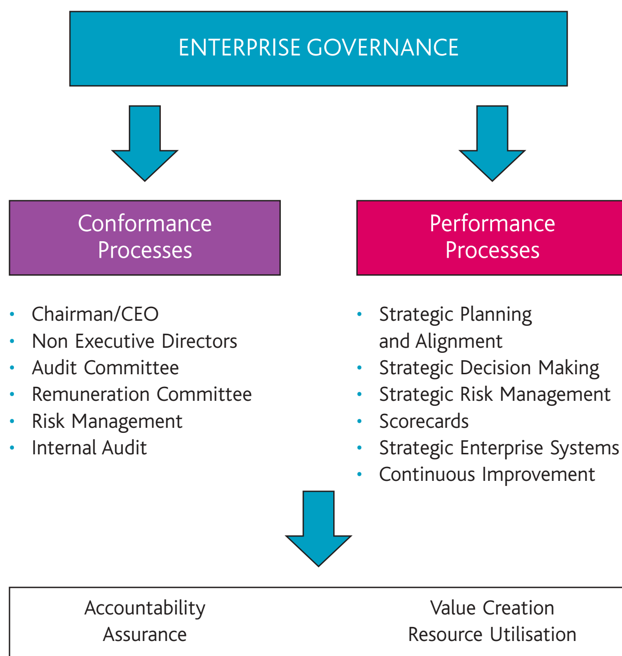
Summary

The insights from these case studies have given us the impetus to develop frameworks to guide companies to manage conformance and performance effectively.

4 Strategic Oversight

Introduction
Enterprise governance provides an integrated framework to help companies focus on both the value-creating drivers that move the business forward and the need to ensure adequate control and oversight. We have seen how important it is to achieve a balance between conformance and performance in order to have the best chance of business success.

Supporting this framework are a number of key processes and structures as shown below



Conformance processes have been well covered in recent years and there will continue to be developments in this area. Appendix 2 provides a synopsis of international developments.

Audit committees are well-established mechanisms for ensuring effective oversight of the corporate governance dimension, particularly with respect to financial reporting. The examples of corporate failures in the case studies demonstrate the importance of such effective conformance mechanisms.

However, there is no equivalent mechanism to ensure effective oversight of the performance or business dimension. In other words, there is an "oversight gap". This was supported by the findings of the case studies where strategic failure was the major issue.

The performance dimension does not lend itself easily to a regime of standards, but instead is better served by best practice tools and techniques which can be applied intelligently within the organisation.

This chapter will explore the oversight gap in more detail and consider the possible benefit of a strategy committee. It will also argue that the balanced scorecard is not able to fill the strategic oversight gap and in the next chapter, therefore, we propose the CIMA Strategic Scorecard. Further chapters will recommend best practice in the following areas, all of which featured strongly in the case studies:
- enterprise risk management;
- the acquisition process;
- board performance.

These are the key priority areas for attention.

Strategy, strategic drift and transformational change
Strategy means many things to many people. In 2002 Johnson & Scholes offered one definition as being:

"the direction and scope of an organisation over the long term which achieves advantage for the organisation through its configuration of resources within a changing environment and to fulfil stakeholder expectations."

They also explain so-called strategic drift as follows:

"Historical studies of organisations have shown the prevalence of processes leading to emergent strategy. There are usually long periods of relative continuity during which established strategy remains largely unchanged or changes incrementally, and there are also periods of flux in which strategies change but in no very clear direction. Transformational change, in which there is a fundamental change in strategic direction, does take place but is infrequent. This pattern has become known as punctuated equilibrium – the tendency of strategies to develop incrementally with periodic transformational change."
(ibid)

Much of the relative continuity relates to the "way we do things around here".

There is the danger that the incremental change of strategy does not match the pace of the change in the environment. Organisations can become merely reactive to the environment and fail to question or challenge what is happening around them or to innovate to create new opportunities. In short, they become complacent. 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. For example, this was very apparent in the cases of all the telecoms companies that were studied including Nortel, Cable and Wireless, Marconi, France Telecom and Vivendi. Another example was that of Enron which had to create a strategy to generate profits and cash flow in the wake of the federal deregulation of natural gas pipelines in 1985. In consequence, it transformed itself from a traditional energy company to a trading business.

It is at times of transformational change, particularly at a corporate level, that the executive directors of the board are heavily involved and this can put at risk objectivity and transparency both to the board and to outside stakeholders. If such risks are identified, then appropriate safeguards should be put in place.

The presence of independent directors on the board is one such safeguard. Potentially, they bring considerable experience to board deliberations over strategy. To contribute effectively to the future strategic direction of the company, independent directors have to assimilate a substantial amount of information. In situations where they are largely reliant on information supplied by the executive management, it can be easy to fail to spot what is missing.

In the case of Marconi in the UK, the

"biggest failure [was]....of corporate governance – that is, shareholders, non-executive directors and the wider analytical community, including the press, failing to act as an effective check and balance on managements that were under pressure to address exceptionally difficult strategic problems".
(John Plender, 2003).

The HIH Royal Commission in Australia found that

"there arose many instances that caused ... great concern about the information flow to the board. There were occasions when there were material omissions from information given to the board, to the point where the information provided was misleading. Directors can do little if they are misled. But the question that arises is whether appropriate checks and balances were in place to minimise both the risk of that happening and its effect if it did occur"
(Report of the HIH Royal Commission, 2003).

Enterprise governance provides an integrated framework to help companies focus on both the value-creating drivers that move the business forward and the need to ensure adequate control and oversight.

The strategic oversight gap

As identified in chapter 2, there is generally no specific committee that oversees strategy from an independent perspective. There are different governance structures in different jurisdictions and each offers challenges as to how the board satisfies itself that it has a true and fair view of the financial position of the company.

Perhaps even more challenging, as several of the case studies illustrate, is getting a true and fair view of the strategic position of the company. The financial position is a key aspect of the conformance dimension as is the transparency of this financial position to investors and other stakeholders. In contrast, the strategic position of a company and its communication to stakeholders is not generally covered in legislation, standards, and codes. As is clearly evidenced by the case studies, the lack of strategic oversight is often a key weakness in enterprise governance.

HIH is a good example, and the following are quotes from the Report of the HIH Royal Commission:

"At board level, there was little, if any, analysis of the future strategy of the company. Indeed, the company's strategy was not documented and … a member of the board would have had difficulty identifying any grand design. If the HIH board discussed strategy at all, it was in the context of an annual budget meeting. But budget sessions are generally about numbers, and there is no indication that the board seriously grasped the opportunity to analyse the direction in which the company was heading.

Generally speaking, it is for management, rather than the board, to propose strategy. This is not an impediment to the board taking the initiative in an appropriate case. But management is best able to dedicate time to strategic thinking and is likely to have greater industry knowledge and experience. Nevertheless, it is the board's responsibility to understand, test and endorse the company's strategy. In monitoring performance, the board needs to measure management proposals by reference to the endorsed strategy, with any deviation in practice being challenged and explained. This is what the HIH board failed to do.

As one director conceded, if he had been asked to commit to writing what the long-term strategy was he would have had difficulty doing so; the other directors struggled when asked to identify strategic directions. The chairman of the board maintained that HIH's strategy was international growth and diversification. But the formulation of strategy requires more than just a broad statement of the intended result. Further, the board must regularly review and test the strategy's appropriateness, and it must monitor and assess whether the strategy is being achieved and, if so, to what extent. According to the chairman of the board, it appears the same 'strategy' existed from at least 1995 and was never subjected to rigorous analysis to gauge its continuing suitability in a changing environment.

A long-term strategy or plan was never submitted formally to the board for critical analysis. Nor did one emerge or evolve informally. In the absence of a framework within which investment and other decisions could be evaluated, the growth of the group was opportunistic and lacking in direction.

There is a related problem. A board that does not understand the strategy may not appreciate the risks. And if it does not appreciate the risks it will probably not ask the right questions to ensure that the strategy is properly executed. This occurred in the governance of HIH. Sometimes questions simply were not posed; on other occasions the right questions were asked but the assessment of the responses was flawed"
(ibid).

In terms of "business governance" there is a vital need for a board to be assured that management is taking the necessary action to progress strategy. This is particularly so for independent directors as their roles and responsibilities are increasing in most markets.

Perhaps even more challenging, as several of the case studies illustrate, is getting a true and fair view of the strategic position of the company.

How can the strategic oversight gap be addressed?

Is there a role for a strategy committee?
There have been proposals made for a strategy committee or something similar. Professor G Donaldson of Harvard Business School put forward a proposal for a strategic audit committee in 1995, as follows:

"a strategic audit committee should be made up of outside directors who meet every three years to evaluate strategy using objective financial measurements with which both the directors and the CEO are thoroughly comfortable."

In tune with the now emerging framework of enterprise governance, Donaldson stated in 1995 that:

"One problem I see with many of the reform initiatives is that they are concerned only with the broad principles of governance and offer little practical guidance. More important, these proposals do not directly address the fundamental issue at the heart of investors' concern – namely, the capacity of the board to intervene in the face of an unsuccessful or ailing business strategy. Proposals to strengthen that ability are among the most important to consider but are also the most difficult to gain consensus on and to implement."

Donaldson then raises a rhetorical question:

"Therefore, the question remains: is it possible to create a formal mechanism within the existing governance process so that the board can exercise proactively its responsibility for strategic oversight? My answer is yes. The mechanism is a formal strategic-review process – a strategic audit – which imposes its own discipline on both the board and management, much as the financial audit process does. I believe such an audit can be designed to stand the test of time and survive the inevitable disputes over authority. The process would centre the leadership of strategic oversight in the hands of independent directors and provide them with the authority to establish both the criteria for and the methods of review."

Donaldson goes on to recommend a database of strategic financial information and, rather controversially even ten years ago, he recommended the involvement of the company's public auditors. In today's environment, this would be an unwelcome and undesirable development and the role would be far better served by an effective internal audit or business assurance function. However, the concept of a strategy committee or something similar is worthy of exploration. Arguably, with the increased pace of change, a more frequent review of strategy is required.

Different international approaches to governance require different solutions but in most jurisdictions any such committee could only be a "preparatory committee" for the full board. Major strategic decisions would still have to be taken through the full collective agreement of the board.

In exceptional circumstances, a strategy committee might have the right to access external advice (not from the audit firm) on management proposals of transformational change. Again this would only be to the effect of better informing the full board's deliberations over a strategic decision.

Whilst such committees are a rarity in most countries, the case studies of Vivendi and Aventis suggested this might be a trend in France. Further research showed that 14 of the 40 companies making up the CAC40 Index now have a strategy committee. For these 14 companies, the strategy committee met, on average, three times a year. In 10 of the 14 companies, the chairman is a member of the committee.

These committees typically review the major transactions. As an example, Vivendi has established a strategy and finance committee, comprising at least four independent directors. It makes recommendations to the full board on all major acquisitions and disposals over €100m.

This is an interesting development but one that many would see as putting at risk the fundamental tenet that the board must take collective decisions on matters of strategy. For example, principle A.1 of the UK Combined Code states that "every company should be headed by an effective board, which is collectively responsible for the success of the company". The code makes it very clear that the board should set the company's strategic aims and review management performance. Such strategic issues should also be included on a formal schedule of matters specifically reserved for the board's decision.

The balanced scorecard does not fill the strategic oversight gap.

The so-called balanced scorecard is a respected performance management tool used by professional accountants in business in many enterprises (private, public, non-profit, academic etc).

Kaplan and Norton developed the balanced scorecard. In the preface of *The Strategy-Focused Organisation* they recall that:

"We first developed the balanced scorecard in the early 1990s to solve a measurement problem. In knowledge-based competition, the ability of organisations to develop, nurture, and mobilise their intangible assets was critical for success. But financial measurements could not capture the value-creating activities from an organisation's intangible assets: the skills, competencies, and motivation of employees; databases and information technologies; efficient and responsive operating processes; innovation in products and services; customer loyalty and relationships; and political, regulatory, and societal approval. We proposed the balanced scorecard as the solution to this performance measurement problem"
(The Strategy-Focused Organisation, 2001).

Kaplan and Norton developed a framework that covered four perspectives:

- **Financial –** The strategy for growth, profitability, and risk viewed from the perspective of the shareholder.
- **Customer –** The strategy for creating value and differentiation from the perspective of the customer.
- **Internal business processes –** The strategic priorities for various business processes, which create customer and shareholder satisfaction.
- **Learning and growth –** The priorities to create a climate that supports organisational change, innovation, and growth.

Kaplan and Norton surmised that:

"Strategies differed so that the organisational changes differed from company to company. The common feature, however, was that every strategy-focused organisation put strategy at the centre of its change and management processes. By clearly defining the strategy, communicating it consistently, and linking it to the drivers of change, a performance-based culture emerged that linked everyone and every unit to the unique feature of the strategy"
(ibid).

It seems that, in some companies, the balanced scorecard has been used to translate strategy into action with a clear understanding of the business model and of which business drivers produce which results. In other companies, it is just used as a way of bringing non-financial key performance indicators into better focus (itself not a bad thing).

The balanced scorecard is a respected performance management tool used by professional accountants in business in many enterprises (private, public, non-profit, academic etc).

The balanced scorecard approach is less successful in addressing strategic issues either from internally driven transformational programmes, including mergers and acquisitions, or of major external disruption such as market collapse, competitor activity or regulator stance.

Strategic choices are typically ambiguous, uncertain, complex, organisation-wide, fundamental and with long-term implications. The key issue is not so much the existence of a strategic plan but rather a state of preparedness for major changes. Andy Grove of Intel defines such changes as 'strategic inflection points' –

"a time in the life of a business when its fundamentals are about to change. That change can mean the opportunity to rise to new heights. But it may just as likely signal the beginning of the end.

Strategic inflection points can be caused by technological change but they are more than technological change. They can be caused by competitors but they are more than just competition. They are full-scale changes in the way business is conducted, so that simply adopting new technology or fighting the competition as you used to may be insufficient ... A strategic inflection point can be deadly when unattended to. Companies that begin a decline as a result of its changes rarely recover their previous greatness....But strategic inflection points do not always lead to disaster. When the way business is conducted changes, it creates opportunities for players who are adept at operating in the new way"
(Grove, 1996).

In these cases, the issues are not operational and reactive under a given strategy but rather ones of transformation or abrupt change as identified in many of the case studies.

Summary

This chapter has explored the issue of the strategic oversight gap and possible ways of addressing this, including a strategy committee. The limitations of the balanced scorecard have been discussed. The next chapter proposes a Strategic Scorecard as a means of improving strategic oversight.

5 The CIMA Strategic Scorecard

With these issues in mind, CIMA is developing a pragmatic approach for enterprises facing issues over strategic oversight. This pragmatic approach falls somewhere between the perhaps controversial establishment of a strategy committee and the possibly inappropriate reliance on the use of a balanced scorecard for transformational change. In fact, the Strategic Scorecard is complementary to both of 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.

The Strategic Scorecard has four basic elements as set out opposite. This generic approach would need to be adapted to each company's own situation. It helps to identify the board's 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. Internal audit could give the board assurance focusing on process and coverage rather the precise detail of the output.

Strategic Scorecard

The Strategic Scorecard is not concerned with:

- the structure of the board and balance of power;
- the roles and responsibilities of directors;
- getting the right people on the board and director training;
- measuring the board's performance;
- a strategic plan.

The role of the professional accountant in the Strategic Scorecard

In a framework of enterprise governance, it is key that good quality information is available to the board which is understandable, reliable, relevant and timely. Critical information needs to be presented in such a way that it cannot be ignored.

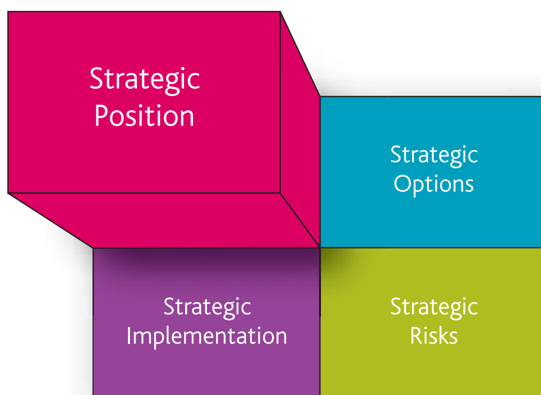
The role of the finance director as the lynchpin of information provision is fundamental. Strategic decisions are likely to demand an integrated approach to managing the organisation. The finance director should have a balanced, objective oversight of all areas of the company.

In a framework of enterprise governance, it is key that good quality information is available to the board which is understandable, reliable, relevant and timely.

The Strategic Scorecard – the generic elements

Element 1 – The strategic position

Information for the board, no decision points



A company needs to be continually reviewing its strategic position. In a group this would need to be for each major stream of business as well as the group itself.

The areas that should be reviewed fall into the following categories:

- micro environment(s) – eg, market, competition, customers;
- macro environment(s) – eg, economic, political, regulatory;
- threats from significant/abrupt changes eg, strategic inflection points;
- business position(s) – eg, market share, differentiation on pricing, quality, service;
- capabilities – eg, core competencies, SWOT analysis (Strengths, Weaknesses, Opportunities and Threats);
- stakeholders – eg, investors, employees, suppliers.

There are various models available. Porter's five-force model is well known (Porter, 1985). The board should have updates and analysis of the forces at intervals appropriate to the company, market structure and competitive dynamics.

Porter's model categorises the forces under the power, vigour and competence of:

- existing competitors – rivalry among existing firms;
- potential competitors – threat of new entrants;
- customers – bargaining power of buyers;
- suppliers – bargaining power of suppliers;
- threat of substitute products or services.

Where possible, the financial analysis should be based on economic profit, residual income or an equivalent.

The board should also receive a thorough analysis of general environmental influences. The PESTEL framework is also a respected framework which considers political, economic, socio-cultural, technological, environmental and legal factors (Johnson & Scholes, 2002).

Other models can supplement or be substituted but these are well acknowledged frameworks. The point of the Strategic Scorecard is to make the board aware of what work is being done and when within the strategic process.

In today's fast moving competitive environment, scanning should not be the one-off exercise typically associated with the strategic plan or strategic review cycle. It should rather be thin but constant. It means that the board must be sensitive enough to spot what could possibly be significant developments. If there is a need to dig deeper it can and should be done.

In terms of evidence from the case studies, the telecoms industry is a good example as several of the strategic failures took place in this sector.

In the case of Marconi, a report by the UK Financial Services Authority (FSA) into the suspension of Marconi's shares in 2001 revealed numerous attempts to revise disappointing internal forecasts. Commentators suggested that the directors were slow to admit to themselves that the company was heading for trouble despite clear evidence to the contrary (profits warnings by other competitors, the peaking of the stock market and European mobile phone auctions that left its customers strapped for cash).

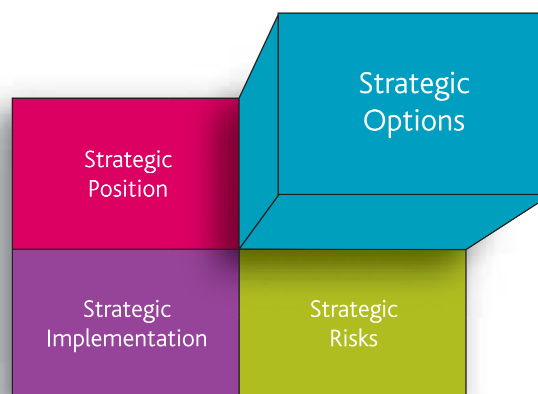
"By far the most worrying thing about Marconi over the past nine months is how slow the company's management, led by Lord Simpson, was in grasping what was happening"
(The Economist, 6 September 2001).

Whilst hindsight is helpful, it is worth reminding ourselves what was happening in the sector that was affecting IT vendors in the US as well as in Europe:

"They knew, for example, that the vast majority of their dotcom customers were burning through cash at a ferocious rate but had no visible earnings. The same was true for many of the fledging telecom outfits that were buying equipment using vendor financing. These companies were building fibre-optic networks far faster than they could be utilised. With bandwidth increasing more rapidly than demand, it was only a matter of time before plummeting prices would drive many of these debt-heavy companies to the wall.

There were other warning signs. In 1990, US companies spent 19 per cent of their capital budgets on information technology. By 2000, they were devoting 59 per cent of their capital spending to IT. In other words, IT had tripled its share of capital budgets – this during the longest capital-spending boom in US history. Anyone looking at the data in 2000 should have been asking, will capital spending keep growing at a double-digit pace? And is it likely that IT spending will continue to grow so fast? Logically, the answer to both questions had to be no. Things that can't go on forever usually don't. IT vendors should have anticipated a major pullback in their revenue growth and started 'war gaming' post-boom options well before demand collapsed"
(Hamel & Valikangas, 2003).

Element 2 – strategic options
How the board considers decision points on change



The board needs to be aware of what strategic options are available to the company in terms of the following:

- Change of scope – eg, geography, product, market sector.
- Change of direction – eg, high/low growth, offering of price/quality.

These options would be those big strategic bets that have the greatest potential for creating or destroying shareholder value. Such bets are often difficult to reverse and in several of the case studies, perhaps unwisely in retrospect, amounted to betting the company.

These kind of decisions fit under the framework of "real options". This topic easily becomes very complex but much can be gained from a "real options" way of thinking. Real options are features that make a project flexible. The word

real signifies that they concern real assets rather than financial securities.

For each business there are probably only about three or four strategic options that will be under active consideration at any one time. For each of these, it is useful for the board to know what analysis has been done, what the resource constraints are, and when the board may be presented with alternatives.

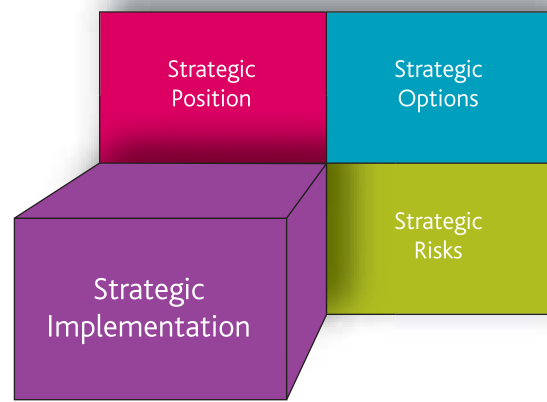
It is also useful for the board to know what other strategic options are available that are not under consideration at that point of time. A short rationale as to why they are not being pursued informs the board, particularly the independent directors, as to the context of the current strategy.

A summarised presentation of all the options and the actions on the selected few should enable a reasonably informed debate at the board. This can cover why certain options are being explored, whether these are the right ones in terms of value creation, whether certain options are missing or possibly whether the options could be better framed.

This does not comprise a strategic plan but rather a scoping of options that can evolve in a dynamic way and allow the state of preparedness that Grove referred to (ibid). The detailed analysis of each of the options would need to be the subject of a separate board discussion. The purpose of the Strategic Scorecard is to set out the landscape.

As already mentioned in relation to the HIH Royal Commission report, *"it is the board's responsibility to understand, test and endorse the company's strategy"* (ibid).

Element 3 – strategic implementation
Measuring how well the strategy is being implemented



Once a project has moved through the evaluation stage to implementation, the board needs to be updated on progress.

The detailed evaluation of a specific option should have developed and set out attainable milestones and timelines to be met. These should be reported on regularly with failures to meet the targets explained along with an outline of any implications and corrective action that has, or needs to, take place.

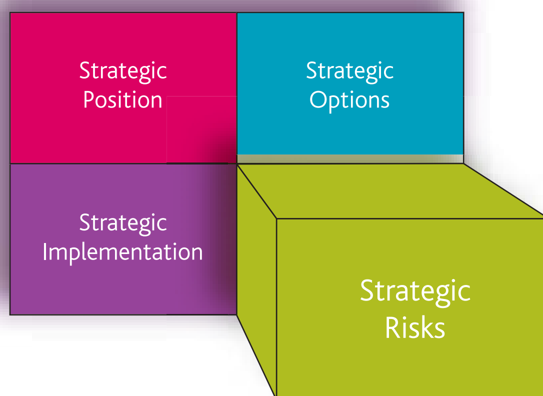
Critical success factors should also be clearly set out – what are those things that must happen to make the strategy successful? There may be a critical path linked with the milestones.

The board needs to be aware of where there are breakpoints when board decisions and/or intervention might be required. These decisions would include whether to accelerate, abort, delay or, possibly, switch strategy. Management needs to react to new information rather than sticking rigidly and dogmatically to the original plan.

For each business there are probably only about three or four strategic options that will be under active consideration at any one time.

Also covered here would be the reporting of whether a post completion audit has or will be carried out. Organisations need to learn from experience and an objective review after completion is a key part of this.

Element 4 – strategic risk
What can go wrong and what must go right?



Chapter 6 of this report covers enterprise risk management in more detail.

Much work has taken place under The Committee of Sponsoring Organisations of the Treadway Commission (COSO, 2003). This group is seeking to establish a common framework for enterprise risk management with a common terminology. The latest draft exposed for public consultation states that:

"Enterprise risk management is not an end in itself, but rather an important means. It cannot and does not operate in isolation in an entity, but rather is an enabler of the management process. Enterprise risk management is interrelated with corporate governance by providing information to the board of directors on the most significant risks and how they are being managed. And, it interrelates with performance management by providing risk-adjusted measures, and with internal control, which is an integral part of enterprise risk management."

This is why enterprise governance is such an important framework as it encapsulates corporate governance, performance management, internal control and enterprise risk management. It strives to achieve a balance between conformance and performance.

In recent months, there has been a very heavy focus on risks and internal controls associated with financial reporting due to the issuance of SEC rules addressing section 404 of the US Sarbanes-Oxley Act. There is a vivid contrast between the very prescriptive nature of the SEC rules, which only cover financial reporting, and the more principled approach taken by the UK Turnbull guidance which covers all areas of risk that a company faces, including financial reporting. The risks on the Strategic Scorecard will generally fall under the Turnbull guidance rather than under the Sarbanes-Oxley approach.

In the context of the Strategic Scorecard, the types of assurance on risks that would be covered include:

- a thorough review of risks in strategy – the twenty tough questions that need asking;
- impact and probability analysis for key risks;
- strategic risks embedded in company/divisional plans;
- due process to review risks (eg, risk workshops, stress testing);
- action plans for key risks monitored against milestones;
- risk management is embedded in acquisitions and major projects.

Summary

This chapter has presented the Strategic Scorecard with its four key elements:

- strategic position;
- strategic options;
- strategic implementation;
- strategic risks.

The following three chapters will explore complementary issues that will guide companies towards achieving robust conformance and performance.

Enterprise governance is such an important framework as it encapsulates corporate governance, performance management, internal control and enterprise risk management. It strives to achieve a balance between conformance and performance.

6 Enterprise Risk Management

This chapter was prepared by Richard Sharman and David Smith of KPMG.

This report has outlined the concept of enterprise governance and discussed the dimensions of conformance and performance. The inter-relationship of enterprise risk management with both dimensions has been introduced in the preceding chapters on strategic oversight and the CIMA Strategic Scorecard.

We will now discuss how formal risk management is being practically applied. The aim is to reconcile what, for many, are the conflicting agendas of conformance and performance in relation to the practical application of formal risk management.

Risk management and corporate governance

The role of risk management has historically been a largely peripheral one in many organisations. Focused on the prevention of physical and financial loss at an operational level, the formal consideration of risk was far removed from key decision-making. However, recent high profile corporate failures have highlighted that failure to identify and appropriately manage risk at a strategic level has a far greater potential impact on organisational fortunes than insured or tightly controlled operational risk.

The problem with this conclusion is the fact that there has traditionally been little appetite at board and senior management levels to overly formularise decision making – it is always viewed as a sure fire way of increasing bureaucracy and hindering performance. This is not to say that risks weren't considered in relation to strategic decisions in the past – no business would have lasted very long if this had been the case – but that it was an informal and often unconscious decision.

The global developments in corporate governance regulation in the 1990s attempted to prompt management to formalise the processes by which they assessed risks to organisational objectives. The aim was to protect and improve shareholder value through the formal consideration of risk. So how did we get to the stage where conformance and performance were seen as somehow antagonistic and mutually exclusive?

With hindsight it is clear that despite the best efforts of Cadbury, Turnbull et al it was the letter, rather than the spirit, of corporate governance that was adopted by many organisations. The identification and assessment of strategic risk, or 'business' risk as it had become known, itself became a discrete process; one that was reported in annual reports but failed to engage management and influence formally the key decision making processes.

The new agenda for risk management

Central to the requirements of enterprise governance is a clear relationship between the management of risk and the fulfilment of business objectives. Profits and growth are, in part, reward for successful risk taking.

Indeed it would be unfair to say that compliance requirements have driven the development of risk management at all organisations. Many organisations have now recognised that the modern business environment, characterised by an ever-increasing pace of change, necessitates a more performance-focused approach to risk management. The same approach needs to help their managers actually take more risk.

It is this recognition of a performance-driven approach to risk management – one that is wholly aligned with the spirit of good enterprise governance – that has given rise to the concept of enterprise risk management.

Central to the requirements of enterprise governance is a clear relationship between the management of risk and the fulfilment of business objectives. Profits and growth are, in part, reward for successful risk taking.

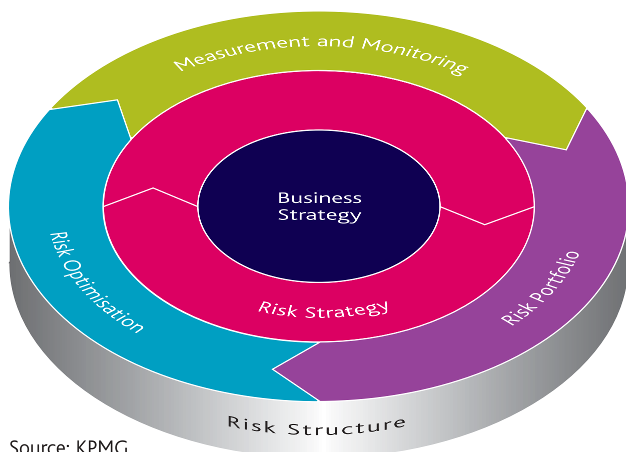
The extract from the current COSO enterprise risk management framework exposure draft on page 30, illustrates how enterprise risk management reconciles both:

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

In other words, it reconciles the conformance and performance dimensions.

A framework approach

Organisations adopting enterprise risk management generally do so through the development of a risk management framework or system. This approach attempts to pull together all of the elements required to integrate the consideration and management of risk with the everyday management of the business. The diversity of these activities, which are discussed in more detail, signifies a much broader approach than those driven by compliance requirements.



Source: KPMG

Through our work with a number of organisations that take risk management seriously, KPMG has defined a framework approach for the key elements of risk management:

The first stage of developing an approach to risk management is the development of a strategy which is supported by an appropriate structure. The delivery of the strategy is evidenced through the processes in place to generate a risk portfolio for the organisation. Once risks have been identified they need to be managed, or optimised, based on willingness or capacity to accept risk. Finally, the measuring and monitoring of the risk portfolio involves the establishment of measuring criteria and management reporting.

In using this best practice framework with organisations, KPMG has identified a number of key insights into the development of risk management. These include:

- Ignore the change management aspects of risk management at your peril. Introducing a risk management framework brings a number of changes to an organisation. Organisations that fail to address this appropriately will fail to fully embed risk management into their operations. At best you get two chances at implementing risk management, at worst, you get one. Organisations that are successful in managing change quickly create a consistent understanding across the organisation of what risk management entails and continually engage and energise their management and employees.
- Understand what you have and what you need. All organisations have elements of risk management already in place that work well, as well as some that don't. In recognising your position, you can prevent your organisation from re-inventing the wheel as well as identifying barriers to implementation moving forward. Current behaviours, culture, level of buy-in and practical support for risk management are key in this analysis.

- Risk assessment is a good introduction to risk management. Our experience tells us that conducting a risk assessment in isolation to achieve regulatory compliance will fail to deliver any real business benefit. However using risk assessment as a tool to enable a wider risk management discussion allows for an appropriate framework to be developed with management.
- The leaders need to lead, and be seen to lead. Senior management buy-in, commitment and the "tone from the top" are necessary for an organisation to get the full benefit of introducing risk management.
- Business strategy and risk strategy need to be aligned. Only through aligning your strategy for risk management with your organisation's strategy can the full benefits of risk management be achieved.

This last insight is worthy of further discussion. As outlined above, for many organisations risk management has generally been established to manage the meeting of compliance requirements and, as a result, often lacks any real relevance to the performance of the business.

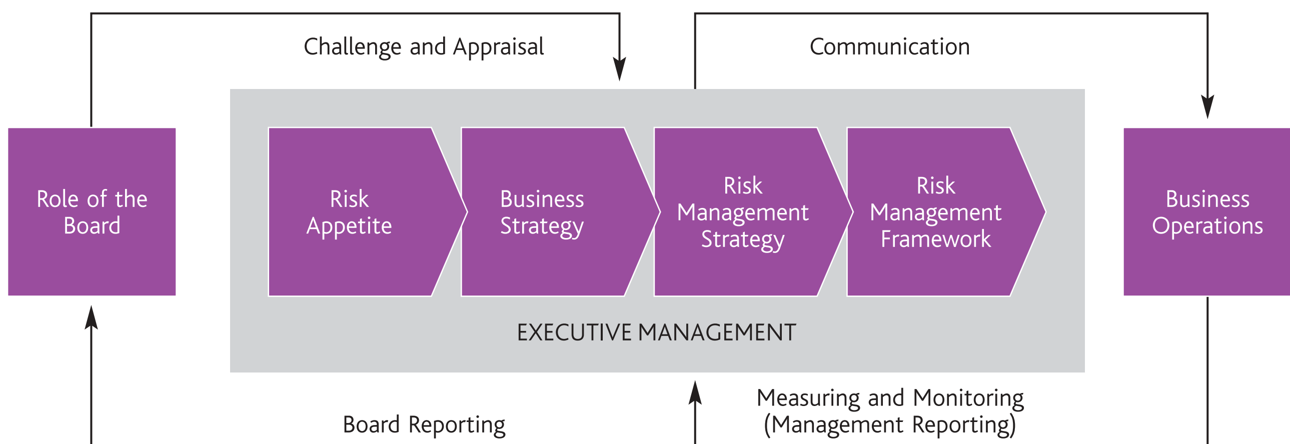
Without the direction provided by aligning the requirements for risk management with the objectives and strategic direction of the business, any framework for co-ordinating risk management activity is unlikely to offer any real value over and above compliance.

Therefore for the remainder of this chapter, we shall focus on reconciling the conformance and performance agenda.

Reconciling conformance and performance

There is currently much discussion as to the role of the board in relation to risk management. The terms "defining risk appetite" and "setting risk management strategy" are frequently used to illustrate what that role should entail. But what exactly do we mean by risk appetite or risk management strategy, and what is the role of the board in relation to these activities?

The diagram below summarises the key steps required for the development of an appropriate performance-focused approach for risk management at board and executive management level.



Source: KPMG

Risk appetite

The first step for any organisation seeking to improve the alignment of its risk management activity with its key decision-making is the formal definition of the amount, and type, of risk that is acceptable in the pursuit of its business objectives. This is its risk appetite.

Management and the board will normally consider the environment in which their organisation operates, and the risks inherent to that environment, and the amount of risk they are willing to accept in that environment. However, without an articulation of this position, decisions are likely to be taken inconsistently and the ability of the board to challenge the recommendations of management will be limited. Neither outcome is particularly healthy for an organisation, whether viewed from a conformance or performance perspective, and it is the lack of appropriate challenge on the acceptability of strategy that characterises much of the case study material in this report.

In most cases, risk appetite is defined by a mixture of quantitative and qualitative elements. Quantitative elements are generally difficult to define with great precision and most organisations arrive at an estimation of the amount of capital investment, for example, it is willing to risk in the pursuit of its objectives. Qualitative elements generally relate to the more intangible measurements of the organisation's value (eg, reputation and stakeholder relations).

Occasionally the terms "risk appetite" and "risk capacity" are used interchangeably. However, the two terms have very different implications. Considered simply:

- Risk appetite relates to the amount an organisation is willing to bet in the pursuit of its objectives; and
- Risk capacity relates to the amount an organisation is capable of losing before it endangers its own sustainability or, as is more often the case, market sentiment becomes irreparably damaged.

The risk appetite decided upon should be formally considered as part of the setting of business strategy, with investment plans, acquisitions, divestments and other strategic decisions reviewed against it as they arise.

In practice, in more decentralised organisations there will most likely be different levels of risk appetite for different operations or individual businesses and a portfolio view of risk and return will be taken. Even in less diverse organisations, it will be the case that certain ventures or activities are looked to for providing the future growth of the organisation, and are therefore likely to carry greater associated risk, whereas some activities may be core to the organisation's current performance, providing a platform for growth elsewhere, and consequently there will be less appetite for risk in these areas.

The definition of risk appetite can be as complex or as simple as organisations would like to make it. But somewhere in the discussions of corporate objectives, and the setting of the strategy to deliver those objectives, there should be the formal recognition of what the pursuit of these objectives will mean in terms of the acceptability, or otherwise, of the risks attached.

A well-defined appetite for risk will influence the setting of overall business strategy. The strategy documents that go to the board for approval should include commentary on the key risks associated with the strategy and their acceptability in line with the agreed risk appetite.

Risk management strategy

The setting of organisational strategy constitutes how an organisation will prioritise its focus and allocate its resources to exploit identified opportunities. Supporting strategies will also be developed for the allocation of resources and investment in areas such as human resources and IT. The allocation of risk management resources and investment is no different in this respect.

A core minimum requirement of risk management capability exists for most organisations to meet conformance requirements (eg, to at least annually review the effectiveness of internal control). But it is the performance requirements of business objectives and strategy that should ultimately direct the organisation's investment in risk management.

For example, the extent of risk management training for management and employees will be driven by the amount, and type, of risk contained in the business strategy and targeted at recognised high risk areas of the business. It should also be recognised that the nature of the training will differ between areas of the organisation where managers are directed to take more risk in the pursuit of high returns, and those areas where there is less appetite for risk.

In general, a risk management strategy should contain the following key areas:

- Statement on the value proposition for risk management – specific to the organisation and in relation to its business objectives and the risk environment in which the organisation operates;
- Definition of the agreed risk appetite of the organisation;
- Definition of the objectives for risk management based on organisational objectives and supporting business strategy;
- Statement on the required organisational culture and behavioural expectations with regards to risk taking;
- Definition of organisational ownership for the risk management strategy at all levels;
- Reference to the risk management framework or system being employed to deliver the above requirements; and
- Definition of the performance criteria employed for reviewing the effectiveness of the risk management framework in delivering the risk management objectives.

As with any element of strategy, how an organisation actively targets its risk management resources to manage risk both effectively and appropriately to deliver performance should be reviewed and revised regularly in line with its overall business strategy.

Risk management framework

Much has already been written on the purpose of a framework approach to risk management and the activities that constitute that framework. As stated above, the risk management framework should be constructed for the effective implementation of the chosen risk management strategy across an organisation, and for most organisations the elements that constitute such a framework already exist.

Most organisations already have a process for the consistent assessment of risk across their operations. The majority of organisations have a function, or dedicated responsibility, for risk management at a corporate level and an increasing number have a dedicated forum for the direction and oversight of risk management[1]. What else do organisations need to do in relation to the practical application of risk management?

First, the board needs to spend more time on risk. As discussed above, the leaders need to lead and be seen to lead. For a risk management framework to be effective, the board needs to understand the organisation's risk management strategy and framework and adapt them as necessary in line with the organisation's overall business strategy, objectives and direction.

Secondly, the board should rely more on its risk management resource. Relying on its risk management function to understand how the organisation is performing allows a risk specialist to assess the organisation's performance against the agreed strategy and supporting framework more accurately than the board would be able to conduct in isolation.

The risk management function needs to:

- Continue to support the embedding of risk via a co-ordinated and simple approach;
- Improve the development and formalisation of the risk management strategy and engage leadership;

(1) As at August 2003 24% of FTSE 100 organisations disclosed the existence of a Risk Management Committee. A recent survey conducted by CFO Europe and KPMG found that 26% of survey organisations had established a Risk Management Committee in 2002/03 and 15% planned to do so in 2003/04 (Source: Governance, Risk & Assurance Survey, CFO Europe 2003).

- Move away from compliance to a more strategic input;
- Spend less time on facilitation and act with more teeth;
- Provide more detail on the key risks and how they are being managed;
- Develop a learning culture to become more sophisticated in terms of risk management;
- Define what it can and cannot do;
- Become more efficient and cost effective; and
- Continue to identify and justify the value it is adding.

In addition, the board needs to improve the reporting structures used to report risks. Improving the risk reporting structures allows for a more complete, timely and accurate analysis of the position of the company. This will help the organisation make better-informed decisions more quickly.

Hand in hand with improved reporting structures is the increased disclosure of risk information. Investors and financial analysts are starting to put more emphasis on the management of risk within organisations and are looking favourably at organisations that are able to demonstrate a strong risk management position.

Finally, the board needs to increase its interest in assurance. Whilst it is important that the board understands its risks, it also needs to understand how these are being controlled and how effectively this is being done.

Once this alignment is made through following the preceding stages of defining risk appetite and setting the risk management strategy, the value of a coordinated framework of risk management activity becomes clear to the organisation.

Conclusion

A developed approach to risk management, commonly termed an enterprise risk management approach, seeks to reconcile both the conformance and performance dimensions of the enterprise governance framework.

With strategic direction, the risk management framework will also operate more efficiently and will ultimately provide the board and senior management with the information they need to discharge both conformance and performance duties. It will give:

- Increased confidence that the right skills and support exist at all levels to manage risk in line with the objectives and appetite for risk of the organisation;
- Improved ability at board level to challenge management recommendations based on having the right information on the risks associated with key business decisions and an agreed benchmark (risk appetite) of acceptability;
- Improved ability to increase stakeholder confidence that the organisation is taking risk management seriously and actively using it as part of its everyday management to support performance objectives. This need is set to intensify with the introduction in many countries of more demanding company reporting requirements.

Where the direction of risk management activity, collectively termed a risk management framework, is developed to support the delivery of organisational performance objectives, it is more capable of providing assurance that the business is being managed responsibly – the guiding spirit of corporate governance requirements.

7 The Acquisition Process and the Risk Management Process to Support it

Mergers and acquisitions are notoriously risky and often fail to deliver the benefits envisaged when they are approved. They can be driven by emotion and enthusiasm rather than fact and logic, and are frequently managed poorly. This chapter, therefore, attempts to identify key issues and put forward an approach whereby risk plays an important role in the acquisition process. The sections are:

- Why acquisitions are different;
- Acquisition must be linked to strategy;
- The acquisition process;
- Risk management;
- The risk management process;
- Summary.

This chapter is based on case studies in the BOC Group plc (an industrial gas and vacuum company that operates in over 50 countries), on research on best practice in acquisitions and the case studies examined in the enterprise governance project.

Why acquisitions are different

A KPMG survey of acquisitions in 2001 revealed the following statistics:

- 30 per cent of deals added value;
- 39 per cent of deals produced no difference;
- 31 per cent of deals destroyed value.

The common reason for failure was a lack of effective project management and the research indicated that companies adopting effective project management were 29 per cent more likely to be successful than those without.

A quote in *The Economist* article *'Why too many mergers miss the mark'* commented:

'What does seem to link most mergers that fail is the acquirer's obsession with the deal itself, coupled with too little attention to what happens next – particularly the complex business of blending all the systems, informal processes and cultures that make the merging firms tick.'

Research by Ernst & Young indicated that internal issues were cited by 58 per cent of respondents as the main reason why cross-border acquisitions were riskier than domestic ones. This seems to indicate that such things as regulatory differences and differences in standards are considered to be surmountable, but that most intangible differences, such as cultural ones, are more difficult to crack.

Further quotes on integration highlight the issue that post acquisition is always the last piece attended to:

"Planning is the exception, not the rule, and a large number of acquisitions fail because companies do not plan integration as part of the deal."

"Most top executives are aware that poorly conceived or overpriced acquisitions are doomed to failure regardless of subsequent events, but few appreciate that even well-conceived deals can quickly disintegrate without active and sharply focused management of the post-acquisition integration process."
I.J.R. Harbison and S.J. Silver
Booz-Allen & Hamilton

"The weak spot in the acquisition is right after the deal is completed. That is when companies face value-killing indecision and aimlessness."
Mergers and Acquisitions Magazine

Acquisition must be linked to strategy

Many acquisitions are entered into in order to achieve strategic objectives when other means have failed. In these circumstances, the acquisition is often viewed as a desperate measure to achieve success and rarely succeeds.

Similarly when consolidation occurs within a business sector or when there is a great deal of acquisition activity in a market sector, the temptation is to be active in the acquisition market and sufficient time and effort is not taken to complete the process as outlined in this chapter.

Mergers and acquisitions are notoriously risky and often fail to deliver the benefits envisaged when they are approved. They can be driven by emotion and enthusiasm rather than fact and logic, and are frequently managed poorly.

The case of Marconi in the UK provides an interesting example. For many years, Marconi had been a business based on heavy industry with large cash holdings. It was widely perceived as a stagnant and slumbering giant. With the departure of the long-standing chief executive, who was something of a cult figure, overwhelming pressure had built up for rapid and radical change. There was no appetite for a measured approach. The decision was therefore made to move away from heavy industry to being a high-tech telecoms equipment provider. This was to be achieved through mergers and acquisitions and, at first, Marconi was lauded for "executing one of the boldest and most successful metamorphoses of a British company". However, it appears that the emphasis on buying and selling businesses meant that the actual operational task of integrating and running the businesses was overlooked. John Kay, a leading UK economist described the Marconi executives' perception of their role as "meta-fund managers" where the director manages a portfolio of businesses for shareholders. In his opinion, this is the wrong job and instead, executives should concentrate on running operating businesses well.

In the case of Xerox in the US, "*Xerox tended to buy the wrong company at the wrong price and then run it into the ground*" (Business Week, March 2001).

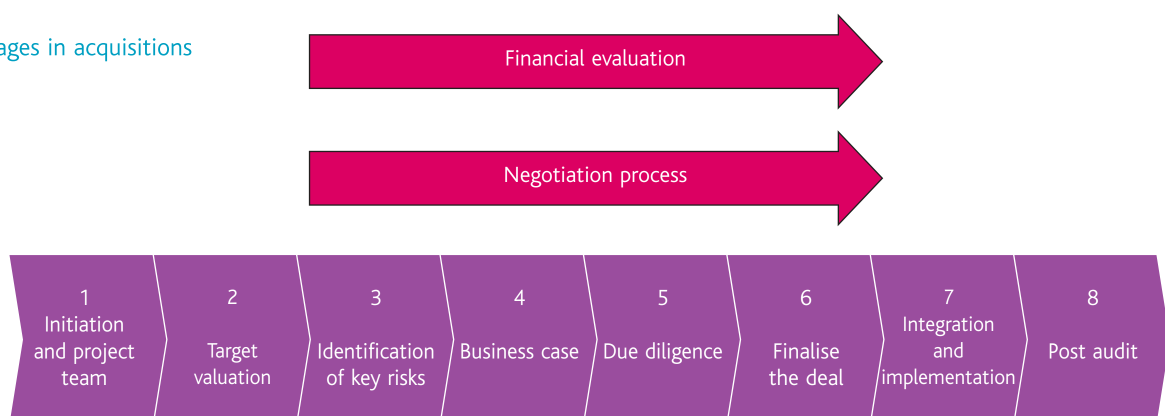
Successful acquisitions should occur as part of a planned strategy. The strategy should identify target businesses in targeted markets. Rarely do successful acquisitions come out of opportunistic approaches by buyers or sellers where it is then rationalised as a strategic fit.

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. Conversely gaps in the answers highlight the key risks that will face the acquisition. See section below on the acquisition process where stage 3 discusses the identification of key risks.

The acquisition process

The process map below, therefore, starts when the target has been identified and is regarded as a strategic fit. Arguments are often made that the sequential steps in the process are not reasonable when the pressures of financial evaluation and particularly re-negotiation are layered on top. In effect these two processes can go through many interactions during stages 2 to 6. In some instances, some of the steps will be run in parallel.

The key stages in acquisitions



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. Companies that had an experienced process/project manager in acquisitions from target identification until post implementation evaluation were 71 per cent more likely to be successful than those that did not.

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. This enables a derivation of a range of valuations. The most rigorous technique is the use of discounted cash flows with an explicit incorporation of the cost of equity. The other techniques are less rigorous but allow reality checks that relate to market values and similar previous transactions. Sensitivity and scenario analysis should be undertaken to establish the key variables and probable ranges of benefits to be secured.

It is important to keep in mind the intrinsic value to the bidder compared to the cost to be paid. Other things being equal, the objective must be to maximise this difference and, ideally, to pay only one more dollar than the next highest bidder. It is also important to value, using similar techniques, how much the business is worth to the vendor through possible alternative courses of action including continuing as an ongoing business, asset disposal, fire-sale etc.

An important opportunity cost that is often not factored in, even on a notional basis, is that of executives' time. A major acquisition involves a substantial amount of executive time that might otherwise be dedicated to the improvement of value in the main business.

Two areas that will also need covering are tax issues/opportunities and the appropriate accounting treatment of the acquisition both in the initial and subsequent years. Areas of increasing importance in valuations are existing and potential liabilities associated with post-retirement benefits, healthcare costs and the impact of social and environmental legislation.

The detail of these and other techniques are not covered here and there are several respected texts on the methodologies. A couple of these are listed in Appendix 5 – References and further reading, eg, Brealey and Myers, 2003 and Tom Copeland et al, 2000.

The valuation process must be objective and well documented. It must be closely connected with the business case (see stage 4). As far as possible, the assumptions must be well-grounded on facts or well–substantiated hypotheses. One of the greatest risks is so-called winner's-curse where emotions overrule objectivity and a company wins a contested bid at a price at which it is unlikely to ever gain any economic benefit.

Stage 3 – identification of key risks
There are many risks in an acquisition, as already identified earlier in this chapter. It is critical to manage all of the risks at the earliest stage possible:

- Is the deal consistent with the business strategy?
- What is the quality of the business being acquired?
- What is the track record of the acquiring management team?
- Has the management team considered alternatives to acquisition? (eg, internal development or alliance/partnership).

- Does the management have the capacity to integrate the deal?
- At a high level, what are the synergies available?
- Can the deal be financed?
- What is the quality and motivation of the management team being acquired?
- Early identification of potential deal breakers.
- Fix the maximum you are prepared to pay and walk away.
- Evaluate all ways of getting an inside track to get priority bid status.
- Identify the other potential bidders and undertake a competitive bid assessment.
- Don't lock yourself in or over-commit in the initial bid.

Have a clearly defined negotiation strategy for the next phase.

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.

Management should clearly set out the business case for the acquisition. This should include the fit with strategy, the key assumptions and sensitivities, a summary of risks (as per stage 3). It must also include a clear integration plan (see stage 7) with time-scales and resource allocation (including key personnel).

"For an acquisition to deliver improved financial performance, it must enhance the strategic position of the acquirer's business or of the target's businesses. More precisely, it must either improve either market economics (market profitability, size or growth) or competitive position (differentiation or relative cost) of the business units. Testing this linkage between strategic position and financial performance can help to unearth issues with a deal's value creation potential" (Armour, 2002).

It is in testing the strategic rationale that the independent directors on the board can add significant value to the decision-making process. Management must therefore give a clear exposition of the rationale.

Stage 5 – due diligence
This is covered in a subsequent section – the risk management process.

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 – eg, commitments, due diligence outcomes, warranties and indemnities, risks and mitigation, resolution of issues etc. Copies of the sale and purchase agreement and any other documents relevant to the transaction should be attached to the sponsor's note. This process clarifies the basis of the final decision and ensures that all are aware of the conditions and of course the risks of the deal.

The critical steps here are to ensure that:
- due diligence has been properly carried out and that there are no unresolved issues;
- the deal reflects the business case;
- there is a clear integration plan.

It is best to formalise the process for each step and for the complete process. Best practice is to mandate the use of the process and report formally to the board. The investment committee can then track all acquisitions from early warning papers to post audit and reports on the steps for each in a monthly summary. Research has identified that:

- Transactions were more successful in creating shareholder value where clear decisions were taken about how each of the steps would be managed and by whom.
- Successful acquirers (remember the low success rate of 30 per cent) undertook all stages earlier in the process than those who failed to create value.
- Companies that failed to create shareholder value in acquisitions responded that they would have undertaken all activities earlier if given the opportunity to re-perform the transaction.
- Adopting a thorough process with clear responsibilities increased the likelihood of success by 29 per cent.

Stage 7 – integration and implementation

Much of the loss in value in acquisitions occurs because of poor integration and implementation. This is an area poorly covered in many acquisitions. See further information on this in the section below – the risk management process.

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.

Risk management

Project management must pick up the risk management process. This is often facilitated by an expert (ie, risk specialist) and this is expanded upon in the next section. A list of the tasks for risk management includes:

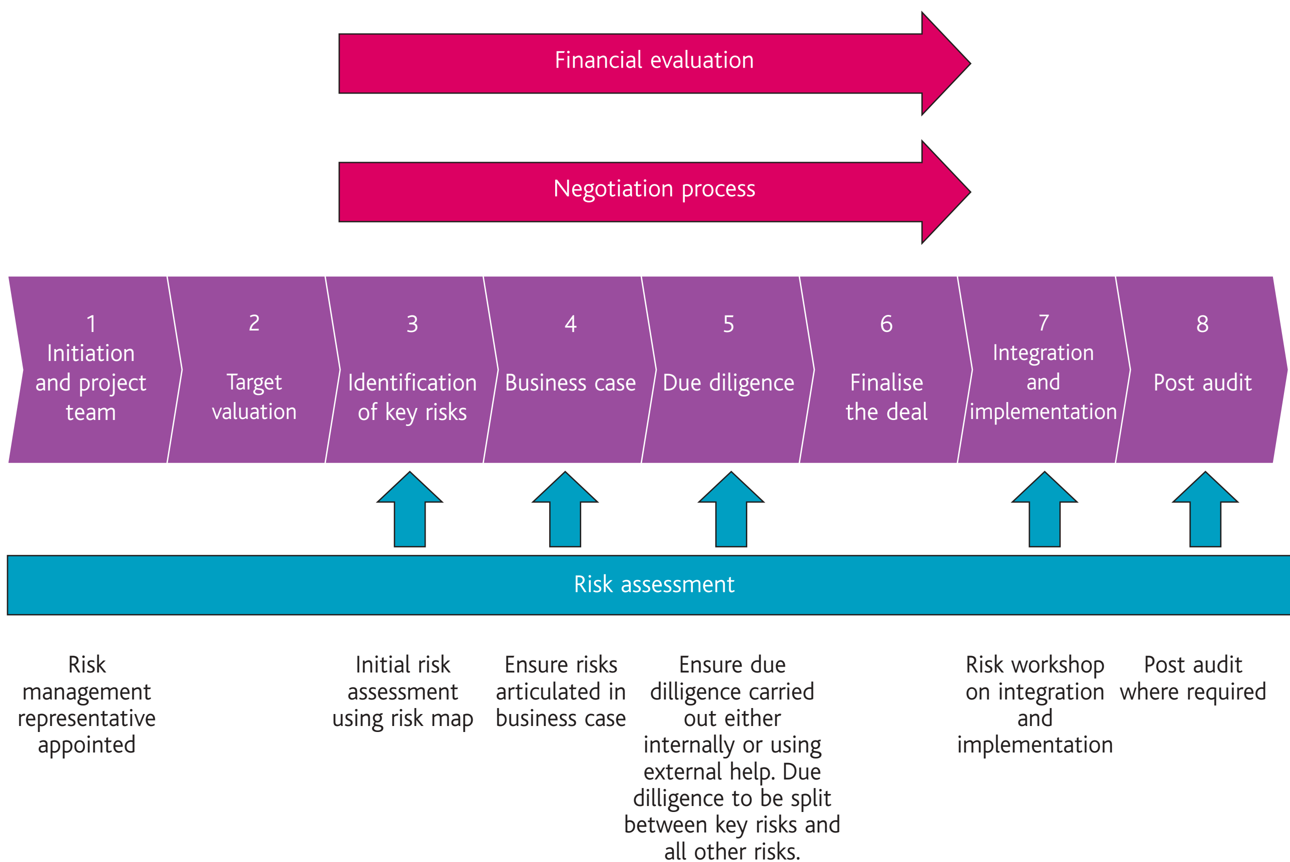
- Repeatedly check the strategic and business rationale as new information is disclosed.
- Perform external checks on the target's management team.
- Compile a checklist of doomsday scenarios and ensure all have been assessed.
- Ensure the deal team is balanced: internal deal practitioners; external advisers; management responsible for subsequent performance etc.
- Take the synergy plan to a high level of detail, include costs and timings, get both managements to commit to the targets if possible.
- Plan the integration in meticulous detail, including resourcing.
- Understand all political, regulatory and environmental risks.
- Have a clear set of actions on day one and in the first few weeks.
- Decide early on the composition of the new management team.
- Have a clear communication plan for all stakeholders.
- Anticipate potential employee issues, particularly where unions or works councils are involved and redundancies are planned. How could they disrupt the business?
- Understand the IT systems in detail and how they will be integrated. Make sure a very strong technical service agreement is in place if necessary, with appropriate regular service delivery assessments.
- Keep an eye on spoiling tactics by competitors.
- Negotiate the sale and purchase agreement (SPA) to allow for price adjustment.
- Check for change of control clauses – everywhere.
- Ensure target management is locked in where desired and that mechanisms are in place to retain their motivation and hunger.
- Be prepared to walk away! Objectivity is critical, especially approaching closing.

Much of the loss in value in acquisitions occurs because of poor integration and implementation. This is an area poorly covered in many acquisitions.

The risk management process

Due diligence is well recognised as a process for reviewing the risks in an acquisition, but it is often too late in the process and it would be more effective if risks were identified at the earliest possible stage and the potential show stopper risks prioritised.

The following diagram builds on the process map and identifies the responsibilities of a risk management function.



The following gives a brief summary of the tools and techniques to be used by risk professionals.

Stage 1 – initiation and project team
Risk management representative appointed to the project with responsibility for ensuring risk management support is provided at each stage. This is likely to be different people at different stages to reflect the skill requirements, eg, carrying out due diligence, facilitating an integration and implementation risk workshop or external specialists if necessary.

Stage 3 – identification of key risks
The use of a risk map enables the risk specialist to conduct a discussion with the project manager – usually lasting two to three hours. The business risks need to be evaluated from all angles – strategic, financial and operational. The topics covered in the discussion are:

- business environmental;
- operational complexity;
- financial health;
- impact on company (ie, acquirer);
- future.

Each heading has a list of sub-headings to promote discussion. The objective of the exercise is to identify the key risks relating to the specific acquisitions (normally around five) and to ensure that future work is focused around these key risks. This process also helps to prioritise due diligence and avoid the situation where key risk areas are poorly addressed by the target in any data room or due diligence exercise, whether intentional or not!

Stage 4 – business case
To ensure that all the key risks are included in the business case. There is the temptation to say that a certain risk is out of scope by the local project team whereas in fact, it is a critical requirement in a corporate review.

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. It is useful to bring in corporate or global business functional managers to sign off the important areas of due diligence which of course vary by acquisition but may, for example, be HR or safety related.

A primary purpose of due diligence is to ensure that there are no black holes in the acquisition. A recent survey identified that deals were 26 per cent more likely to be successful if acquirers focused on identifying and resolving cultural (or soft) issues in the due diligence process. On significant acquisitions, a full time due diligence co-ordinator is required who will manage this important process and produce weekly executive reports highlighting issues. This executive report on due diligence is an essential document in finalising the deal and may indeed be the main topic in a final review before completion.

Stage 7 – integration and implementation
The risk specialist can ensure that the risks at this stage are well understood and that appropriate mitigation plans are put in place. 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.

The specific integration plans focus on integration of:

- processes and functions (especially when impacting customers);
- technology;
- people and culture.

Some best practice guidelines on integration and implementation include:

Integration leadership
The complexity of integrated programme management requires a full time leader who focuses exclusively on directing the process.

Strategy alignment
Creating and disseminating a document that focuses the integration team on the acquisition value drivers ensures prioritisation of critical activities. Regularly requiring the integration leader to apprise the CFO and board of directors of progress against documented strategic integration activities mitigates the risk of task misprioritisation.

Employee communication
Building comprehensive communication plans that provide early, frequent and clear messages.

Key talent identification
Interviewing senior executives in the target company regarding key mid-level personnel and evaluating employees' performance on integration teams increases the probability of identifying hidden talent. This enables the acquiring company to target and retain these valuable employees.

The final guideline on integration is: "The first 100 days after acquisition are the most critical for success – the process is often derailed because of speed."

The following is a typical, but not comprehensive, list of actions arising from a risk review:
- Rigorously maintain senior management focus on delivering the identified benefits.
- Make sure the board is aware of and involved with the progress – keep the pressure on.
- Make it clear the integration leader has full management and board authority.
- Take people decisions fast – don't have leavers hanging around causing problems.
- Make sure team leader and integration resources are in place and where necessary full time allocated. Fast integration must be their number one priority.
- Initiate the communication plan, make sure all stakeholders are involved and check that messages are being received and understood.
- Visit all the key customers to retain their business.
- Control the chequebooks, capital authorisation and signing authority.
- Deal with unexpected issues fast – don't let them multiply and have an escalation process.
- Watch out for spoiling from inside your business – some people may wish to see the deal fail, often for non-obvious reasons.
- Don't let the costs creep – hold people accountable for plans and estimates.
- Pay special attention to IT, especially security against disaffected employees.

Stage 8 – Post audit
The audit function can assist in the post audit exercise with the focus on establishing learning.

There should be a formal process for post audits – normally twelve months after the completion of the acquisition and, of course, to assess the results of the deal.

As part of the learning, old and expensive mistakes can be eliminated to ensure that shareholder value is maximised.

Surprisingly, in recent research it was stated that less than half (45 per cent) had carried out a formal post-deal review.

6. Summary

Given the poor results from acquisitions and the enormity of risks that arise both during the pre-bid, the due diligence and the post-bid activities, it is surprising that more focus has not been placed on acquisitions.

The research has identified the following as key requirements to ensure success:

- Effective and experienced project management is essential and a full time role.
- Rigorous evaluation of synergies and ruthless implementation of these is essential.
- Effective due diligence is critical.
- Experienced specialists are essential – with recent deal experience. This is not a job for the inexperienced executive, even if he/she has been successful in other roles.
- Early identification of risks with appropriate mitigating action.

8 Board Performance

The case studies clearly showed the importance of an effective board. New measures that have been introduced in various countries to strengthen corporate governance have tended to focus on corporate board structures. The key issues that have been covered include the balance between executive and non-executive directors, the independence of directors, the appointment process and the alignment of directors' interests with those of the shareholders.

However, it is also being increasingly recognised that such measures, while valuable, do not necessarily guarantee more effective board performance. For example, companies featured in the case studies such as Cable & Wireless in the UK conformed with all the board provisions in the UK Combined Code, but this did not prevent trouble. Consequently, increasing attention is being paid to issues such as:

- director induction and training;
- widening the pool of possible candidates;
- board design; and
- boardroom dynamics.

As part of this drive, there has been a move towards introducing performance evaluation processes for boards. A recent example is the revised UK Combined Code on corporate governance which states that the board should undertake a formal and rigorous annual evaluation of its own performance and that of its committees and individual directors. The code contains guidance in the form of additional questions that should be considered, for example:

- What has been the board's contribution to the testing and developing of strategy?
- What has been the board's contribution to ensuring robust and effective risk management?
- How has the board responded to any problems or crises that have emerged and could or should these have been foreseen?
- Are the matters specifically reserved for the board the right ones?
- Is the board as a whole up to date with latest developments in the regulatory environment and the market?

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

CMA Canada's guideline *Measuring and improving the performance of corporate boards* also proposes a range of measures that can help boards to increase their effectiveness. It argues that in many cases of recent corporate failure, it was the board's lack of a strategic performance measurement process that resulted in inadequate board oversight and control. This allowed improper activities to occur. Its focus is therefore on performance measurement systems and it includes performance metrics for board self-evaluation, the evaluation of chief executives and the board's evaluation of corporate performance. With its focus on both corporate governance issues and strategic aspects, this guideline is consistent with the enterprise governance framework.

The Australian "Group of 100" senior finance executives has also recently issued guidance, *Boardrooms that work: a guide to board dynamics*. This focuses on the interactions between board members and highlights warning signs of board dysfunction. These include:

- The dominant personality;
- Hurried decision-making;
- Serial restructuring and resignations of key executives;
- Favouring particular interests;
- Interfering with information flows.

The case studies clearly showed the importance of an effective board. New measures that have been introduced in various countries to strengthen corporate governance have tended to focus on corporate board structures.

The report argues that the creation of a healthy board culture is essential to achieve effective board performance and covers issues such as communication, listening, performance evaluation and the use of external experts to provide fresh perspectives.

There is little doubt that expectations of company boards is greater than ever and yet directors are limited by the amount of time that they can devote to what are becoming increasingly complex businesses. Consequently, demands for greater independence of directors carries a high cost in terms of reduced knowledge of the business – independent directors may be even more captive to management's view of the business.

In *Back to the Drawing Board,* Colin Carter and Jay Lorsch argue that boards need to give explicit consideration to the issue of board design. Even within the confines of corporate governance recommendations, boards still have considerable freedom of manoeuvre. The structure, composition and processes of the board should be designed to suit the particular circumstances of the company and the role that the board has elected to play. In general, boards have three key tasks:

- Monitoring management;
- Decision-making;
- Providing advice.

Different boards should combine the three tasks in different ways. So, for example, boards may lean to a more hands-on, pilot role in companies in industries that are going through rapid change. Carter and Lorsch do not regard the distinction between governance and management as cut-and dried. The design of the board also needs to balance independence and the need for a knowledgeable board. Furthermore, it needs to be kept under regular review rather than ruled by habit and tradition.

This is an interesting approach which recognises the need to find the best way of managing the board within the constraints of time and knowledge.

Summary

Effective board performance is crucial for corporate success. This requires more than simply conforming with corporate governance guidelines. A number of interrelated approaches have been considered that are designed to assist boards improve their effectiveness.

9 Appendices

APPENDIX 1

Objectives of the Project

In October 2002, the Professional Accountants in Business Committee (PAIB) was asked by the IFAC Board 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.

The key outcomes targeted for the project were to:

- Test further the concept of enterprise governance and expand the framework;
- Explore what causes corporate failures against the evolving framework of enterprise governance. This would focus as much, if not more, on reasons of strategic failure as much as on fraudulent activity;
- Explore the concept of a Strategic Scorecard as a means of the board (particularly non-executive directors in a unitary board structure and the supervisory board in a two-tier structure) having an assured monitoring of the entity's strategic positioning, options and progress.

APPENDIX 2

Synopsis of International Corporative Governance Developments

Efforts to improve standards of corporate governance have been underway for many years both at national and international level. However, as indicated below, there has been a notable upsurge in activity since the collapse of Enron. What is of particular note is increasing international convergence. Many countries are adopting the "comply or explain" approach. This requires companies to comply with an evolving set of best practice principles rather than rule-based, inflexible legislation – or explain with reasons why they have not complied. There are, however, variations in how these provisions are implemented in different countries. The one notable exception to this principles-based approach is the United States with the Sarbanes-Oxley Act, although as indicated below, the legalistic response to recent corporate scandals is being questioned. Going forward, a key challenge is the achievement of high minimum standards of corporate governance worldwide. The OECD Principles of Corporate Governance (see below) are a welcome statement of intent in this regard, but there is some way to go before they are implemented with equal rigour globally.

The following is a brief outline of national and international developments, including all of the countries represented on the project team.

General Background

Listings of international codes can be found on the following websites:

The International Chamber of Commerce
www.iccwbo.org/CorpGov/Best_Practices_And_Codes.asp

and the European Corporate Governance Institute (includes all international codes, not just European ones).
www.ecgi.org/codes/index.htm

Australia

The Australian Stock Exchange (ASX) convened the ASX Corporate Governance Council in August 2002. Its purpose was to develop corporate governance recommendations that reflected international best practice. The council issued *Principles of good corporate governance and best practice recommendations* in March 2003. These set out ten essential principles of good corporate governance.

The Australian Federal Government has been undertaking a comprehensive programme of company law reform in recent years in a drive to promote business, economic development and employment. The Corporate Law Economic Reform Program (CLERP) has, to date, comprised a series of initiatives including the Corporate Law Economic Reform Act 1999 which set out changes in corporate governance and accounting standards (CLERP 1-5). Most recently, the draft CLERP 9 Bill focuses on audit reform, corporate disclosure and executive remuneration and the outcome of consultation is awaited. It is expected to become law in July 2004.

In addition, in April 2003 the Report of the HIH Royal Commission which looked into the failure of the HIH Insurance Group was published. Of the 61 policy recommendations in the report, 17 related to corporate governance and some of these are reflected in the draft CLERP 9 Bill.

Canada
The Joint Committee on Corporate Governance (the Saucier Committee), was established in July 2000 and published *Beyond Compliance: Building a Governance Culture* in November 2001. It argues that the board adds value, first and foremost, by selecting the right chief executive for the company. Beyond this it adds value by setting the broad parameters within which the management team operates, coaching the chief executive, monitoring and assessing his or her performance and providing assurance to the shareholders and other stakeholders about the integrity of the company's financial performance.

France
France has issued a series of reports on corporate governance within the last ten years (the two Viénot Reports in 1995 and 1999 followed by the Bouton Report in 2002). The European Commission issued a Recommendation that each member state should designate a code of best practice with which businesses must comply or explain reasons for non-compliance. In response to this recommendation, these three reports have now been combined into a single code *(Le gouvernement d'entreprise des sociétés cotées* or *The corporate governance of listed corporations)*. This was published in October 2003.

The main focus of the report relates to the roles and responsibilities of the board, board committees (especially the audit committee), individual directors, off-balance-sheet items and risk disclosure, but there are also far-reaching provisions in relation to the independence of auditors.

In addition to French law which provides for joint statutory auditors, a fixed appointment of six years, a rotation in signatories of accounts for accounting firms in the major networks, the code provides for a ban on non-audit services and for the audit committee to have the authority to steer the procedure for the selection of the statutory auditors.

Hong Kong
Corporate governance has attracted increasing attention since the Asian financial crisis in 1997. Most recently, in June 2003, the Standing Committee on Company Law Reform issued an extensive consultation paper relating to Phase II of its Corporate Governance Review. This covers various aspects of corporate governance reform and follows an earlier consultation on Phase I in 2001. The outcome of this consultation is awaited.

Italy
The Preda Report was issued in October 1999 under the sponsorship of the Italian Stock Exchange. A revised version was published in July 2002. Its main objective is to enable Italian companies to increase access to, and lower the cost of, capital. The code covers the various aspects of corporate governance, including the roles and responsibilities of the board, internal control, executive remuneration and relations with shareholders. However, laws against fraudulent accounting have actually been watered down in recent years and there have been renewed calls for reform and regulation following the recent, devastating Parmalat scandal.

Netherlands
The Dutch code of best practice (the 40 recommendations of the Peters Report) was reviewed in 2003 in the light of concerns over excessive executive pay and corporate scandals. Notably there was the €970m loss at Ahold, the Dutch grocery group and one of the companies featured in the case studies in this report. The Tabaksblat Committee issued a revised code of best practice in December 2003 and this came into effect on 1 January 2004. The code is based on the principle of "comply or explain". The two-tier board structure that is characteristic of most Dutch companies is maintained, but a clear distinction is drawn between management and supervisory board roles.

South Africa
The King II Report on corporate governance was published in early 2002 to update King I which had been in place since 1994. New measures include the possibility for shareholders to bring class actions against companies where there have been corporate governance failures. The South African approach has embraced environmental, ethical and particularly social issues more than any other country. This has been influenced by the country's history of apartheid and the need to bring about rapid social transformation.

United Kingdom
There have been a number of reviews of corporate governance in the UK, starting with the Cadbury Report in 1992, followed in 1998 by the first Combined Code on corporate governance. A revised Combined Code was issued in July 2003 and came into effect for all reporting years beginning on or after 1 November 2003. Although the revised code remains voluntary, it is appended to the Listing Rules so that listed companies are required to comply or explain the reasons for non-compliance with the code. In practice, therefore, the code is far more than voluntary.

The 2003 revisions to the code are the consequence of a number of reviews which were launched by the UK government in response to the Enron failure. One of the reviews resulted in the Smith Report that provided guidance to assist company boards in making suitable arrangements for their audit committees and to assist directors serving on audit committees in carrying out their role. The Higgs Report investigated the role and effectiveness of non-executive directors. Higgs' suggestions for good practice are included in the revised code and cover topics such as induction for directors and performance evaluation for boards.

In summary, the Combined Code now contains a Code of Best Practice comprising a series of main principles with supporting principles and the detailed "comply or explain" code provisions. This is supplemented by the Higgs and Smith guidance together with the earlier Turnbull guidance on internal control, all of which are aimed at providing further guidance on how to implement the provisions of specific areas of the code.

United States

In the wake of Enron, WorldCom and the other major US corporate scandals, the US moved quickly to strengthen corporate governance. The result was the Sarbanes-Oxley Act which was passed in 2002 and represented the most fundamental overhaul in US corporate legislation since the 1930s. Included in the Act are measures to establish a new oversight board for the auditing profession (the Public Company Accounting Oversight Board or PCAOB); increased requirements on management to report on internal controls and to sign off accounts, and; a requirement for audit committee members to be independent.

The Act also applies to foreign companies listed in the US. This has been the subject of much controversy although the Securities and Exchange Commission (SEC) has now relaxed some of the rules such as the audit committee requirements for these companies.

Recently this legalistic approach has been questioned. The new chairman of the SEC, William H Donaldson, and other leading commentators have expressed concerns that compliance is becoming too onerous.

Also of note is the Breeden Report *(Restoring Trust)* on the future corporate governance of MCI Inc (formerly WorldCom) which was published in August 2003. This contained 78 wide-ranging recommendations which MCI is obliged to implement. These cover the selection of the board, executive remuneration, the establishment of the position of non-executive chairman, accounting and disclosure, ethics etc. Although the report was aimed at one specific company, it is being seen as a blueprint for future US corporate governance.

European Union

In September 2001, the European Commission appointed a High Level Group of Company Law Experts, chaired by Jaap Winter. This group presented its Final Report *(A modern regulatory framework for company law in Europe)* in November 2002, which focused on corporate governance in the EU and the modernisation of European Company Law. In response to this report, the European Commission issued an Action Plan in May 2003 *(Modernising company law and enhancing corporate governance in the European Union – a plan to move forward)*. The Commission has concluded that there is no need for a European Corporate Governance Code as this would simply be an additional layer between international principles and national codes. Instead, it proposes a common approach covering a few essential rules, including:

- the requirement for listed companies to publish an Annual Corporate Governance Statement in their Annual Reports;
- the establishment of minimum standards on the creation, composition and role of the nomination, remuneration and audit committees;
- the requirement for greater transparency and shareholder influence in relation to executive remuneration;
- the creation of a European Corporate Governance Forum to foster co-ordination and convergence of the development and enforcement of national corporate governance codes.

Consultation on the Action Plan is now complete and the first corporate governance initiatives under the Action Plan are expected to be implemented in the second half of 2004. The following initiatives have been identified as the most urgent:

- a Recommendation aimed at promoting the role of non-executive or supervisory directors;
- a Recommendation on directors' remuneration, giving shareholders more information and influence.

FEE (Fédération des Experts Comptables Européens)
FEE issued a discussion paper on *The financial reporting and auditing aspects of corporate governance* in September 2003. The paper describes the elements of good corporate governance relevant to the process of financial reporting and auditing. It does not attempt to cover every aspect of corporate governance. It highlights the importance of internal control and the pre-requisites for sound corporate governance including structures, relationships and behaviour. In particular it considers the fundamental relationships and obligations between company boards, auditors, shareholders and other stakeholders as key to an effective corporate governance system.

IFAC
IFAC commissioned a Task Force on Rebuilding Confidence in Financial Reporting in October 2002 to look at ways of restoring the credibility of financial reporting and corporate disclosure from an international perspective. Its report *(Rebuilding Public Confidence in Financial Reporting: An International Perspective)* was published in July 2003 and set out ten recommendations as follows:

1. Effective corporate ethics codes need to be in place and actively monitored.
2. Corporate management must place greater emphasis on the effectiveness of financial management and controls.
3. Incentives to misstate financial information need to be reduced.
4. Boards of directors need to improve their oversight of management.
5. The threats to auditor independence need to receive greater attention in corporate governance processes and by auditors themselves.
6. Audit effectiveness needs to be raised primarily through greater attention to audit quality control processes.
7. Codes of conduct need to be put in place for other participants in the financial reporting process, and their compliance should be monitored.
8. Audit standards and regulation need to be strengthened.
9. Accounting and reporting practices need to be strengthened.
10. The standard of regulation of issuers needs to be raised.

OECD (Organisation for Economic Cooperation and Development)
The OECD Principles of Corporate Governance were published in 1999 and are a widely-recognised reference point on the various aspects of corporate governance. These include the rights and treatment of shareholders, the role of stakeholders, disclosure and transparency and the role and responsibilities of the board. Revised draft principles were issued for consultation in January 2004 and are expected to be approved at the annual meeting of the OECD Council at Ministerial Level in May 2004. Key additions include principles covering:

- an introduction which sets out the importance of ensuring an effective corporate governance framework;
- an increased role for shareholders;
- protection for minority shareholders;
- protection for whistleblowers.

The OECD has also issued a useful summary of recent corporate governance developments in OECD countries.

APPENDIX 3

Summary of the case studies

The following lists all the case studies relating to the enterprise governance project with a very brief description of what went wrong or right.

What went wrong?

Company	Country	Sector	Brief Background
Ahold	Netherlands	Supermarket retailing	Large scale accounting irregularities
Cable and Wireless	United Kingdom	Telecommunications	Failure of acquisition strategy
Enron	United States	Energy	Serious accounting irregularities
France Telecom	France	Telecommunications	Failure of acquisition strategy
HIH	Australia	Insurance	Unquestioning culture allowed poor management to continue unchecked
Livent Inc	Canada	Entertainment	Serious accounting irregularities
Marconi	United Kingdom	Telecommunications	Failure of acquisition strategy
Marks and Spencer	United Kingdom	Retailing	Complacency led to strategic drift, exacerbated by boardroom infighting
Nortel Networks	Canada	Telecommunications	Pursued aggressive growth by acquisition strategy but taken by surprise by telecoms downturn
Peregrine Investment Holdings Ltd	Hong Kong	Banking	Company over-extended itself with insufficient regard to governance and risk management
Saskatchewan Wheat Pool	Canada	Agriculture	Failure of diversification strategy
D Tripcovich	Italy	Shipping and financial services	Failure of acquisition strategy, exacerbated by in-fighting
Vivendi	France	Environment, energy and telecommunications	Failure of diversification by acquisition strategy
WorldCom	United States	Telecommunications	Major accounting fraud
Xerox	United States	Optical imaging	Serious accounting irregularities
YBM Magnex	Canada	Manufacturing	Alleged to be front for organised crime

What went right?

Company	Country	Sector	Brief Background
Aventis	France	Pharmaceuticals	Result of successful merger but company appears to have run out of steam more recently and is under threat from hostile takeover bid
Bangkok Mass Transit System	Thailand	Transport	Good corporate governance enabled company to weather lean times in Thailand
Bank of Nova Scotia	Canada	Banking	Successful risk management
Hewlett-Packard	United States	IT	Jury still out on success of merger with Compaq
Li & Fung Ltd	Hong Kong	Consumer products trading	Reinvented itself from broker between manufacturers and merchants to coordinator of sophisticated supply chain networks
Proton	Malaysia	Car manufacturing	Managed to achieve international presence in car sales
Southwest Airlines	United States	Airline	Strong corporate culture centred on customer service and employee satisfaction
Tesco	United Kingdom	Supermarket retailing	Focused strategy, well-executed and supported by strong management team. Learnt from acquisition mistakes
Total	France	Oil and gas	Successful post-acquisition integration
TransCanada Corporation	Canada	Energy	Strategic focus and disciplined implementation
Unicredit Group	Italy	Banking	Successful reorganisation into more customer-focused structure

APPENDIX 4

Case study analysis

The following tables illustrate some of the outcomes of an analysis of the case studies in terms of specific corporate governance and strategic issues. This is not a comprehensive listing of all the cases as the intention is to highlight the broad trends. A full list of the case studies is shown in Appendix 3. The use of • is where this issue had relatively minor significance in the case study, •• indicated that the issue had moderate significance while ••• meant that the issue was of major significance. An absence of dots does not mean that the issue does not exist eg, in Table 1, it does not mean that Vivendi, Cable &Wireless and D Tripcovich had no ethics, culture or tone at the top. It means only that the issue did not dominate the story of success or failure. In a similar vein, Table 3 does not indicate that Tesco lacks internal controls, but that the other issues simply featured more strongly in discussions of Tesco's success.

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 Tripcovich (Italy)			•••	••	
France Telecom (France)	••	••	••	••	

Table 2 – What went wrong? – strategic factors

	Choice/clarity of strategy	Strategy execution	Market conditions	Abrupt changes	Mergers and acquisitions
Ahold (Netherlands)		•••			•••
Cable & Wireless (UK)	•••		•••	•••	•••
Marconi (UK)	•	••	•••	•••	•••
Vivendi (France)	•		•••		•••
France Telecom (France)	•		•••		•••
D Tripcovich (Italy)		•••	•••		•••
Xerox (US)	•••				•••

Table 3 – What went right? – corporate governance issues

	Ethics/ culture/ tone at the top	Board of directors	CEO	Internal control/ compliance/ risk management	Succession planning
Bangkok Mass Transit System (Thailand)	●●●	●●●		●●●	
Southwest Airlines (US)	●●●		●●●	●●●	●●●
Tesco (UK)	●●●	●●●	●●●		●●●

Table 4 – What went right? – strategic factors

	Choice/ clarity of strategy	Strategy execution	Responsiveness/ information flows	Mergers and acquisitions	Risk management
Li & Fung Ltd (Hong Kong)	●●●	●●	●●●	●●●	●●
Southwest Airlines (US)	●●●	●●●			
Tesco (UK)	●●●	●●●	●●●	●●●	
Unicredit Group (Italy)	●●●	●●●		●●●	●●

APPENDIX 5

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