

## INTRODUCTION: ENTERPRISE GOVERNANCE

**I**t is almost impossible to write about the dramatic changes currently sweeping the world's financial markets without mentioning Enron. Never before has a corporate collapse caused so much public anger, resentment and distrust, nor created as much market turmoil. Enron was, after all, one of the most successful, responsible, and above all profitable organisations operating within the strict corporate governance parameters of one of the world's most highly regulated capital markets; and yet it disappeared amidst a puff of accounting scandal overnight. With investor pockets and confidence stripped to the bone, the performance and ethical behaviour of publicly listed organisations were put under forensic investigation. How had this happened, and, more importantly, what could be done to prevent such a collapse from happening in the future?

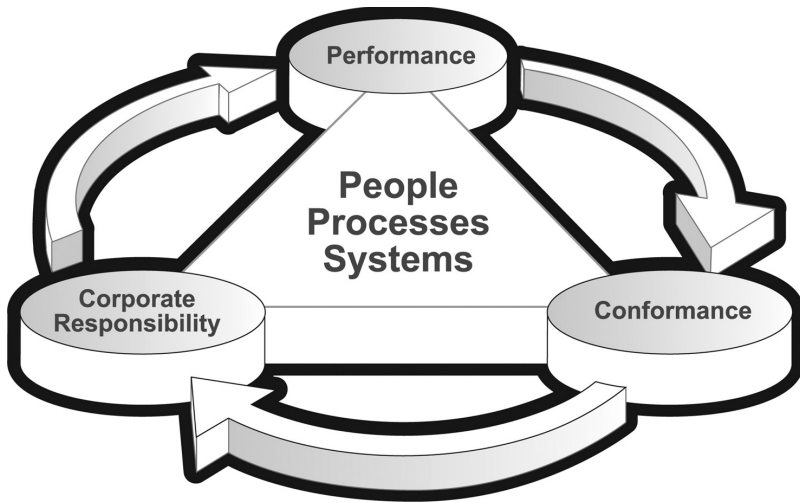
Unfortunately Enron proved only the first bad apple to fall. Just as the first public reports into corporate governance standards had been commissioned by governments, a similar 'corporate rot' was exposed at WorldCom, Tyco, Xerox, Global Crossing, and HIH, to name but a few. And the list of corporate casualties has continued to grow, with Italian dairy giant Parmalat one of the more recent to fall foul of alleged widespread accounting

irregularities and fraud. The full effect of new regulations born out of those reports, such as the Sarbanes–Oxley Act in the USA, remains to be seen. What can be said is that the traditional view of stock market investment has changed irreversibly. Investors want to see the inside workings of the organisation they are putting their money into; they want explanations of every material issue that affects or could affect their investment; and, above all, they want long-term shareholder value.

Although studies of corporate scandals involving companies such as Enron, Vivendi, Cable and Wireless, and Royal Ahold show a lack of ethical culture and tone from the top,<sup>1</sup> poor corporate governance alone will not necessarily bring a company to its knees. Corporate strategy is of equal, if not greater, importance. There is plenty of evidence to show that companies with poor strategies commonly suffer ineffective risk management, weak strategy execution, and an inability to respond to fast-changing market conditions. But while there have been lengthy discussions on how to achieve effective compliance and improved strategic performance, the two disciplines rarely collide, despite considerable evidence that adopting good conformance as well as effective strategic management is essential to achieving sustainability.

## **Enterprise Governance – a New Framework**

Enterprise Governance is based on the principle that good governance alone cannot make an organisation successful. The emerging framework, under the three dimensions of *Performance*, *Conformance* and *Corporate Responsibility*, addresses the primary concerns that boards and senior executives must effectively manage to ensure the delivery of long-term value to stakeholders (Figure 1.1). Unlike most current management thinking, which is based on the premise that conformance links directly to accountability, and performance to value creation,<sup>2</sup> Enterprise Governance clearly shows that these two disciplines are interchangeable; in other words performance can lead to



**Figure 1.1.** Enterprise Governance.

assurance and conformance to value creation.<sup>3</sup> Furthermore, it provides evidence that this is not only desirable, but essential in returning stability to the capital markets.

Neatly bridging the two established principles is Corporate Responsibility (CR). Inextricably linked to corporate governance and risk management, as well as ‘ethical’ environmental and social stewardship, on which its origins are founded, CR has fast gained considerable significance for stakeholders and the corporate community. Although the emerging concept of Enterprise Governance originally focused on the conformance and performance dimensions, we believe that CR is of sufficient importance to create a third element within the framework. Furthermore, evidence shows that sustainable value can only be successfully achieved with the adoption of all three disciplines; as Dell, Microsoft, Tesco, GE and Alcoa, to name but a few, can testify.

### ***The Performance Dimension***

The performance dimension of Enterprise Governance is concerned with developing and deploying effective strategic

management processes to ensure that the firm creates value for shareholders. As such, it encompasses the systems, people and processes that enable the firm to determine:

- Which parts of the business are creating shareholder value?
- What are the real drivers of our performance?
- What do these figures mean? How important are they?
- How are we performing relative to the competition?
- Which customers are delivering the bulk of our profit?
- What is driving cash generation?

US-based technology consultancy Gartner<sup>4</sup> coined the phrase Corporate Performance Management (CPM) as ‘an umbrella term for the methodologies, processes, metrics, and systems that enterprises use to monitor and manage business performance’. Research suggests that more effective CPM capability may in the long term be the only sustainable form of competitive advantage. Firms that have embraced CPM are able to make effective strategic choices, which deliver the superior financial outcomes ultimately reflected in long-term shareholder value.

In more tangible terms, CPM involves deploying systems across the enterprise including analytical applications such as:

- scorecards;
- planning and budgeting;
- business intelligence.

Decision-makers are then given access to these applications, ensuring that that they are all working from the same data, thereby guaranteeing that management analysis is consistent and up-to-the-minute.

A key feature of this decision support approach is the recognition that technology needs to be combined with management intuition and ‘gut feel’ for the most effective outcome. This, in turn, attempts to address what has become known as ‘strategic drift’ or oversight, whereby organisations that

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have failed to keep pace with change adopt aggressive or overly-ambitious strategies to survive. As such, objectivity and transparency are often substantially compromised, and risk assessment is rendered ineffectual. Although the creation of strategy committees has been suggested as a possible solution to this particular problem, it is seen as a somewhat militant and unpopular prospect. Having the appropriate systems and culture in place to create efficient performance-orientated 'checks and balances' is a more plausible and sustainable solution.

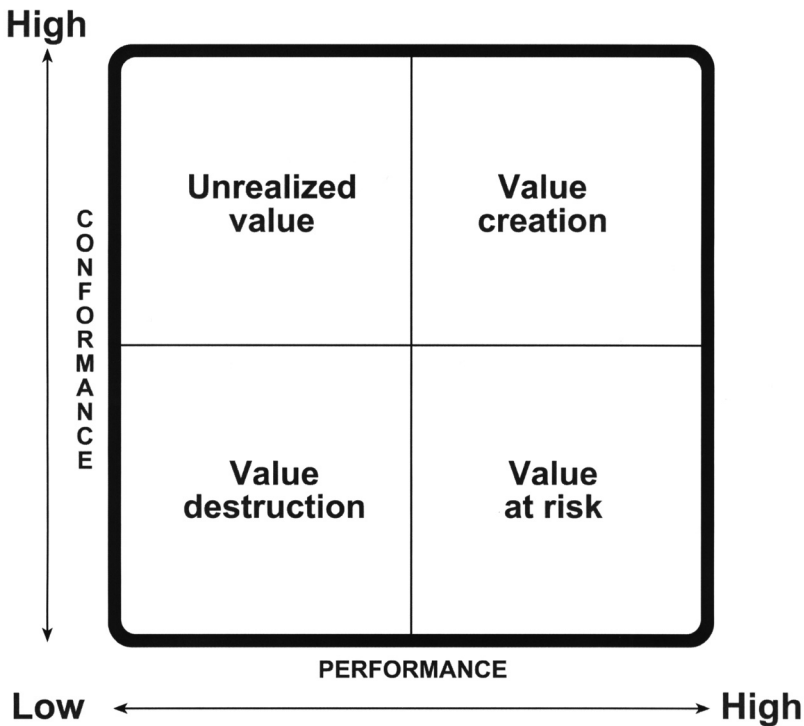
### ***The Conformance Dimension***

The conformance aspect of Enterprise Governance is concerned with corporate accountability, which is governed by regulatory codes, corporate legislation and accounting standards. Conformance concerns the effectiveness of management structures (including the role of directors), the sufficiency and reliability of corporate reporting, and the effectiveness of risk management systems.

Corporate governance typically addresses the following:

- risk management and internal controls;
- corporate culture;
- stewardship and accountability;
- board operations and composition;
- monitoring and evaluation of activities.

Corporate governance, or its apparent failure, has received a lot of attention in recent years with market meltdown and high profile scandals. Often regarded as a mandatory box-ticking exercise, corporate governance has rarely been counted as an activity that can create sustainable shareholder value. However, as the recent corporate collapses go to show, focusing solely on profit and aggressive earnings targets often fosters an environment of unethical corner cutting, and risks commercial failure. Traditionally, financial performance was the main concern of



**Figure 1.2.** The relationship between value and conformance.

shareholders, but increasingly performance and corporate accountability have become the domain of a wider audience of stakeholders (such as employees, strategic partners, customers and non-governmental organisations).

These stakeholders are now more interested in long-term value rather than short-term gains, as reflected in the growth of ethical investment and corporate benchmarking indices (Figure 1.2). With the growth of communication technologies such as the Internet, compounded by regulatory changes allowing shareholders to communicate with each other without prior screening, previously isolated shareholders have become a force to be reckoned with. Companies must now cope with shareholder coalitions and cyber-campaigns run to force organisational change.<sup>5</sup> Financial institutions are also flexing their shareholder muscles; forcing organisations to adopt transparent ethical

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policies, or remove failing senior executives with the threat of withdrawing their investment.

However, the rise of shareholder activism is not solely connected with a desire to take back corporate control and ownership. The wider public is fully aware that the world's capital markets, and economies, cannot continue to weather such dramatic financial losses. But in order to meet stakeholders' demands for unequivocal assurances on numbers, ethical behaviour and value, the finance function will have to undergo fundamental change. Sustainable conformance and performance will be driven by a new species of Chief Financial Officer (CFO), who will view compliance as a value-added function and not just a 'box-ticking' exercise. Finance professionals, for years isolated in their function from other business operations, will no longer solely focus on transactional processes or historical reporting, but will help position organisations for market success, combining their traditional services with technology consulting and assurance services. The next generation finance professional will be expected to perform a range of duties, including due diligence, shareholder relationship management, and business process outsourcing (BPO). They will also be expected to have merger and acquisition skills, especially in the new regulatory environment, and deliver value-added strategic decision support.

### ***The Corporate Responsibility Dimension***

The third dimension of Enterprise Governance is Corporate Responsibility (CR). Despite having previously been regarded as a 'philanthropic' business practice preached by non-governmental organisations (NGOs), CR is fast becoming the latest value-added platform for organisations seeking long-term shareholder value and brand protection (Figure 1.3).

CR typically addresses the following areas:

- managing/reducing environmental, societal, and cultural impact;



protection, consumer loyalty, and greater access to available capital.<sup>6</sup> Ethical investment funds, previously associated with shareholders less concerned with financial return than company ethics, have reported significant growth across the UK, Europe and the USA, having attracted capital from a wider investment base. Mainstream institutional investors, such as insurance companies and pension funds, have also recognised the need to offer members access to ethical investment, or have chosen to invest in companies with proven governance and CR records. These investors wield substantial power and influence – even acting as catalysts for boardroom change, having adopted a more ‘hands on’ approach to fund management.<sup>7</sup> After all, fewer people today want to keep their investment in companies with poor environmental or human rights records. The risks to brand, reputation and ultimately the creation of long-term value are just too high.

However, CR is not just about protecting intangibles and avoiding unpleasant and controversial exchanges with NGOs. Adopting an ethical corporate culture also has other significant business and societal benefits. It is well documented that CR can help attract, motivate and retain talent, especially in a fast-moving employment market, can stimulate departmental and organisational innovation, and can provide organisational flexibility, thus allowing a company to take advantage of opportunities, react to market fluctuations and manage risk effectively. It is also inextricably linked to governance and performance. As such, organisations that fail to implement sustainable development strategies will be unable to develop the culture vital to the creation of long-term value. Nor does CR mark the end of the chemicals, oil, and mining sectors. Corporate responsibility also translates as the recognition of impact, and what can be done to minimise its effect. Companies such as ChevronTexaco, Alcoa, and BP have made considerable efforts to improve the quality of life in countries where they operate. Whereas companies such as ExxonMobil still refuse to recognise the Kyoto Treaty, BP has invested heavily in renewable energy, giving other large

manufacturers the choice and the ability to reduce their emission rates. Such development is a catalyst for innovation, which in turn helps create value and long-term sustainability.

### **The Importance of People and Culture**

Developing and maintaining a performance-orientated entrepreneurial culture are essential ingredients of Enterprise Governance. Companies that champion high level performance and ethical behaviour will not only meet and exceed shareholder expectations by adding value, but will also generate loyalty from their employees. Innovation, leadership, internal and external communication are therefore vital in achieving best practice. Bureaucracy and hierarchical management structures, for example, often hinder innovation and entrepreneurship. Employees feel they are unable to exercise initiative – not only damaging morale but also affecting organisational efficiency. It is not by chance that Tesco, Microsoft, and Dell, all highly successful companies that strive for long-term shareholder value, regularly come top in the ‘best places to work’ surveys. Each has developed a supportive employee culture that focuses on career development, equality, ethnic diversity, as well as community involvement. Some companies, such as coffee chain Starbucks, have even stopped referring to staff members as employees, but call them partners, emphasising their wider value as stakeholders within the enterprise. The company supports and encourages local community-based CR initiatives as well as national projects, including the education programme Right to Read. It has developed a series of pilot funding schemes to help coffee farmers in developing countries such as Colombia. The company’s firm belief in the development of an ethical culture has resulted not only in low staff turnover, but also in market success, brand loyalty and a sustainable supply chain, even if its high street domination has become food for satirists and the target of anti-globalisation protestors.

People and culture are just as significant, if not more so, for small organisations, especially in highly competitive low-margin industry sectors where quality of service can act as an effective market differential. Mid-market organisations can qualify for many of the benchmarks and awards now being used for ethical measurement by financial institutions and venture capitalists, such as ISO 14001. Larger organisations also want assurances that their smaller partners are adopting an ethical culture. But while it is important to allow employees to sustain an inspirational environment, evidence shows that the development of an ethical culture should be fostered from the ‘boardroom to the mail-room’. A CEO’s ability to communicate with all levels of employees is therefore essential, even if it does mean donning an overall and working on the shop floor sometimes.

### **It is all about Flawless Execution**

According to ‘What Really Works’<sup>8</sup> – a comprehensive study of what makes an organisation a corporate ‘winner or loser’, published in the *Harvard Business Review* – organisations that excel at four primary management practices: strategy, execution, culture and structure, supplemented by any two of the following secondary disciplines: talent, innovation, leadership, mergers and partnerships, deliver sustainable value. Their study, which led to the development of the 4+2 success formula, showed that corporate ‘winners’ such as FedEx demonstrated innovation, commitment to strategy, organisational excellence, clear communication, and a commitment to meet customer expectations. The losers were companies that offered poor technical support, delivered inconsistent messages and had a poor ‘ethical’ culture.

What the study really highlighted, however, is that developing the best corporate strategy alone is not enough. To produce the anticipated results, strategy needs to be executed flawlessly.

Flawless execution is about having the right systems and processes, culture and people.

### **How this Book Supports Flawless Execution**

Successful firms have long recognised that excelling at Enterprise Governance is about creating an environment in which executives have the time and capability to design and configure an effective business model which delivers value to shareholders but which does so at an acceptable level of risk and in a manner which is socially responsible.

Our research shows that the biggest constraint on more effective Enterprise Governance is not a shortage of technology or techniques but a lack of time to think about the challenges facing the firm. In recent years the demands on an executive's time and resources have grown exponentially. The Enterprise Governance concepts discussed in this book are designed to support executives to leverage information and insights to provide better decision support. As such, it uses a range of approaches to help executives manage the enterprise better. In this respect, Enterprise Governance may finally fulfil our expectations and provide useful information for senior managers.

But it is important to appreciate that Enterprise Governance is not a magic wand that will completely transform an organisation overnight. In fact, this book will argue that Enterprise Governance as a management activity has been around for decades ever since firms began to recognise the need for better strategy formulation and execution. Finance professionals such as management accountants and others have been struggling for decades to address Enterprise Governance issues using calculators, spreadsheets and old-fashioned elbow grease. For years we have seen a continuous stream of management innovations such as TQM, BPR, and Six Sigma, many of which were sold as a panacea for all corporate shortcomings. In this book we put forward a framework for Enterprise Governance, which draws

valuable lessons from our less-than-successful experiences with these earlier approaches by recognising the primacy of the executive.

The book is divided into three parts, each focusing on a dimension. Chapters 2 to 6 look at performance, Chapters 7, 8 and 9 focus on conformance, and Chapters 10 and 11 on corporate responsibility. Chapter 12, in conclusion, offers insights into actionable knowledge to allow finance professionals to respond to the challenges of Enterprise Governance.

## Resources

A website with web links to many of the professional organisations, studies and reports used in this book has been created to allow further investigation of any chosen area. Visit [www.beyondgovernance.com](http://www.beyondgovernance.com).

## Notes

- 1 CIMA and IFAC (2004) *Enterprise Governance: Getting the Balance Right*, IFAC, Feb. Available online at: [www.ifac.org](http://www.ifac.org)
- 2 Ibid.
- 3 Ibid.
- 4 Gartner Group (2002) *Introducing the CPM Suites Magic Quadrant*, Gartner Group Research Note 2, Oct. 2002, Ref: Markets, M-17-4718.
- 5 Rosie Lombardi (ed.) (2000) *PwC Risky Business*, December.
- 6 The Equator Principles. Available online at: [www.equator-principles.com](http://www.equator-principles.com)
- 7 Examples include Michael Green, former CEO of UK broadcasting network Carlton, who was forced to quit after a shareholder revolt led by investment group Fidelity following the announcement that Carlton and rival broadcaster Granada were to merge. In 2004, Sir Peter Davis, former

chairman of UK supermarket chain J Sainsbury resigned after shareholders threatened to vote against a proposed £2.5m bonus despite falling profits.

- 8 N. Nohria, W. Joyce and B. Roberson (2003) 'What really works', *Harvard Business Review*, July, vol. 81, no. 7, pp. 43–52.