Professional Accountants in Business Committee

Articles of Merit
August 2005

Articles of Merit Award Program for Distinguished Contribution to Management Accounting



International Federation of Accountants

This booklet was prepared by the Professional Accountants in Business (PAIB) Committee of the International Federation of Accountants (IFAC). The PAIB Committee Articles of Merit Award Program is an annual competition. The 2005 competition covers articles published in the calendar year 2004.

IFAC's overall mission is to serve the public interest, strengthen the worldwide accountancy profession, and contribute to the development of strong international economies by establishing and promoting adherence to high quality professional standards, furthering the international convergence of such standards, and speaking out on public interest issues where the profession's expertise is most relevant.

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 welcomes any comments you may have on this booklet. Comments received will be reviewed by the PAIB Committee and may influence further activities. Comments should be sent to:

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FOREWORD

The Professional Accountants in Business (PAIB) Committee's Articles of Merit Award Program for Distinguished Contribution to Management Accounting

The recognition of the increasingly important role of professional accountants in business and the broadening scope of their activities has led to the publication of numerous high quality articles designed to assist them in carrying out their responsibilities. The Professional Accountants in Business (PAIB) Committee's Articles of Merit Award Program provides important recognition of these articles published in journals around the world and makes them available in a single collection online (www.ifac.org/store) and in print.

Since the program was begun nearly a dozen years ago, more and more member bodies continue to submit articles to be judged on an ever widening range of topics. Topics have also changed significantly. This is due, in part, to the fact that the concept of what is meant by management accounting has changed. This booklet features articles on some of the most pressing issues facing accountants in business: risk management and corporate social responsibility.

The winning article in the 2005 booklet is 'Corporate Social Responsibility: Why Business Should Act Responsibly and be Accountable'. It was first published in the *Australian Accounting Review* in November 2004, the in-house magazine of CPA Australia. It notes that all organizations are under pressure to produce corporate social reports. The authors discuss what constitutes a good report, noting that the quality of much of corporate social responsibility is poor and in many cases inadequate as a means of assessing the extent to which companies have acted in a socially responsible manner.

The Articles of Merit Award Program was established by the PAIB Committee of IFAC to give particular recognition to a published article that is judged to have made (or is likely to make) a distinct and valuable contribution towards the advancement of management accounting. Every year, journal editors from IFAC member institutes are asked to nominate up to three outstanding articles either in print or on websites during the year for inclusion in this award program. Judges for 2005 were Robert Dye (Canada), Priscilla Payne (USA), John Petty (Australia), Colleen Quinn (Ireland) and Yeo Tek Ling (Malaysia).

Nine articles in addition to the winning article are included in this booklet. The authors and their sponsoring member bodies are to be congratulated. So too are those authors who submitted articles but on this occasion fell outside the judges' top ten. It is hoped that their non-inclusion will not dampen their enthusiasm to participate in the future.

The PAIB committee is grateful to all those member bodies who continue to support this award program. The submitted articles are of great help in highlighting the evolving nature of the role and domain of the professional accountant in business to a wider audience.



Bill Connell
Chairman, IFAC Professional Accountants in Business Committee

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Corporate Social Responsibility: Why Business Should Act Responsibly and Be Accountable

By: CAROL ADAMS AND AMBIKA ZUTSHI

This paper identifies drivers which are pressurising organisations to adopt corporate social responsibility and produce corporate social reports. The authors discuss what constitutes good report, some of the problems with current reporting practices, benefits to organisations which produce corporate social reports and the costs to those which do not.

Behaving in a socially responsible manner is increasingly seen as essential to the long term survival of companies. An international survey conducted by PricewaterhouseCoopers in early 2002 found that nearly 70% of the global chief executives believed that addressing corporate social responsibility was vital to their companies' profitability (Simms 2002).

Corporate social responsibility has been defined as "the integration of business operations and values whereby the interests of all stakeholders, including customers, employees, investors, and the environment are reflected in the organisation's policies and actions" (Smith, 2002, p. 42) and "the obligation of the firm to use its resources in ways to benefit society, through committed participation as a member of society, taking into account the society at large, and improving welfare of society at large independently of direct gains of the company" (Kok *et al*, 2001, p. 287).

There are a number of other definitions, all of which include taking into account the social and environmental impact of corporate activity when making decisions. Corporate citizenship and corporate social responsibility are often used interchangeably, although Waddock (2003, p. 3) argues that corporate citizenship necessarily places a strong emphasis on "developing mutually beneficial, interactive and trusting *relationships* between the company and its many stakeholders" while

corporate social responsibility does not necessarily involve stakeholder engagement.

Information on environmental and social issues is commonly communicated by companies either as a section in their annual reports or in stand alone reports. Stand alone reports are either hard copy only, Internet based only or, most commonly, provided in hard copy format as well as being put on the Internet (Adams 2002, Adams and Frost 2004). Many companies are now following the Global Reporting Initiative guidelines (GRI 2002) and adopting Triple Bottom Line (TBL) reporting on economic, environmental and social issues to demonstrate their socially responsible behaviour (see www.globalreporting.org/guidelines/companies.asp for list of companies following the GRI guidelines).

CORPORATE SOCIAL REPORTING

An international survey of corporate sustainability reporting conducted by KPMG in 2002 found that 45% of the world's largest 250 companies now produce environmental and social reports, up from 35% in 1999 (Simms 2002, p. 49).

Corporate social reporting or corporate social disclosure has been defined as the "process of communicating the social and environmental effects of organisations' economic actions to particular interest groups within society and to society at large. As such, it involves extending the accountability of organisations (particularly companies), beyond the traditional role of providing a financial account to owners of capital, in particular, shareholders. Such an extension is predicated upon the assumption that companies do have wider responsibilities than simply to make money for their shareholders" (Gray *et al* 1996, p. 3).

The quality of corporate social reporting is poor and much of it is inadequate as a means of assessing the extent to which companies have acted in a socially responsible manner (see Adams, forthcoming).

THE QUALITY OF CORPORATE SOCIAL REPORTING IS POOR AND MUCH OF IT IS INADEQUATE AS A MEANS OF ASSESSING THE EXTENT TO WHICH COMPANIES HAVE ACTED IN A SOCIALLY RESPONSIBLE MANNER.

INCREASED FOCUS ON CORPORATE SOCIAL RESPONSIBILITY AND REPORTING

There are two key drivers for companies to act in a socially responsible way and be accountable for their activities and impacts. First, a recognition of the *power* of companies and acceptance by them that they have *broader* responsibilities than simply earning money for shareholders (ie, a moral justification) and, second, a recognition that it is in a *business's interest* to report. For example, consultation with stakeholders assists in building trust, improving their image while also minimising the risks of incurring financial liabilities through environmental or occupational health and safety (OHS) legislation. Moral justification for behaving responsibly is often translated to a business reason for change (see Adams and Harte 1998). Other drivers for change are discussed below.

Globalisation

Over the past few decades companies have been expanding in size (for example, through mergers and acquisitions) and are

operating in more and more countries. This growth has increased the power of companies and the impacts they have on the social, political and ecological environment of the countries in which they operate. This brings an increasing expectation from society for companies to act responsibly and be accountable for those impacts. While these expectations may be greater for large multinational companies, the responsibility of all companies, regardless of their size, to minimise social and environmental impacts is therefore greater than before. Smith (2002, p. 42) revealed that a survey conducted to identify the desirability and feasibility of corporate social responsibility standard found that "consumers expect firms to meet high health and safety, worker, human rights, consumer protection, and environmental standards regardless of where their operations [were] located". A survey conducted in 2002 by Marsteller (2000) and cited in Ogrizek (2002) in the UK found that, for 89% of the respondents, presence of corporate social responsibility would influence their buying decisions. Another 66% commented that the extent to which corporate social responsibility was demonstrated would influence their view of companies in the future. A survey of consumer behaviour conducted by Environics in 2000 found that 42% of the North American consumers (Europe 25%, Latin America 23%, Africa 18%, Eurasia 10%, and Asia 8%) would "punish companies for being socially irresponsible – either by boycotting products or bespeaking critically about them to others" (as cited in Ogrizek 2002).

Non Government Organisations (NGOs)

Perhaps in recognition of the increasing powerlessness of governments to influence major companies' operations and decisions and their lack of willingness to interfere, activists are increasing the pressure for change. For example, they are buying shares in companies and attending annual general meetings (AGMs). The insurance giant CGNU, which grew from the old Norwich Union, owned 2% of Cape Plc, a British based company which used to mine asbestos in South Africa. At CGNU's AGM in 2001 a representative from the South African National Union of Mineworkers asked the chair to give one minute's silence to those who died as a result. Questions about asbestos were asked by the Director of Action for South Africa and an official of the GMB union (see Jones 2001).

At BP's AGM in 2001, Greenpeace tabled motions in favour of a tougher line on tackling climate change and withdrawing links with PetroChina, a Chinese firm building a pipeline across Tibet (Buchan 2001,Frey 2002). Opponents claimed that this would lead to large scale population transfer and threaten local culture (Millar and Macalister 2001). Greenpeace may not have been able to get enough shareholder support to get policy changed, but their actions brought the company negative press.

The Wilderness Society in Australia collected the100 signatories required under the Corporations Act to force the Commonwealth Bank to table a motion to ban the bank from investing in logging operations such as Gunns in Tasmania (Potts 2002, Gettler 2002). They did not expect to get the 75% of votes required to win, but nevertheless they did succeed in making a point about the bank's investment practices (Boreham 2002).

Organisations' reasons for reporting

Adams (2002) asked people responsible for environmental reporting in British and German chemical and pharmaceutical companies why they started reporting. Their responses highlight the complexity of the decision to report:

"The public wanted more information and we started to report on figures in the mid eighties,

giving information on waste, air and water…Then, of course there was the Sandoz accident in 1986, which again brought additional pressure from the public, from the politicians, from legislation and so on. It was necessary to react, but it was also driven by desire to act responsibly…to help improve the situation and to give information to the public that they wanted to have" (interviewee in communications from German chemical company, Adams 2002 p. 234).

"The reason for the increase in the number of companies producing environmental reports since the early 1990s is not regulation or public pressure. The main objective is to improve corporate image with customers, state authorities, journalists and the press" (interviewee in senior management in safety and environment from German chemical company, Adams 2002, p. 234).

Businesses now acknowledge that it is in their interests to consult their stakeholders (Kok *et al* 2001) and that pressure from the public can result in companies changing their reporting style and mediums (paper to electronic versions and vice versa). Companies may attempt to alter outside expectations or perceptions of their performance through their reports rather than their actual performance when they feel that their stakeholders have unrealistic expectations of their social and environmental performance (Fowler *et al* 1999, Hooghiemstra 2000). Adams (forthcoming), for example, shows a gap between the way in which an unnamed company portrayed its performance and the way in which its performance was portrayed by the media, NGOs and other sources external to the company. Companies may attempt to counter criticism caused by perceived poor performance or negative media coverage by informing their stakeholders about positive changes with respect to the organisation's performance (Fowler *et al* 1999).

Legislation

Many developing countries have inadequate legislation and/or resources to enforce legislation to protect the environment, the workforce and local communities. These countries have difficulty curbing the negative impacts of multinational corporations. This reinforces the moral responsibility of companies to consider the environment and the communities of the countries in which they operate.

The desire to minimise risks of incurring financial liabilities through environmental or health and safety legislation can also result in companies becoming more socially responsible and initiating reporting (Ogrizek 2002). The explosion at Esso's gas plant in Longford in 1998 killed two workers and resulted in shutting off the gas supply to Victoria for about two weeks. The coroner's verdict concluded that Esso was solely responsible for the accident, having failed to conduct detailed periodic risk assessment and a more comprehensive hazard audit in line with its own policies (Gale 2002, Kletz 2001, Lapthorne 2002, Madden 2002, Pheasant 1998).

BENEFITS FROM CORPORATE SOCIAL RESPONSIBILITY AND REPORTING

Companies that demonstrate social responsibility and account for their social and environmental impacts gain specific benefits, although not all can be quantified in dollar terms.

Better recruitment and retention of employees

Acting responsibly and being accountable for social and environmental impacts assists organisations in attracting and retaining the most talented people (Adams 2002, Bernhut 2002, Simms 2002). This is evident from the findings of a survey conducted by Hill &

Knowlton's *Corporate Reputation Watch* in Europe, the UK and the US. The survey found that 88% of the British businesses believe that social responsibility will be more important in the future in recruiting and retaining employees (Simms 2002, Knowlton 2002). Large salaries, bonuses and termination packages paid to directors of the Commonwealth Bank, OneTel and HIH are likely to have had a negative impact on workforce morale and motivation and are unlikely to help the organisations attract and retain the best staff.

Improved internal decision making and cost savings

Organisations that produce social and environmental reports develop better internal control systems and better decision making and cost savings, resulting in continuous improvements (Adams 2002). Improved operational and process efficiency results in reduced risks and improved safety at work (King 2002, Simms 2002). This is facilitated when organisations seek to communicate bad, as well as good news, to their employees and other stakeholders through social or TBL reports.

Improved corporate image and relations with stakeholders

By disclosing information on social and environmental issues, companies can minimise risks of powerful consumer boycotts by external parties (Adams 2002). Better understanding of corporate activities reduces criticism from external and internal sources leading to improved reputation (Adams 2002). Further, it improves communication with the community and other stakeholders (Anand 2002, Bernhut 2002, Marx 1992/93) and results in a competitive advantage (King 2002).

In 2000, Camelot, the national lottery office in the UK conducted a survey of eight stakeholder groups comprising about 6,000 individuals. Based on the findings of the study, Sue Slipman, then social responsibility director, commented that "stakeholders do not always share common interests. Sometimes the correct response will be for the management to reject the calls of stakeholders. But social reporting remains valuable, because it provides an informed basis for explaining the company's actions" (Pike 2000, p. 18).

Indeed, the judges of the 2003 ACCA Australia and New Zealand Sustainability Reporting Awards, commenting on the report of British American Tobacco (Australia), said: "The judges would like to see the stakeholder engagement programme develop to address the conflicting views of key groups which undoubtedly occur in such a controversial sector" (ACCA 2004 p. 13).

Evidence of organisations benefiting by practising corporate social responsibility and reporting can be seen in a study of 10 entrepreneurs who had developed successful new ventures (Joyner *et al* 2002). The study found that all 10 organisations and their entrepreneurs went beyond the requirements of the law with respect to corporate social responsibility and in their interactions with their stakeholders. The organisations benefited by growing in size and establishing their presence in the community.

Improved financial returns

Socially responsible investment (SRI) involves investors taking personal values and social concerns into account when making investment decisions. Ethical investment funds consider the investors' ethical values and financial needs and the impact on society of the companies they invest in. Since Friends Provident (FP) set up the first ethical fund in the UK in 1984 (Brown 2003), the number of such funds has grown to some 55 and the increase is likely to continue. SRI managed funds grew 32% to $13.9 billion dollars in the

2001/02 financial year (Gibson and Kendall 2003) while assets of managed funds as a whole declined.

Joyner and Payne (2002) identified a positive link between firm's value, business ethics, corporate social responsibility and financial performance, indicating that investors may be making money through SRI as well as adhering to their own values. Margolis and Walsh (2003) examined the relationship of corporate social performance (CSP) with corporate financial performance (CFP) between 1972 and 2002. Their review suggests a positive association and very little evidence of a negative association. Orlitzky *et al* (2003), in an analysis of 52 CSP CFP studies, also found a positive association and concluded that "corporate virtue, in the form of social responsibility and, to a lesser extent environmental responsibility, is likely to pay off" (p. 403).

Advantages of reporting and disclosure were also raised by the interviewees in Adams's (2002, 1999) studies: "Better acceptance in the public eye. We are sure of that. Better understanding by politicians in our country and better understanding inside the company also because people inside the company read this report just as much. Better understanding of environmental topics because you can see it all together. We just have a better explanation of what we do and invest in this area . . . it is changing" (Adams 2002, p. 236).

"There is a very important internal message about the performance of the company and where we are doing well and where we are not. So that when that information goes out, the businesses can then benchmark their own performance against that of the Group. And there are some businesses where performance is sadly lacking. So they have got an opportunity with that report to help boost their performances within their own businesses because they have actually got a measurement that they can compare with. So it is a very important internal management tool" (Adams 2002, p. 236).

"I think one of the big advantages is credibility with your external audience you are saying you have got nothing to hide, you are explaining where there are problems as there inevitably are. You are explaining why they have happened. Obviously you are setting yourself targets within the organisation you need to be measuring these things if you don't measure it, you can't manage it" (Adams 1999, p. 42).

It is true that benefits resulting from environmental initiatives such as improved corporate image or better relations with stakeholders are difficult to measure or quantify in dollar terms (Bernhut 2002, Evans 2003). This can sometimes result in challenges for managers trying to convince company directors of the advantage or usefulness of good reporting and disclosure systems (Simms 2002). Indeed, one of the interviewees in Adams's (1999) study said: "We strongly believe it is good for us to report on environmental issues, but we can't measure the effects in financial terms. Our CEO . . . likes things to be measured and quantified, but you can't put a figure on the impacts on your image if you had not passed the EMAS certification" (p. 41).

INFLUENCES ON CORPORATE SOCIAL RESPONSIBILITY AND REPORTING

Recent developments that are exerting pressure on companies and governments to be more responsible and accountable for their actions include changes to pension fund and investment product legislation, consumer boycotts and action by NGOs, industry initiatives, corporate social responsibility and reporting guidelines, awards and indices, legislation, and remuneration and bonuses.

Changes to pension fund and investment product legislation

In the UK, pension funds are now required to incorporate their policies on socially responsible investment in their statements of investment principles, providing a greater incentive for investors to put pressure on companies (Friedman and Miles 2001, Olivier 2001, Skorecki 2001b). For example, Friends Provident put pressure on drug companies facing criticism in South Africa over the sale of cheap copies of drugs (Clark 2001, Ryle and Mathiason 2001). Morley Fund Management, which manages assets equivalent to 2.5% of the UK stock market, announced in 2001that it would exclude any FTSE 100 company that does not include an environmental report (Dickson2001, Parker 2001, Skorecki 2001a). In March 2002 Australia adopted similar legislation, the Financial Services Reform Act 2001, which requires sellers of investment products to disclose the extent to which environmental, social and ethical considerations are taken into account in the selection, retention and realisation of investments (Macken 2002).

Consumer boycotts and action by NGOs

Consumer boycotts and action by NGOs such as Amnesty International and Greenpeace have played an important role in changing the corporate agenda (Kok *et al* 2001, Maitland 2002b, Ogrizek 2002).

Winston (2002) identified and evaluated strategies used by NGOs to influence the behaviour of multinational corporations. He concluded that NGOs could succeed in their efforts only if they worked in collaboration with consumers and governments. Such collaborations can also work well for companies. Evidence is provided in the case of Rio Tinto, the largest mining company in the world (Walker 2002) which, through collaboration with the World Wide Fund (WWF), has formed a four year partnership to encourage community participation and education. Another initiative of the company involves the halting of its Jabiluka mining project following denial of consent from traditional Mirrar landowners (Garnaut 2002).

Industry initiatives

Industry initiatives, such as the chemical industry's Responsible Care Initiative, have focused corporate attention on specific key performance indicators, but performance falls short of that demanded by key stakeholders (Adams 1999, Schmitt 2002). Stakeholders are primarily concerned with levels of emissions or discharges. They want to hear what is being done to reduce emissions and discharges of toxic substances, what the corporate targets are and why they have not been met (Adams and Kuasirikun 1998). The Association of British Insurers (ABI) has released new guidelines for organisations regarding disclosure of information on corporate impacts on human rights, the environment and on social and stakeholder relations (Anonymous 2001). There is concern that such industry initiatives may be used as a legitimating or risk management tool without any real commitment to accountability (Adams, forthcoming). For example, following the chemical industry's Responsible Care Initiative does not result in complete reports. Adams and Kuasirikun (2000) identified a number of issues which were not addressed but which were found to be of concern to the stakeholders, including:

- Working conditions around the world. For example, Nike has been criticised for alleged labour rights abuses at its factories in Indonesia and Mexico. As a result of student concerns, US universities threatened to find another supplier of clothing with university logos. Nike responded by hiring an independent agency to monitor the employment practices overseas (Edwards 2002).

- Policies regarding foreign direct investment, for example, in countries with poor human rights records.
- Equal opportunities and discrimination. Sexual harassment is reportedly widespread in factories in developing countries supplying goods to the western world (Klein 1996).
- Export of dangerous products or those banned in the home country. For example, a pesticide which has been banned in some countries because of the number of deaths it has caused was advertised as environmentally friendly in the Malay Mail on 15 April 1999 (Adams, forthcoming).
- Drug prices. This is of particular concern in the world's poorest countries. In South America, where 10% of people are HIV positive, 39 drug companies sued the government to block implementation of a law allowing the country to import cheap copies of their medicines. Organisations such as Oxfam put pressure on GSK, resulting in the company cutting the prices of drugs to less developed countries (Boseley and Astill 2001).
- Correct and complete labeling and packaging of chemicals (Adams and Kuasirikun 2000).
- Product safety issues such as the increasing use of fertiliser in developing countries and its impact on human health and nitrogen loading.

Corporate social responsibility and reporting guidelines, awards and indices

The Global Reporting Initiative (GRI) and the Institute of Social and Ethical AccountAbility (AccountAbility), both international, multi stakeholder organisations founded in the past six to seven years, have launched new guidelines and standards on sustainability reporting. The GRI guidelines focus on issues which should be reported (Maitland 2002a); while AccountAbility's AA 1000 and AA 1000S standards focus on the processes of reporting and auditing. A focus on processes, and in particular the involvement of stakeholders through a robust process of dialogue, is much more likely to result in a company discharging accountability than complying with a list of disclosure items (Adams, forthcoming).

Indices such as FTSE4Good[1] and Dow Jones Sustainability are influencing companies' reporting practices (although not necessarily performance) in countries such in Northern Europe (Bernhut 2002, Simms 2002). The ACCA Social, Environmental and Sustainability Reporting Awards in the UK have achieved significantly better submissions during each year of operation.[2] The entries for the ACCA Australia Sustainability Reporting Awards, first presented in 2003, were less well developed than their British counterparts, further evidence that such awards motivate companies to be more accountable and enable companies to identify how reports might be improved.

Legislative requirements

Some countries, including Denmark, the Netherlands, Norway and Sweden, stand out because they require companies to report to the public on their environmental performance (KPMG 1999). US companies have to submit data on their emissions to the Environment Protection Authority which is available publicly. However, the Securities and Exchange Commission in the US, the Securities Commission in Canada and the UK Companies Act require only the disclosure of social and environmental information which affects current or future financial performance (KPMG 1997). EC Green Paper 18.7.2001, "Promoting a European Framework for Corporate Social Responsibility", is another initiative aimed at making companies disclose

their social and environmental information (Simms 2002).

WHAT MAKES A GOOD SOCIAL AND ENVIRONMENTAL REPORT?

There is increasing consensus among practitioners, standard setters and consultants about the criteria that a good social, environmental or TBL report should meet (see, for example, the judging criteria and the reports of the international judging panels in the ACCA sustainability reporting awards at www.accaglobal.com). A report should:

- be *transparent*;
- demonstrate a *genuine* attempt to be *accountable* to all key stakeholders;
- cover *negative* as well as positive impacts on society and the environment;
- demonstrate corporate acceptance of its social, ethical and environmental *responsibilities*; and,
- be *complete*; in other words it should incorporate details of impacts on communities and the environment which are material to key stakeholder groups.

The Shell Report is one example of a "good" report. Even though the nature of its business is fundamentally unsustainable, and despite bad press surrounding the Brent Spar incident (Edwards 2002) and its treatment of the Ogoni people in Nigeria (O'Riordan1999), it was joint winner of the first AccountAbility/ACCA Social Reporting Awards (ACCA 2002). Its report provides information on, for instance, deaths at work, negative environmental impacts and even negative comments about the company from employees and other stakeholders. It is important to note that good reporting does not necessarily equate to good performance. In identifying the extent to which the company was complying with GRI sustainability reporting guidelines on economic, environmental and social performance, and the costs involved, the GRI found that Shell had spent about $3million for compliance purposes (Evans 2003). This cost excluded other system implementation/maintenance costs. The Shell Report demonstrates that while a good report accurately reflects performance, performance itself is not necessarily good.

CONCLUSION

The most concerning feature of current reporting on social, ethical and environmental issues is its lack of completeness as defined in the GRI guidelines (GRI 2002). Reports are leaving out details of impacts on communities and the environment which are material to key stakeholder groups. Issues of concern to stakeholders include:

- the omission of key events, issues and negative impacts from an organisation's reports;
- the very different portrayal of events and issues by external sources compared with the organisation's own sources;
- conclusions drawn by the industries from scientific literature on key sustainability issues;
- values statement and key objectives that the company wishes to achieve;
- quantified targets and the extent to which they have been achieved;
- identification of key stakeholders (that could be different for each company) and the process of consultation with them;
- explanation of governance system;
- findings from external audits and other external/independent comments on company's operations and targets; and
- improvements that the company aims to achieve in the future.

(See Adams's forthcoming study of the reporting performance portrayal gap in a case study company for examples.)

Voluntary guidelines specifying issues that companies should report on are not solving this incompleteness problem (Adams and Kuasirikun 2000). In fact, there is a danger that they provide organisations with a means of legitimating poor performance, allowing them to get away with omitting material impacts on issues not covered in the guidelines.

Areas which need to be addressed in the future by researchers, practitioners, service providers and policy makers include:

- how to influence a company's suppliers in issues related to corporate social responsibility (Silver2002);
- how organisations will benefit from practising corporate social responsibility and conducting open dialogue with their stakeholders (Gelb and Strawser 2001).
- appropriate governance structures to ensure that social and environmental impacts and concerns of key stakeholder groups are addressed in corporate decision making;
- how to make the stakeholder dialogue robust and remove the power differential between the organisation and key stakeholder groups;
- making sure corporate values are embedded in organisations and that this is reflected in their reports:
- how to improve reporting processes (see Adams 2002);
- how to use the internet for reporting purposes (see Adams and Frost 2004);
- the lack of completeness in the reports (Adams, forthcoming); and
- developing guidelines to audit processes of reporting and clarify audit scope, assessment criteria and terminology.

Progress in each of these areas should lead to benefits for companies, the environment and key stake holder groups.

NOTES

1 The FTSE4Good index in the UK has been criticized in the media because, for example, it includes BP despite the fact that the nature of its business is fundamentally unsustainable. Its selection criteria cover three main areas (FTSE4Good 2003):

   - working towards environmental sustainability;
   - developing positive relationships with stake holders; and,
   - upholding and supporting universal human rights.

2 The first author is a former judge of the AccountAbility/ACCA UK Social Reporting Awards.

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Businesses can use ERM to manage a wide variety of risks.

Enterprising Views of Risk Management

By: RUSS BANHAM

Industry insiders tout enterprise risk management (ERM) as the most effective strategy an organization can use to manage a plethora of risks, running the gamut from strategic, market, credit, operational and financial exposure to the daunting array of man-made and natural disasters.

New ERM committees led by chief risk officers identify, quantify and monitor these risks via a holistic, portfolio-based management system. However, new internal audit standards from the Institute of Internal Auditors (IIA) (www.theiia.org) may change the paradigm; they require internal auditors to assume responsibility for monitoring enterprise risk, creating tension in some organizations over who is in charge. CPAs with internal audit or risk management responsibilities can use this article to determine whether ERM is a strategy that will benefit their organizations and who should be responsible for overseeing risk management.

ERM BASICS

The difference between ERM and more traditional ways of managing risk (see the exhibit on page 68 for more details) is that ERM calls for high-level oversight of a company's entire risk portfolio rather than for many different overseers managing specific risks – the so-called silo or stovepipe approach. ERM, in effect, centralizes management under a chief risk officer or ERM committee who manages the individual overseers to help identify overall how much risk the entity can tolerate, assess mitigation tactics and otherwise take advantage of risk opportunities.

The idea of viewing risk as an opportunity may surprise some CPAs. ERM adherents explain that absorbing, hedging or transferring risk requires capital – dollars a business might otherwise direct to other, more productive and profitable endeavors. "Since entities must hold capital to absorb the risk of loss, there is less to invest in other profit-producing activities," explains Peter Nakada, executive vice-president of ERisk, a New York-based ERM consulting firm and software provider. "ERM helps determine the right amount of capital companies should direct toward risk."

How does ERM help a company arrive at this figure? It's done by gathering or otherwise polling risk overseers to determine the threats to the organization, the financial impact and the effectiveness of risk mitigation options. "The goal of the process is to determine the appropriate amount of capital you need. You can't get that number unless you identify and measure all the risks threatening the organization," Nakada says. "Once you know you can determine where to direct capital."

Why should CPAs care about ERM? "Because it will directly affect how and why they do their job," says William Spinard, senior vice-

president in the Washington, D.C., office of Marsh Inc., a large multinational insurance broker that works with clients to develop ERM strategies and systems. "With ERM an entity establishes risk definitions and tolerance levels, as well as policies. It defines procedures to measure risk and creates monitoring activities. ERM will basically be the standard bearer for risk management in a company, a role traditionally handled by internal audit. "The question now emerging, Spinard says, is "Who should head ERM: the internal audit department – given the new Institute of Internal Auditors standards – or chief risk officers and other traditional risk overseers from finance?"

Embracing ERM

In a survey of 200 senior finance and risk management executives,
- 41% said their companies were implementing some form of enterprise risk management (ERM).
- 90% whose companies were pursuing ERM were very confident in their ability to manage risk, compared with just 45% of those not using ERM.
- 84% believed ERM could help improve their companies' price/earnings ratios and cost of capital.

Source: *Enterprise Risk Management: Implementing New Solutions*, The Economist Intelligence Unit and MMC Enterprise Risk, **www.mmcer.com**.

While Spinard advocates that internal audit take a back seat to more traditional risk managers – "to effectively preserve the checks-and-balances element of the audit function" – some organizations are designating internal audit as the über risk manager. "Having set the standards for internal controls, the auditors are now setting the benchmarks for ERM," Spinard adds. But should internal audit manage the entity's ERM strategy? "Rather than be in charge of the process," Spinard says, "it should be critiquing it" and making suggestions for improvements.

BEGIN AT START

ERM's departure from silo-based risk management doesn't preclude decentralized risk

EXECUTIVE SUMMARY

- ENTERPRISE RISK MANAGEMENT (ERM) IS A STRATEGY organizations can use to manage the variety of strategic, market, credit, operational and financial risks they confront. ERM calls for high-level oversight of risks on a portfolio basis, rather than discrete management by different risk overseers.
- ERM HAS GIVEN RISE TO A QUESTION: Who should head the risk management process – internal audit or a chief risk officer? Some believe internal audit should take a back seat to preserve the checks and balances the audit function provides. Others say risk leadership should depend on what a company is comfortable with,
- USING ERM ENABLES AN ENTITY TO ASSESS risk across the enterprise instead of looking at it on a per-project basis. It also gives the company a means to assess the controls in place to handle each risk and identify any gaps. This consistent approach also offers businesses an opportunity to determine authority and responsibility and allocate resources appropriately.
- TO EXTRACT RISK DATA, MANY ORGANIZATIONS use business intelligence software. Many packages feature "traffic-light" systems that show a red light if risk exceeds acceptable levels. The chief risk officer then can "drill down" to see the reasons and make more informed decisions.
- OVERALL RESPONSIBILITY FOR ENTERPRISE RISK is changing because of new standards from the Institute of Internal Auditors. They require the internal audit function in a company to monitor and evaluate the effectiveness of the organization's risk management and control systems.

management. Rather it establishes a hierarchy with discrete risk managers typically reporting to a central figure using so-called dashboard technology – business intelligence software that extracts risk-based information, collates it and reports it to the chief risk officer or ERM committee, which has overall responsibility.

Take the case of Capital One Financial Corp., a McLean, Virginia-based financial services organization with$71 billion in managed assets. "We have four legs to the stool – a chief risk officer who heads an ERM team that sets methodologies and reporting standards and educates the company at large; functional groups throughout the enterprise that manage risks in their own sectors and report the results to the ERM team; internal audit which is responsible for ensuring the risk management process works throughout the company as intended; and risk stewards or advisers who are experts in each individual risk category and provide guidance," says Michael Glotz, Capital One audit director for North American business lines and head of the company's new ERM audit team.

Such a bird's-eye view of risk is not available with more traditional risk management where insurance risk managers address hazard and liability risks, internal audit manages financial reporting risks, business units handle project risks, treasury deals with foreign-exchange risks and so on. "Previously, we had been less proactive in instituting processes and reporting around risk management, with each functional area responsible for its own," Glotz explains. "That made a single version of the truth, in terms of full enterprise risk, hard to come by."

As in other organizations, Capital One's ERM strategy rests on a thesis that managing risks holistically offers value, in terms of identifying the breadth of organizational risks, quantifying them and distinguishing both risk correlations (two risks that may moderate each other's impact) and risk relationships (one risk that begets another, such as a product recall that creates a public-relations nightmare). In the past, certain risks hedged others, but the company overlooked or undervalued the correlations because of discrete risk management practices. Someone needed to be in a position to discern enterprise risks from 70,000 feet, observing their interplay, the effectiveness of mitigation options and the aggregate costs of the different risk transfer strategies. "Someone has to bring risk management into the strategic planning process to ensure business strategies are aligned with the organization's overall appetite for risk," says Glotz.

That someone at Battelle Memorial Institute is Jane Cozzarelli, CPA, vice-president of internal audit at the $1billion Columbus, Ohio-based research and development entity. Cozzarelli is spearheading the development of an enterprise-level risk management process at the not-for-profit organization, an effort motivated by Battelle's rapid growth. "We're doing a lot of contract research for commercial clients and want to take ownership of the intellectual property we develop," says Cozzarelli. "These new businesses and markets create new risks – unfamiliar territory for us." She says Battelle is entering a whole new world involving joint ventures, acquisitions and the like. "While we were confident about the traditional risks we confronted in a research context, we were leery of taking on new commercial-type risks without a framework." Cozzarelli says the institute decided to "assess risk across the enterprise to obtain a portfolio approach" – hence, she says, the ERM strategy.

Previously, Battelle had looked at risk on a per-project basis, which limited its ability to

appreciate the opportunities proper risk management creates. "Risk isn't necessarily bad," Cozzarelli, says. "By measuring your risks, you can direct capital to them more efficiently. You also are better able to understand the upside and downside of undertaking a risk." For example, if Battelle undertook a $50,000 project on behalf of a pesticide company, and the Environmental Protection Agency approached it to do a similar project for $2 million, the resulting conflict of interest would cause it to lose the larger project because it didn't understand the strategic risk of doing the pesticide company project. "We had no systematic process for looking at risks across the breadth of the organization," Cozzarelli says.

Battelle sent out requests for proposals to consulting firms to help develop an ERM infrastructure, selecting Marsh. The broker undertook an initial assessment that involved interviews with senior managers about their risk concerns – "the stuff that keeps them awake at night from an organizational and individual market sector standpoint," Cozzarelli says. Each manager had particular market responsibility, from medical products to environmental issues to transportation. Following this initial assessment Marsh sent out an electronic questionnaire to 250 Battelle product-line managers and research support staff eliciting their perspectives on risk. The organization conducted several workshops to examine the results of the initial assessment and survey responses. Ultimately, Battelle identified its top 10 risks. Using anonymous voting techniques, it rated them for potential likelihood and impact and mapped the risks on a matrix.

The next step was to assess the controls in place to address each risk and identify any gaps. "That gave us a starting point to know where we needed to focus our resources," Cozzarelli says. Marsh then worked with Battelle to draft a new risk management structure governed by an executive risk management group. "We're trying to determine levels of authority and responsibility," Cozzarelli says. "Once we decide that, we will implement dashboard technology to monitor and report on risk across the enterprise."

Businesses "want a process to assess all risks in a systematic, consistent way," says Spinard, who led the Battelle project at Marsh through late 2003 when Battelle decided to continue item implementation in-house. Others agree about the need for a systematic approach." What you want to do with ERM is get all the overseers together to pinpoint and measure the critical risks confronting the company and then develop a systematic way to manage them," says Ted Senko, CPA, national partner in charge of risk advisory services in the Denver office of KPMG LLP. "You end up taking something that is typically a cost center – risk – and turning it into something that can give you a return. But you can't do that unless you meet with officers and key business unit managers to talk about the risks they face in trying to meet their respective goals."

To elicit candid responses, KPMG tries to assemble all of the individual overseers in a conference room "to develop a

Traditional RM vs. ERM: Essential Differences

Traditional risk management	ERM
Risk as individual hazards	Risk in the context of business strategy
Risk identification and assessment	Risk portfolio development
Focus on discrete risks	Focus on critical risks
Risk mitigation	Risk optimization
Risk limits	Risk strategy
Risks with no owners	Defined risk responsibilities
Haphazard risk quantification	Monitoring and measuring of risks
"Risk is not my responsibility"	"Risk is everyone's responsibility"

Source: KPMG LLP.

frame of reference around risk." Senko says, "if that isn't feasible, we conduct a structured interview process with the overseers. We then develop a map that pin-points 'high impact probability' – the critical risks the company must monitor and control."

Senko recalls working with a *Fortune* 50 consumer products company to execute this process. "The company runs fairly autonomous business units. As we assembled the risk overseers, we learned that although the units confront many similar risks, such as commodity hedging, they had very different risk profiles as to when and how they would hedge." Senko says the company learned a very tangible lesson. "Because it didn't have a consistent hedging strategy, some business units had higher or lower risk tolerances than the overall corporate threshold. By having all businesses understand the company risk tolerance, they were able to optimize their individual strategies to be consistent." In effect, Senko says, "they changed their hedging strategies to be consistent with the common risk framework, which saved them money. Synchronizing their commodity program globally enabled them to enhance their return on capital."

In his consulting work with dozens of companies undertaking an ERM project, Spinard says strategic risks typically dominate the discussion." Companies cite things such as market erosion and competitors' actions as the real threats," he says. "A risk that impedes growth targets or has significant stock implications is the one usually plotted on the section of the matrix depicting the greatest impact or severity, things such as new product development or customer issues." Spinard says his firm just consulted with a food service company that cited customer obesity concerns as presenting enormous risk.

Once a company has mapped major risks on a matrix, it must align business processes to ensure data relating to each risk are routinely stored in a database the chief risk officer or executive risk committee can monitor for exceptions – risks extending beyond tolerance or threshold levels. "A large part of ERM rests on the efficient and correct collection and organization of data," says Dennis Ceru, director of retail brokerage and investing at Needham, Massachusetts-based Tower Group, a research and advisory firm. "That's where technology comes into play to determine potential risk trends, such as the interplay of economic factors with market trends. Provided on a timely basis, such intelligence can guide improved decision making."

To extract risk data and observe them on a dashboard, organizations can use business intelligence software packages available from companies such as Hyperion Solutions (www.hyperion.com), Cognos Inc. (www.cognos.com), Algorithmics Inc. (www.algorithmics.com), SAP (www.sap.com) and Crystal Decisions (www.businessobjects.com), among others. The cost of such packages typically is in the six-figure range. At RBC Financial Group, a Toronto-based financial institution with an ERM strategy in place for two years, chief risk officer Suzanne Labarge uses business intelligence technology from Portiva Corp. (www.portiva.com)that features a traffic-light system, with red, yellow and green lights. "We mapped all our risks on a matrix and have clear data reporting responsibilities in place to ensure a constant flow of risk-based intelligence," Labarge says. "If a particular risk exceeds acceptable levels, a red light pops up on the dashboard. I can then 'drill down' into the reasons, enabling me to make more informed decisions."

WHO'S ON FIRST?

While the process of building an ERM strategy is similar, overall responsibility for enterprise risk is changing because of the IIA standards. The added risk responsibilities for internal audit are fomenting a controversy of considerable interest to CPAs over who should manage enterprise risks – traditional risk overseers from finance like Labarge or internal auditors such as Cozzarelli.

The basic requirement for the internal audit function, as contained in the new IIA standards, is to monitor and evaluate the effectiveness of an organization's risk management and control systems. Standard 2110 of the International Standards for the Professional Practice of Internal Auditing, for example, says the internal audit activity should help the organization manage risk by identifying and evaluating significant exposures to risk and contributing to the improvement of risk management and control systems. Standard 2120 says the internal audit activity should evaluate the effectiveness and efficiency of the organization's control processes.

Spinard says "several auditors are now saying they want to run ERM, and their organizations are letting them. They say ERM is a natural step forward for internal audit because they typically set and validate internal control standards. Based on their expertise they believe they should manage all controls, including risk." And, says Spinard, that's not necessarily a bad thing. "But others believe ERM should be a management function – something it needs to do because it will help it run the business better."

Cozzarelli has a different opinion and notes that Battelle is considering her to become its chief risk officer. "It would make sense for internal audit to get the information we need to do risk-based audit plans, monitor risk to give management insight and report to the board," she says. "That seems to be where we're headed. I don't believe ERM needs to be a separate process with a separate group running it." Risk management, she says, should be "integrated into everyone's normal strategic planning, literally imbedded in everybody's job description. Then internal audit could reinforce both the governance and internal control issues to make sure processes were in place to adequately safeguard assets."

PRACTICAL TIPS TO REMEMBER

- ERM can help CPAs determine the right amount of capital companies should direct toward risk by gathering or otherwise polling risk overseers to identify the threats to the organization, their financial impact and the effectiveness of risk mitigation options.
- Companies can use ERM to assess risk across the enterprise. Considering risk solely on a per-project basis can limit an entity's ability to appreciate the impact the risk associated with that project can have on the entire organization.
- By mapping major risks on a matrix, companies can align their business processes to ensure they are routinely collecting and storing related information in a database the chief risk officer or executive risk committee can monitor. This will make it easier to identify exceptions – risks extending beyond the company's tolerance or threshold levels.
- Organizations should use business intelligence software packages to extract risk data and display them on a "dashboard." Many of these systems feature a traffic-light system, with red, yellow and green lights. If a risk exceeds acceptable levels, a red light pops up, permitting the responsible party to "drill down" into the reasons and make more informed decisions.

Cozzarelli concedes that Battelle's senior management isn't certain audit should lead risk oversight. The IIA standards, she says, are "kind of fuzzy. Risk leadership should depend on what a company is comfortable with." Obviously, she points out, you can't audit something you put together. "We need to remain objective and independent. But once processes are in place, I don't think there is any problem with audit overseeing them."

The issue boils down to whether a separation of church and state makes financial sense, explains James Lam, president of James Lam & Associates, a Wellesley, Massachusetts-based risk consultant. Although auditing and risk management are complementary, says Lam, they serve different purposes. "Risk management is very broad and comprehensive whereas internal audit is episodic and deep," he maintains. "When you think about risk management, it is global and real-time, anticipating future exposures and developing contingency plans and strategies to deal with them." On the other hand, Lam says, audit works on an annual cycle that is not necessarily real-time or anticipatory. Auditors go deep in terms of looking at policies and procedures and compliance. The truth, he emphasizes, is that audit "should check risk management to ensure it is being performed appropriately, while risk management should do the actual identification, monitoring and mitigation."

Glotz from Capital One notes that in large, sophisticated financial services companies, risk management traditionally is its own organization. "It's really in smaller entities where we're seeing the chief auditor taking on ERM responsibility," he says. "In financial services, the management of risk is a separate function." Still, he says, he is not sure whether the IIA standards insist that internal audit necessarily should manage risk. "We're certainly part of the ERM process, and our head of audit sits on the ERM executive committee, but we don't run the show."

ERM has changed Capital One, Glotz asserts. "The risk and control processes in our business units and functional groups are more formalized, which has begun to make internal audit more efficient," he says. "Now that we've identified the key risks and have processes in place to control them, internal audit's risk assessment obviously is more effective. ERM gives us more proactive risk and control management to evaluate the business and certify controls. It formalizes what – in areas other than credit and financial risk – heretofore was pretty much adhoc risk management."

A PERMANENT FIXTURE

In the wake of the Sarbanes-Oxley Act of 2002 and more stringent corporate governance and compliance regulations, ERM – no matter who is in charge – is here to stay, says Lam. "To comply with the new governance rules in Sarbanes-Oxley and from the stock exchanges, you need to dig into the underlying operational processes that give rise to the financial statements," he explains. "That requires continuous monitoring and measuring of these processes. And by the way, they all involve risk." CPAs, whether as internal auditors or as financial managers, can play a critical ongoing role in the process of minimizing and managing risk.

Russ Banham is a business journalist and frequent contributor to the Journal of Accountancy. *His most recent book is* The Ford Century *(Artisan 2002), a 100-year history of the Ford Motor Company.*

How Finance Can Help Move CSR up the Agenda

By: IONA HILL

Many companies still show little evidence that they are engaging in 'corporate social responsibility' (CSR), and show scant understanding of the benefits. Iona Hill decribes how finance can help change this.

The usual argument cited by critics of corporate social responsibility (CSR) is that it is used as a public relations tool and has little meaning.

Yet, as someone who regularly reviews organisations' social and environmental policies, I am frequently struck by the number of companies where little evidence exists either to show they are engaging in CSR or to indicate the benefits of that engagement for organisation and stakeholders alike. These efforts bear no comparison with the in-depth financial reports some companies prepare by statute.

The better examples of financial statements communicate more effectively by providing clear examples of key financial measures and are transparent and objective. I would like to see this trend extended to CSR reporting.

In the past couple of years a significant number of the FTSE250 have started to publish social and environmental reports. However, a surprisingly small number of those companies provide convincing metrics that demonstrate a company really is doing what it says it is doing.

This article sets out how accountants can help their organisation engage in or develop aspects of CSR, reporting CSR metrics that demonstrate the organisation's engagement with CSR and the benefits to company and stakeholders.

An accountant is well placed in an organisation – multinational or not for profit – to do this. They are largely responsible for management information reporting and are usually custodians of the reporting systems, internal controls and underlying systems and processes that support these.

Rather than a new concept, CSR is a set of practices that form a part of good management or business practice; much of it is about transparency and disclosure. Many organisations find that in actuality, they already do much of what is considered 'CSR' but often do not have formalised systems to report on those activities.

Further, CSR should not be viewed as an add-on activity, as it is a concept of good practice that cuts across an organisation (eg in HR, purchasing, customer services etc). So again, this helps members of the accounting function to be facilitators, encouraging other sectors of the business to consider how they run operations and how to report in terms of social and environmental responsibility.

It can be confusing to identify what an organisation should be doing to engage in CSR. There exists a plethora of codes of conduct, standards, guidelines and frameworks on the notion of corporate social responsibility.

Some of these are generic, such as the (long) list contained within the external reporting framework of the Global Reporting Initiative (GRI) (see: www.globalreporting.org) and those contained in Business in the Community's (BITC's) 'Corporate impact reporting' (www.iosreporting.org) and others are industry specific, for example Worldwide Responsible Apparel Production (WRAP) (www.wrapapparel.org) and FORGE, guidance on corporate social responsibility for the financial services sector (see www.abi.org.uk/forge).

This article discusses specific areas of CSR activities, and provides some examples of measures that can be captured and reported on – and how reporting can be improved. As CSR reporting in the UK is not yet mandatory, there is no one framework that companies use, and this can make comparisons difficult. Having said this, there is an emergent 'core' of activities that companies are starting to report on.

It is important to adapt the best of the different standards and frameworks to the organisation's activities and not be tied into something that does not fit or is in part inflexible. Small and medium-sized enterprises (SMEs) will find that they can report on a slightly different subset of CSR activities as many of the more 'usual' measures are not relevant to them by virtue of size.

Reporting on CSR should be in line with all other management information systems and embedded across a company and be as automated as possible. The same rules of relevance, timeliness, quality and comparability apply.

BITC divides its CSR work into five principal areas: the market place (customers and suppliers), the environment, the workplace, the community and human rights. The GRI contains headings of direct economic impacts, the environment, labour practices, human rights, society, and product responsibility. Add to this the areas of corporate governance and health and safety and you have a reasonably complete list of the different areas of CSR reporting.

If CSR is to be meaningful, it must be more than a box-ticking exercise. Policy statements should be evidenced and supported by meaningful metrics. Where financial accounts are typically historical, CSR reports should not consider solely what has occurred historically, but should address what plans are in place to improve any given situation by setting a target or benchmark in the same manner as other reporting processes.

Whilst applauding the time and effort and glossiness of CSR reports that stretch to 80-odd pages, we should be asking ourselves, is this relevant and meaningful information, who is going to use it and how?

Continuing with the theme of relevance, what does it mean when an organisation says that it spends £500 a head on training? Who benefits from this?

I recommend to clients that they should treat CSR reporting a little like a balanced business scorecard, that there should be no more than five hard hitting and meaningful measures under each of the headings they feel is appropriate to their business.

If your organisation does not have any overseas offices or source from overseas, then maybe human rights and overseas labour are not big issues and require less emphasis, although naturally all companies are subject to their own country's employment legislation.

Many organisations tell me, as a CSR practitioner, that they do not feel the need to report on environmental matters because they are

a service company. This, I feel is an oversight, as there are many measures one can take (many of which can bring cost savings) – for example, monitoring water, electricity, gas and consumable usage such as paper consumption and switching to more environmentally friendly sourcing. Monitoring consumption allows targets for reductions to be made. There are many examples where cost cutting has resulted in improvements, in particular to manufacturing processes.

I am not in favour of a 'one size fits all' statutory solution for CSR reporting, but would like to see improvement in disclosure and targets outside the direct field of finance.

Following a balanced business scorecard type of approach, I advocate that each measure should have both an input and output component. For example, take a training spend of £500 per head. To find out what that really means, the input measure of £500 per head would be accompanied by an output measure recording the efficacy of training courses, through increased skills of the workforce, which in turn can lead to greater workforce retention and loyalty.

While there is no single perfect answer, output measures could include surveying employees to ask if the training helped them with their personal development or enabled them to perform their job more effectively. Similarly, a skills audit could help to identify benefits achieved by training programmes and to target future training requirements.

I urge any organisation considering either CSR reporting or improving their CSR engagement to ask three questions:

- is this relevant to our business?
- what are we going to do about it? and
- what does this mean?

For example, can an organisation explain what benefit, and for whom, derives from sponsoring a ballet company? Or from putting bird boxes in the trees around the company's office? (This line

Suitable CSR measures

Area	Measure type	Input measure	Output measure
Workforce	Staff turnover – this can be coupled with the number of staff grievances and absenteeism rate	Number and % of staff turnover; number and % of absences and working days lost; number of staff grievances	Staff satisfaction survey and plans to improve staff loyalty and retention; perception measures of how the staff views the company
Community	Workforce volunteerism	The number of employees undertaking volunteer schemes, hours spent and whether paid or not	Results of an assessment of the benefits of the scheme for staff, the company and the beneficiary groups
Suppliers	Late payment of supplier invoices	Average creditor days; number of successful legal actions taken for late payment	Increase in service level agreement, eg quality of supply, improved timeliness or service
Customers	Customer retention	Customer satisfaction; disclosure of large accounts lost and broad categories of explanations	Turnover of customers; number of new customers
Environment	Energy consumption	Analysis of different sources of energy consumed and source eg 'green' supplier from renewable sources	Achievement of target and target for future periods; cost savings

of thinking is congruent with Milton Friedman's famous line: "business is in the business of business", and the recognition that ultimately, all organisations are accountable to their shareholders for the appropriate use of funds.)

Hence I recently questioned the classification of arts sponsorship as 'CSR' in the social report of an FTSE100 company, whereupon its corporate affairs director agreed that it was more in line with marketing and not relevant to their CSR activities. (In the above mentioned example of bird boxes, the finance director admitted he did not know how this was relevant to the business, other than the managing director being a keen 'twitcher'.)

Paying invoices is usually the responsibility of the accounts department. How often do your organisation's payment terms differ from those of a supplier? Whose period is usually the longest? How many suppliers are paid on time? A familiar supplier CSR measure is to identify average creditor days taken. This information by different type of supplier, eg size, country, type of services could add to the meaning of the disclosure.

An output measure could be an increase in service level agreement indicators. If a company wished to be more transparent about its relationships with suppliers, it could disclose the number of times it has been threatened with legal action or successfully sued for non or late payment of supplier invoices.

Workforce measures are those which many organisations find the easiest to report on because workforce data is usually available through payroll means or through human resource software etc, and can be identified by gender, ethnic origin of staff, managerial grade by gender and ethnic origin and so on. (BAA does a good job of this.)

For example, supermarkets typically employ far more women than men, yet the number of female managers is low. The question to ask is what plans exist to increase the representation of women managers. This should be disclosed and reported against in the following year to see if the initiatives to increase the number of women managers have increased. This measure can be broadened to compare the local population profile to the profile of the workforce and comparisons made.

The box (see previous page) shows a selection of measures for some of the CSR themes mentioned above. But the sample measures identified there are indicative only and should be tailored to each organisation's activities.

Measures should be incorporated into the standard management information reporting routine, and could be prepared monthly, quarterly, or annually according to the relevance and priority. For example, most organisations prepare staff satisfaction surveys on an annual basis; average creditor days can easily be calculated from the accounting system each month, volunteer projects may be assessed biannually.

Additions to information requirements work best where information can be derived from existing data sources or by simple amendments to existing systems. The number of new information sources should be limited to only those which are considered high priority.

An example of an amendment to existing systems could include an additional code on employee time sheets to identify how much time is spent on volunteer activities. An additional code on gas, water or electricity invoices can record consumption by location. Employee data can be sourced from HR records.

Some measures are perception measures or qualitative measures and do not lend themselves to being measured in a traditional systems way, and this can involve additional time to gather. The benefit of having the information should be weighed against the cost and time involved in data collection. Keep your CSR reporting short, relevant, meaningful and simple.

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Responsible Hands

A Director's Guide to Risk and Its Management

By: ANTHONY A. ATKINSON, CMA, FCMA, AND ALAN WEBB, CA

A recent survey of public and private company directors by the National Association of Corporate Directors in the United States suggests that boards of directors consider risk management one of their most important responsibilities. However, results from this same survey show that less than 30% of directors believe their boards are highly effective in managing risk. Similarly, 36% of the directors who responded to a 2002 survey conducted by McKinsey and Company indicated they did not understand fully the major risks their organizations face, and 42% did not understand fully which elements of the business created the most value for shareholders.

Given this apparent gap between what directors should and do know about risk management, this article identifies and discusses three important contributors to organization risk and how those risks might be managed. In particular, we will look at the control points and the information requirements for managing each of these four types of organization risk.

The importance of risk management

Although a complete review of the numerous sources of risk management guidance, recommendations and requirements for boards is beyond the scope of this article, a few examples will illustrate the importance of this issue in today's regulatory environment. The 2001 report of the Joint Committee on Corporate Governance (CICA/TSX/TSX Venture Exchange) recommends that boards of companies listed on the TSX should oversee management's system for risk management and should regularly monitor the environment for emerging strategic risks and opportunities. Similarly, the Ontario Securities Commission's proposed policy on effective corporate governance released in January 2004 recommends that the board should assume responsibility for "identifying the principal risks of the issuer's business, and ensuring the implementation of appropriate systems to manage these risks." Both of these examples reflect "best practices" guidance that companies are not yet required to follow. However, in industries where fiduciary responsibility is particularly high (e.g. financial services), legislation (e.g. the Bank Act) specifically requires extensive risk management procedures – strong internal control. Similarly, the Canadian Deposit Insurance Corporation requires the board to review and approve organizational and procedural controls as part of its risk management responsibilities.

The nature of risk

Risk is uncertainty in achieving organization objectives. The fundamental nature and consequences of risk apply equally to for profit and not-for-profit organizations. In for profit organizations, risk is usually formalized

as the uncertainty of financial returns. In not-for-profit organizations, risk is usually formalized as uncertainty in achieving the organization's stated qualitative objectives – for example, a provincial health ministry may have the objective of improving some measure of the population's health, and risk relates to uncertainty in achieving that target.

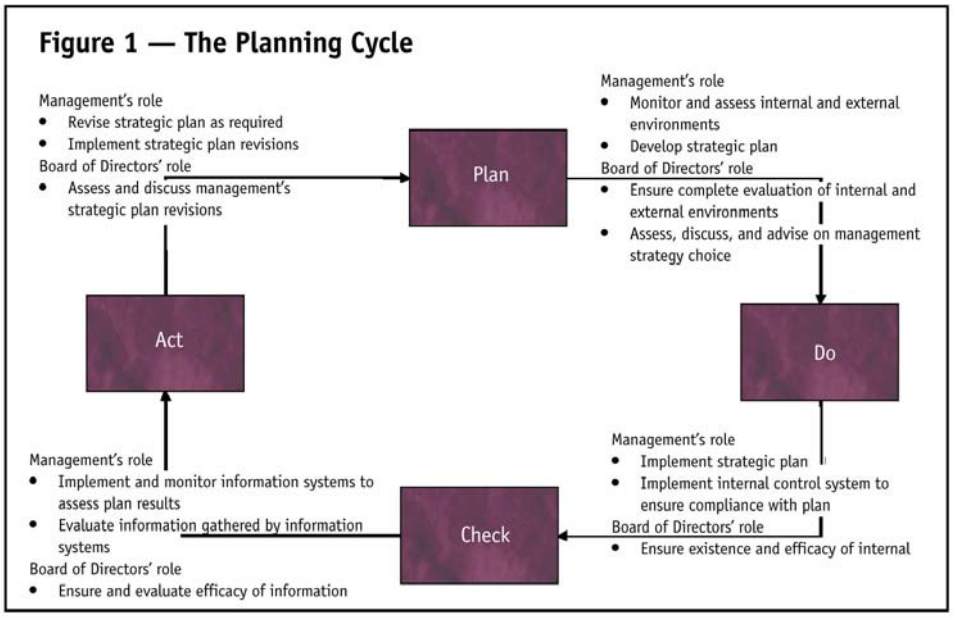
A fundamental proposition in financial economics argues that return compensates risk – the higher the level of firm specific or unsystematic risk, the higher the level of expected return. The primary roles of risk management are to identify the appropriate risk return trade off, implement processes and courses of action that reflect the chosen level of risk, monitor processes to determine the actual level of risk, and take appropriate courses of action when actual risk levels exceed planned risk levels.

The control cycle

It is useful to discuss organization risk within the context of the classic control cycle of plan, do, check, and act. It is senior management's responsibility to plan, implement, monitor, and revise major strategic initiatives, all of which simultaneously create and affect organization risk. Therefore, as part of its responsibility, the board of directors needs to ensure that management has in place each of the four elements of the control cycle.

This means that the board must ensure that management's strategic plans are adequately based on appropriate, reliable, and complete information which, in turn, requires the board to undertake an assessment of management's strategic plans, including their information basis and logic, and a discussion of that assessment with management. The board must verify that management has put in place control systems to ensure that its major initiatives have been implemented as planned. It must also ensure that management has put in place systems to monitor and evaluate the successful achievement of objectives. Finally, the board must ensure that management regularly compares planned and actual results, and appropriately re-evaluates strategy on that basis.

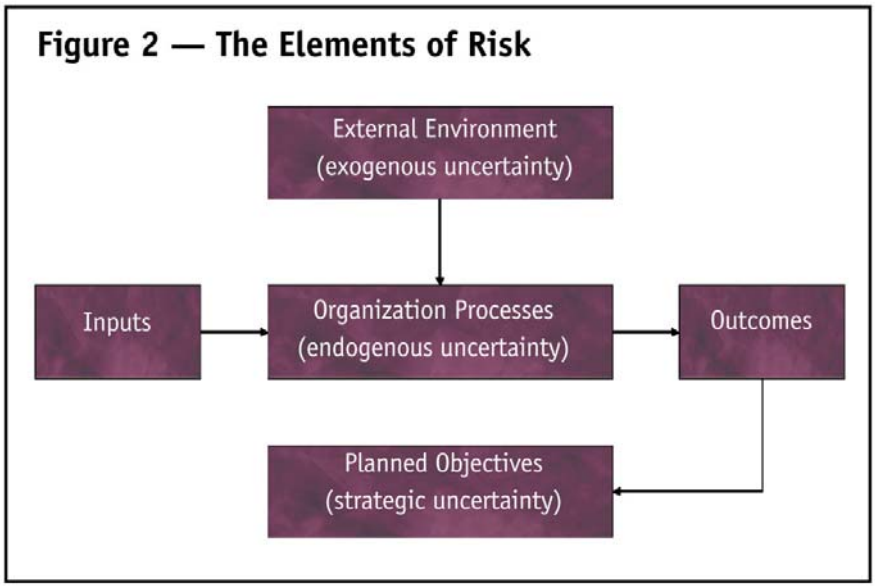
To reiterate, management's role is to ensure that it establishes and carries out the above control system steps (as outlined in Figure 1). It is the board's responsibility to ensure that management has undertaken these steps and, in the case of the plan and act (plan revision) steps, that it has evaluated the information and the logic of management's strategic plans and discussed this with management.



Elements of risk

There are three major contributors to organization risk – strategic

risk, environment risk, and operational risk. Strategic risk relates to an organization's choice of strategies to achieve its objectives. It is represented by a variance, holding constant the effects of any other sources of uncertainty, between a strategy's actual outcomes and its target outcomes, as shown in Figure 2. Environment risk addresses uncertainties in the operating environment of the organization. Environment risk is shown as the exogenous uncertainty in Figure 2. Operational risk has two components: process risk, which addresses the ability or inability of a process to achieve its objectives; and compliance risk, which addresses the potential failure to operate a process as planned.



Strategic risk

Strategic risk addresses the concern that major strategic alternatives may be ill advised given the organization's internal and external circumstances. Strategists have developed the notion of strategic fit, which reflects the alignment between the organization's internal potential (strengths) and its external opportunities. Misalignments occur when senior management pursues strategies that are either unfeasible, given the organization's financial and human resources, or are inappropriate, given its external environment.

Therefore, strategic risk assessment questions whether management has misread its environment or has developed an inappropriate strategy to deal with that environment. A good illustration of the first type of strategic risk was Nortel's decision to acquire unproven technologies to promote growth in the period 1998-2001. A good example of the second type of strategic risk was Microsoft's initial decision to treat the Web as a passing customer fad and its belated, although successful, entry into the Internet browser market.

Management's role is to develop and implement an organization's major strategic initiatives. The control point for strategic risk is the board, which should ensure that management has acquired and used the appropriate information to support this strategic choice and that the choice appears sound, given the information developed.

Environment risk

There are three sources of environment risk: macro-environmental factors, competitive factors, and market factors.

Macro-environment factors

The strategic management tool STEEP (social, technological, economic, environment and political trends) summarizes the macro-environment factors that can affect an organization. STEEP involves the identification, quantification, and evaluation

of the potential effects of each of the potential trends:

Social trends: For example, since 2000, fast food organizations have added so-called healthy alternatives to their menus to reflect societal trends. Some analysts believe KFC's slow or inadequate response to this trend cost it significant market share. Organizations can also overreact to apparent trends, however. By mid-2004 consumers seemed to be abandoning the low carbohydrate diets popular in 2002-3 and some organizations now had products that were expensive to develop and advertise that were no longer in demand.

Technological trends: FedEx quickly recognized the strategic and operational importance of barcode scanning technology for tracking shipments. Competitors quickly followed when they understood that this technology improved the quality and decreased the cost of courier service. Posco, a South Korean steelmaker, spent more than $200 million to develop an information system that linked its 80 Korean steel mills. This information system allowed the company to process customer orders online and channel each order to the appropriate plant to minimize work in process inventories, maximize plant use, and reduce cycle time to customers.

Economic trends: Organizations in the travel industry see their fortunes rise and fall contemporaneously with the economy. Others, such as organizations in the home renovation and graduate business education industries, appear to be counter-cyclical.

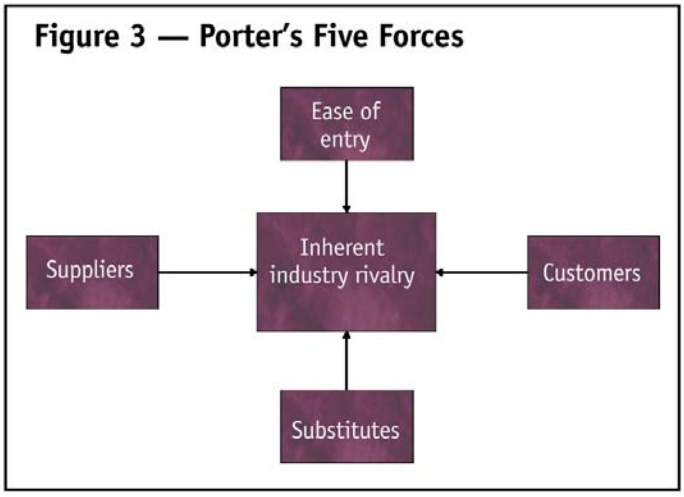
Environment trends: Government regulations and societal expectations can have far ranging effects on organizations, including process and product design. Changes in consumer views of the importance of recycling led fast food restaurants to use paper-based packaging for their food in place of the environmentally unfriendly Styrofoam material they had used in the past.

Political trends: Examples include organizations in regulated industries and organizations whose merger behaviour is subject to government review. An excellent current example is the effect of the Kyoto accord on organizations in the signatory countries.

Competitive factors

Michael Porter proposed a five forces analysis, shown in Figure 3, to identify the elements that can affect an organization's competitive position, which, in turn, affects the organization's ability to achieve sales and profit objectives, thus creating organization risk. These include the existing rivalry in the industry, power of suppliers, power of customers, ease of entry into the industry, and availability of substitutes. For example, increases in substitutes diminish an organization's competitive position, thus creating organization risk.

Figure 3 — Porter's Five Forces



Market factors

Market factors create organization risk through their potential to change the competitive landscape. The three elements of market factors are: product life cycle, market requirements and competition.

Product life cycle. The competitive dynamics in each stage of a product's life cycle (planning and introduction, early growth, late growth and maturity, and decline) require that the organization adapt its competitive strategy to the product's life cycle stage. Failure to adapt strategy in response to a life cycle stage change creates organization risk. A good example is the impact of Apple's iPod on the portable music player industry. Essentially, this new technology moved existing technology from an early growth stage into a maturity/decline stage, creating important issues for competitors concerning whether to follow iPod to the higher price point, higher functionality product, or to remain where they were with existing technology.

Market requirements. Four dimensions summarize customer requirements: price point, quality, functionality, and service. The potential for customer change in any of these dimensions creates customer risk if the organization is not prepared for such changes. A good example of the danger of misunderstanding customer requirements was the belief by North American automakers in the early 1970s that quality was not a significant customer requirement – reflecting the belief that warranties meant that customers did not have quality risks. This misunderstanding, combined with the North American automakers' false belief that higher quality meant higher production costs, opened the door to Japanese imports that customers readily adopted because of their superior quality.

Major competitor. Major competitors create organization risk through their ability to change the competitive dynamics of a market. Organizations that compete in the same consumer segments as Wal-Mart constantly monitor Wal-Mart's planned moves into new markets.

Organizations manage environment risk by continuously scanning each of the changeable environment elements and by identifying issues that must be addressed to sustain a competitive position.

It is management's responsibility to choose the appropriate type of compliance risk control system and to ensure that it is appropriately designed, implemented and operated.

This formal scanning process is part of the strategic management approach known as SWOT, a continuous and thorough analysis of the organization's strengths, weaknesses, opportunities, and threats given its current strategies and processes and the evolving trends in the external environment. The major control tool for managing environment risk is information gathering and assessment of that information by management, and the control point is a senior group responsible for organization planning and strategy. The board's role is to ensure that management has a systematic process for: gathering the necessary environment information; assessing the organization risk (actual or potential) implied by that information; and ensuring that management acts on the identified risks in an appropriate and timely manner.

Operational risk

There are two forms of operational risk – compliance risk and process risk. Compliance risk is the potential that an implemented procedure, control, or prescribed practice that is otherwise well designed will not operate as intended by management. Process risk is the potential that a procedure, control, or prescribed practice contains a design flaw that can create organization risk.

Compliance risk

Compliance failures have accounted for the most spectacular organization failures and losses in the last decade. These compliance failures have resulted in both legal damages being assessed and loss of corporate image – potentially affecting future profitability. Therefore compliance risk is a major source of organization risk and deserves the high level of attention it has attracted in the management control literature. This is perhaps the reason for regulator preoccupation with compliance risk in setting governance standards. The focus on independence between the auditor and management, and among board members and management, reflects the implicit target of lowering compliance risk – the point being that the possibility increases that auditors and board members may not perform as expected when they are beholden to (not independent of) management. While controlling compliance risk is important, regrettably few suggestions for governance improvement focus on methods to reduce strategic, environmental, and process risk.

Compliance failures arise for two reasons: deliberate override or the failure of the people monitoring a system, through negligence or ignorance, to operate it as intended. The Barings Bank failure is an example of a deliberate override, as are most frauds.

The failures of systems to operate as planned are subtler and may reflect many underlying causes. Governance system failures are often attributed to the failure of boards of directors to undertake their duty to monitor and advise management. For example, the board of directors of the New York Stock Exchange came under criticism for approving what many outsiders believed was an extravagant compensation package offered to the CEO. Industrial accidents are often attributed to employees who were inadequately trained. The Exxon Valdez ran aground, creating a massive environmental disaster at a time when only one ship's officer was on the bridge – a direct contravention of company policy.

There are three tools organizations use to manage compliance risk:

1. Preventive controls such as system design and training.
2. Concurrent controls such as process monitoring and random inspections.
3. Detective controls such as audits.

It is management's responsibility to choose the appropriate type of compliance risk control system and to ensure that it is appropriately designed, implemented and operated. It is also management's responsibility, either through systematic information gathering or random inspections, to frequently monitor and evaluate the ongoing efficacy of its implemented control systems. It is the board's responsibility to ensure that management has identified the appropriate compliance risks and the procedures, controls or prescribed practices by which they will be managed. The board is also responsible for ensuring management performs its monitoring and continuing evaluation responsibilities both systematically and effectively. Ultimately, it is the board's responsibility to ensure that management is effectively controlling compliance risk.

Process risk

Process risk arises through inadequate system design. It reflects incomplete consideration of the environment in which the system was designed to operate. Arthur Andersen ultimately failed because of its loss of credibility stemming from its association with Enron. Many observers of Andersen's demise have attributed it to a process failure – local partners were permitted by corporate policy to overrule opinions provided by experts at corporate headquarters.

In response to charges that its Explorer vehicles were unstable, Ford redesigned the vehicles with a wider wheel base. The tracks used to move vehicles along the assembly line were poorly positioned, causing damage to the tires of some vehicles, creating another recall and image problem for Ford.

Occasionally risk is created because of a combination of both process failure and compliance failure. The World Nuclear Association concluded that "*the Chernobyl accident in 1986 was the result of a flawed reactor design (a process failure) that was operated with inadequately trained personnel and without proper regard for safety*[1] *(a compliance failure)* (comments in parentheses added).

Since unforeseen events create process risk, it is possibly the most difficult to mitigate and organizations often engage in risk shifting through insurance or joint venture agreements to control process risk. However, it is important that management put in place systems to evaluate and control process risk. It is the responsibility of the board to ensure that management has undertaken this responsibility in a complete and effective way. Scenario analysis can be used to control process risk, which involves predicting how existing systems would respond to unanticipated events. In this regard, a board can play an important role by asking management "what if" questions concerning the potential for organization risk created by unanticipated events. Boards should insist that organizations that face continuous unforeseeable risks provide for such risks through appropriate accumulation of contingency funds held in liquid investments.

Senior management and boards of directors share responsibility for managing organization risk. While management is responsible for identifying the appropriate level of organization risk and putting in place systems to monitor, assess, and react to unexpected risk, it is the board's responsibility not only to ensure that management has implemented these systems, but also, particularly in the case of strategic risk to be actively involved in assessing risk levels directly rather than simply monitoring management's efforts.

[1] http://www.world-nuclear.org/info/chernobyl/inf07.htm

Risk Type	What is it?	Examples	When is Risk High?	Control Point	Information Needs
Strategic Risk	The possibility that current strategy reflects a misalignment between what the organization is, or is capable of being in the short-run, and the organization's external opportunities causing the organization to fail to achieve its objectives.	• Pursuing growth objectives that are beyond the organization's current or projected financial and human resource capabilities • Pursing strategic objectives that rely on future events that are either highly uncertain or not controllable by the organization • Pursuing strategic alternatives that ignore potential changes in the organization's environment.	• Weak or no strategic oversight by board • Management rewarded in ways that cause it to pursue objectives inconsistent with shareholder objectives • Management shows signs of an irrational commitment to an existing plan.	• Management to choose strategies that balance strength and opportunities with due reflection of weaknesses and threats • Board to engage in frank evaluation of proposed strategy and the rationale and information underlying the chosen strategy.	• Trends in macroenvironment variables, competitive pressures, market changes • Frank assessment of organization resources both financial and human.
Environment Risk	The possibility that changes in the organization's environment including the macroenvironment, competitive conditions, and market conditions will change and affect organization risk.	• Failing to identify the potential for social, technological, economic, environment, and political changes to create organization risk • Failing to identify the potential for changes in competitive strength to create organization risk • Failing to identify important changes in market characteristics.	• An element of the organization's external environment that has potential to create organization risk is highly uncertain • The success of a key organization strategy is highly reliant on some future event that is highly uncertain or beyond the organization's control • The organization's strategy has a high reliance on some internal resource that is not currently in place or will be difficult to acquire.	• Management to ensure that relevant elements of the external and internal environments are constantly monitored and, where appropriate, contingency plans developed • The board to ensure that management is actively monitoring the relevant environment elements.	• Trends in macroenvironment variables, competitive pressures, market changes • Frank assessment of organization resources both financial and human.
Compliance Risk	The possibility that a system will fail to operate as designed, thereby causing damage to the organization. Can be caused by deliberate override or accidental failure.	• Inappropriate use or consumption of organization resources • Fraudulent reporting • Failure to follow a prescribed control procedure • Failures in manufacturing or ethical systems.	• Weak oversight or lack of attention by management and board to internal control • Organization culture that promotes non-compliance attitudes • Excessive or unreasonable performance pressures	• Management to develop effective compliance systems and to ensure that compliance is regularly monitored • The board to ensure that management has implemented effective systems and is regularly monitoring systems compliance.	• Random and independent tests of systems compliance • Oversight of management's evaluation of the results of random and independent systems tests.
Process Risk	The possibility that a system design is flawed so that it cannot achieve its objectives.	• Failing to anticipate an event or circumstance that can degrade system performance.	• Systems complexity and the potential for exogenous events to affect systems • Lack of redundancy in system planning and implementation.	• Management to undertake scenario and issue analysis to develop contingencies for unforeseen events • The board to ensure that management has implemented effective systems and is monitoring systems performance.	• Management to monitor systems performance and identify signs of system stress of potential failure • The board to ensure that management is undertaking its process risk responsibilities.

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Performance Measurement Systems for Corporate Sustainability

By: LINEKE. SNELLER

A case study

When a company chooses for corporate sustainability and to act accordingly, this usually means a drastic change in strategy. Inevitably it calls for adjustment of its performance measurement systems, since the effects of the new strategy cannot otherwise be measured and monitored. This case study describes the performance measurement systems at Interface, a company that opted ten years ago for a strategy of corporate sustainability. It firstly describes the performance measurement systems of Interface, followed by an assessment of their quality.

INTRODUCTION

Corporate sustainability is receiving a great deal of attention in Europe. Large multinationals such as Ikea, Bodyshop and BP opted for corporate sustainability in recent years. In the Netherlands the level of interest in the ecological and social aspects of entrepreneurship may have been less than optimal, but now that corporations of the size of Shell are focusing on these aspects it is clear that this is more than a short-term hype.

For any corporation, the transition to sustainable enterprise comes down to a strategy change. To enable the effects of implementing the new strategy to be measured, monitored and managed, the performance measurement systems and management control processes must be redesigned. This article describes how corporate sustainability can be embedded in the management control processes of companies. This is done on the basis of a case study at Interface, a corporation that has applied sustainable business practices since ten years.

The article is built up as follows. Section 2 describes the company and the performance measurement systems that are used at Interface to support the strategy of corporate sustainability. Section 3 then covers the main features of the theory of performance measurement systems, and it describes four quality criteria that apply to such systems. In the final section the quality of the performance measurement systems at Interface is assessed in the light of these four quality criteria.

INTERFACE: CORPORATE SUSTAINABILITY IN ACTUAL PRACTICE

Interface Inc, an American corporation that is listed on the Nasdaq stock exchange, is engaged in the market for soft floor coverings as a producer and supplier of carpet tiles. This is a niche market, with less than 10 percent of the total production volume of the carpet industry. Interface is the market leader in this niche, with a market share of more than 50 percent in practically every country where it sells its products and services.

The major part of sales by Interface is realised in the business market as its customers are mostly flooring contractors and carpet fitters that lay carpeting in office buildings. In addition, Interface has a retail segment, which serves the consumer market via do-it-yourself and furniture stores.

The carpet industry is facing difficult times throughout the world. The business market is susceptible to cyclical trends, and the products are constantly subject to environmental debate. Interface is one of the stronger players in this difficult market. This is due to such factors as:

- The Heuga brand name in Europe, which covers a range of strong products
- The consistently high quality of its carpet tiles, a technically difficult product.

With over 5,000 employees worldwide, Interface is a medium-sized company. It operates in a diversity of cultures but obviously reflects the American management style of the parent company.

The sections below cover the management control process of Interface. They describe how the strategy of Interface came about, how objectives and targets are set, the performance measurement systems that Interface has designed and the relationship between performance and variable compensation.

2.1 Strategy

Until 1994 Interface Inc aimed at worldwide market leadership. This led to a large number of business acquisitions around the world. The company's environmental policy was simple: do what is minimally required to comply with relevant laws and business regulations.

"Interface will be the first company that, by its deeds, shows the entire industrial world what sustainability is in all its dimensions: People, Process, Product, Place and Profit. In doing so we will become restorative by the year 2020 through the power of influence."

In 1994, however, chief executive officer Ray Anderson came under the spell of the concept of corporate sustainability. The mission of Interface was totally revisited at a large meeting that involved the entire management of the corporation.

The strategy of Interface is based on the five Ps: People, Process, Product, Place and Profit. The idea behind this is that a company can only be sustainable when the five Ps are developed in conjunction. Disregard for one or more of the five will endanger the long-term existence of the company.

2.2 Objectives

The strategy of Interface is to achieve sustainable entrepreneurship by the year 2020. Interface will regard itself as a sustainable enterprise when the following seven objectives are achieved [2]:

- Eliminate waste
- Benign emissions
- Renewable energy reducing the energy demands while substituting non-renewable sources with sustainable ones
- Resource-efficient transportation, with transport of information instead of people and products wherever possible
- Redesign commerce
- Sensitivity hookup
- Closing the loop

The first four objectives speak for themselves, but the next three call for some explanation. The fifth objective, redesign commerce, aims at supply of Interface services instead of products only. An example of this is carpet lease, where, instead of a one-off delivery, Interface provides carpeting, cleaning, replacement and removal services for an agreed period. The company in fact takes total responsibility for the entire life of the carpeting. In that way the carpeting, a product that does not easily degrade, will not end up in the garbage dump, since Interface can arrange for recycling.

As to the sixth objective, sensitivity hookup for all stakeholders to natural systems, Interface tries to realise this in various ways. Examples include scholarship grants for development and education in the field of corporate sustainability, and stimulating community involvement on the part of employees. Writing articles, appearances on radio or television and giving speeches are also activities that serve to promote sensitivity and awareness.

The seventh objective, closing the loop of material flows, is the most ambitious one of all. A cyclical flow originates when a product, after being used, serves as input for a new production process and is thus re-used. For a chemical product such as carpeting this cannot yet be realised in a profitable way with current technology. Interface therefore wants to realise the cycle in phases. One of the most recent developments is the use of organic yarns that are produced from corn, potatoes or soybeans.

Next to the above seven objectives, which relate mainly to the four Ps of People, Process, Product and Place, there is the fifth P, that of Profit. For sustainable enterprise, this is indispensable. Profit-related objectives include operating income, profit centre contribution and cash flow.

2.3 Targets

The Interface strategy has a horizon that expands over many years. To be able to follow the implementation and to adjust where necessary, such a horizon is clearly too long. Each year therefore, corporate management sets target levels per division for each objective. European management then translates these into target levels for the various European managers.

Table 1 presents an example of the overall European target levels and the consequent target levels for Sales in Southern Europe and for Operations in the Netherlands. The table only presents targets in percentage terms. However, there are also quality-related targets. An example of such a target is the preparation of a plan for the development of carpet tiling produced from corn.

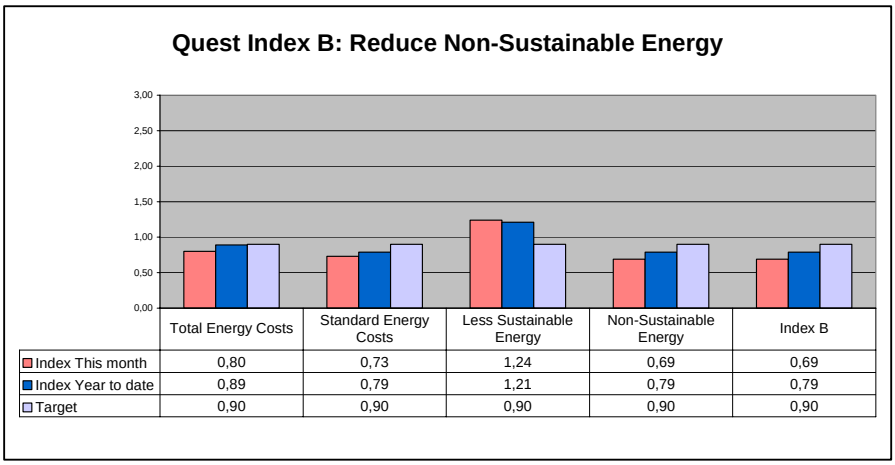
2.4 Performance measurement systems

Table 1 not only presents targets but also

Table 1: Objectives and targets

Performance measure	Location	Objective	Target	Actual	Actual (%)
European division					
Operating income	Total division	Financial	27.0	23.6	88%
Quest	Total division	Waste Energy	0.9	0.9	100%
Cash flow	Total division	Financial	10.1	2.6	25%
Ecopoints	Total division	Emission Energy Stakeholder sensitivity	67.5	130.3	193%
Fixed costs	Total division	Financial	113.4	104.0	109%
Local					
Profit centre contribution	Southern Europe	Financial	17.7	13.2	75%
Days of sales outstanding	Southern Europe	Financial	60.8	70.2	87%
Quest	Netherlands	Waste Energy	1.2	1.5	82%
Operating unit contribution	Netherlands	Financial	99.8	81.5	82%
Stock turnover	Netherlands	Financial	17.5	17.5	100%

actuals. These are measured using the various performance measurement systems that Interface has developed. The financial reports are essentially no different from reports at other companies. They do, however, include aspects that are specifically linked to corporate sustainability such as Ecopoints and Quest.



	Total Energy Costs	Standard Energy Costs	Less Sustainable Energy	Non-Sustainable Energy	Index B
Index This month	0,80	0,73	1,24	0,69	0,69
Index Year to date	0,89	0,79	1,21	0,79	0,79
Target	0,90	0,90	0,90	0,90	0,90

Figure 1: Quest reporting

Ecopoints is a grading system that relates to objectives associated with the Ps of Process and Planet. The activities that generate points can be quite varied. Production sites, for example, can work on improving their production processes. In order to earn points, a plan must be submitted in advance to Interface Research. This laboratory unit examines the feasibility of the plan and determines the number of points that can be earned. The production site implements the plans, and Interface Research then conducts an audit to determine whether the intended improvement has been achieved. When this is the case, the points are granted.

There are also simpler ways to earn points. For example, video conferencing equipment is available at the larger company sites. Such equipment eliminates the need of air travel and the consequent environmental burden. That leads to Ecopoints.

Quest measures waste, thus focusing on the Ps of Place and Profit. The goal is to reduce the amount of waste by 10% each year, in particular from the production process. Employees can also submit ideas to cut waste, a feature that reminds of Japanese quality circles. Figure 2 is an example of a Quest report.

2.5 Linking to variable compensation

The performance measurement systems are linked to variable compensation. Some thirty managers fall under the European bonus plan. This group consists of the European executive directors, their direct reports and a number of managers in strategic functions. Table 2 sets out how this bonus plan works for three managers from different disciplines.

For each manager participating in the bonus plan, a bonus potential is determined at the time of assignment, expressed as a percentage of the manager's salary. The weightings of the individual performance measures are then determined. For example, Table 2 shows that the Quest score has a weighting of 16% in the bonus potential of the Director of Dutch Operations.

Each month, targets and actuals are measured and reported in line with the performance measurement systems described in the previous section. The score at the end of the year determines what percentage of the bonus potential is actually paid out. In the example, the Director of Sales for Southern Europe has achieved 80% of the targets. The bonus to be paid is thus 80% of the bonus potential of 55%, thus 44% of salary.

STRATEGY AND PERFORMANCE MEASUREMENT SYSTEMS: OUTLINE OF THE THEORY

We have just described how Interface has put performance measurement systems into place. This section presents a brief outline of the theory of performance management. The relationship between strategy and performance measurement systems is clearly set out by Simons [5]. A company's strategy indicates how value is created, and also which objectives the employees must keep in mind in order to ensure that such value actually comes about. In order to monitor value creation, the objectives must be stated in terms of performance measures. These are measurable interpretations of the objectives.

A performance measurement system consists of target levels and actuals of performance measures. Targets are specific goals or aspirations for performance measures, while actuals are the measured values. Using a performance measurement system, managers can compare targets and actuals. According to the theory of Simons, they can thus monitor the implementation of strategy.

The quality of the performance measurement system is decisive for the extent to which it is useful for the implementation of strategy. Bouwens and Van Lent [1] identify three quality-related criteria for performance measures:

- Timeliness. After a manager has taken a decision, a certain amount of time passes before the effect of that decision is noticeable. Only then can the result be made visible in the performance measurement system. In a timely performance measurement system, a minimum amount of time passes between the moment when a result is noticed and the measurement and reporting via the measurement performance system.
- Accuracy. In an accurate performance measurement system, the measurements are a reliable reflection of the performance of the manager, and they are objective and verifiable.
- Sensitivity. In a sensitive performance measurement system there is a strong

Table 2: Actuals and variable compensation for three European managers

Performance Measure	Individual weighting			Act-ual (%)	Actual weighting		
	Director of Sales Southern Europe	Director of Dutch Operations	Manager of IT development		Director of Sales Southern Europe	Director of Dutch Operations	Manager of IT development
European Division	**30%**	**30%**	**100%**				
Operating income	13%	13%	45%	88%	11%	11%	39%
Quest	6%	6%	20%	100%	6%	6%	20%
Cash flow	6%	6%	20%	25%	2%	2%	5%
Ecopoints	2%	2%	5%	193%	4%	4%	10%
Fixed costs	3%	3%	10%	109%	3%	3%	11%
Local	**70%**	**70%**					
Profit centre contribution	60%			75%	45%		
Days of sales outstanding	10%			87%	9%		
Quest		10%		82%		8%	
Operating unit contribution		50%		82%		41%	
Stock turn		10%		100%		10%	
Total	**100%**	**100%**	**100%**		**80%**	**85%**	**85%**
Maximum bonus (% of salary	55%	35%	45%				
Actual bonus (% of salary)					44%	30%	38%

relationship between the efforts of the manager and the performance measure. When the manager ignores an objective or pays great attention to it, this is reflected in the performance measures.

A good performance measurement system thus provides timely, accurate and sensitive insight into the various performance measures.

The theory of performance measurement systems is especially applied in companies that define their strategy and added value in financial terms such as share value. A well-known category of performance measurement systems for which this applies is the Balanced Scorecard [3]. In this particular tool, non-financial aspects may well be included in the performance measures, but the prime intent of the Balance Scorecard is to see the ultimate effect, via cause-and-effect relationships, in terms of financial measures.

In corporate sustainability, the strategy and added value are not set out strictly in financial terms. It applies the principle of balanced development in a variety of aspects. A well-known example of a multi-dimensional value concept is the theory of the Triple Bottom Line [4]. This theory assumes balanced development of ecology (Planet), social capital (People) and economy (Profit).

A value concept with various dimensions has consequences for the determination of performance measures that are to be included in the performance measurement system. Therefore, in addition to the requirements of timeliness, accuracy and sensitivity, I wish to add one more quality criterion that is particularly relevant to corporate sustainability, namely:

- Completeness. Corporate sustainability calls for a value concept with multiple dimensions. A complete performance measurement system sets targets and measures actual performance in terms of each of these dimensions. It stimulates balanced improvement across their full range.

In summary, a good performance measurement system for corporate sustainability consists of a complete collection of performance measures, and it provides timely, accurate and sensitive insight into each of these measures.

ASSESSMENT

In this last section the quality of the performance measurement system of Interface is assessed in terms of the quality criteria described in section 3: timeliness, accuracy, sensitivity and completeness.

When the European performance measurement system of Interface is assessed on the basis of the quality criteria mentioned in section 2, this leads to the following conclusions.

Timeliness.

Each month, no later than the fifth working day, actuals for the previous month are measured and reported to European management. Based on these reports, the various management layers discuss actions to be taken. A poor Quest score for Operations in Europe last year led in this way to revision of the quality system in the factories, which resulted in a significantly higher score.

Production and selling processes in the carpeting industry have a throughput time of many months, whereas reports are produced monthly. The Interface performance measurement system thus scores high on timeliness.

Accuracy.

Targets and actuals are determined and reported both at local and division level, leading to proper insight into the performance of the individual managers. The financial reports are reviewed by the accountant, while the Quest and Ecopoints reports are reviewed

by Interface Research, the independent laboratory of the US parent. This ensures the objectivity of the reports. The Interface performance measurement thus scores high on accuracy.

Sensitivity.

The extent to which corrective actions lead to actual improvement of performance depends on the position of the manager. The Sales Director for Southern Europe, for example, is able to exert direct influence on Operating Income by price-setting or increasing sales. The Director of Dutch Operations can impact the Quest scores by producing less waste or by closing contracts for sustainable energy. In the direct functions there is a close relationship between the actions of the manager and actual performance.

This is different for the supporting functions. The Manager of IT Development might contribute most to the objectives by closing the department, thereby eliminating the related fixed expenses. But this would be dysfunctional behaviour since that is likely to lead to lower scores on other performance measures. The relationship between the actions of the manager and actual performance is less clear for the indirect functions.

The Interface performance system scores high on sensitivity for the direct functions and inadequate for the supporting functions.

Completeness.

Interface describes its strategy in terms of the dimensions that are reflected in the five Ps. For each P one or more objectives have been defined. Each year targets are agreed for these objectives, and each month the actuals are measured. All objectives are considered in the level of variable compensation. European management is thus stimulated to consider all objectives. The Interface performance measurement system scores high therefore on the criterion of completeness.

Summarising the above, the European performance measurement system is timely, accurate and complete. Improvements are possible as to sensitivity, in particular in the supporting functions. On the whole it is a useful system. It measures progress in the implementation of strategy and enables the managers to adjust where necessary. The performance measurement system is one of the factors that have enabled Interface to make substantial progress during the past ten years on the road to corporate sustainability.

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Scorecard Support

By: LARRY B. WEINSTEIN AND JOSEPH F. CASTELLANO

Benchmarking and stretch targets are often adopted to support the Balanced Scorecard. But do they do what is necessary to make scorecards effective? Using statistical process control might be more effective.

The Balanced Scorecard (BSC), first proposed by Robert Kaplan and David Norton, has emerged as an important strategic management system. The BSC offers organizations an alternative performance measurement system to overcome the deficiencies associated with an over-reliance on traditional financial measurement systems. By incorporating the perspectives of customers, internal business processes, and learning and growth, it enables users to identify and measure factors critical to an organization's efforts to become more flexible and responsive to customer needs.

The BSC isn't just a mixture of key performance indicators that includes financial and non-financial performance measures. Rather, it's a system that translates the firm's vision and strategy into a linked set of performance measures. These measures must include both outcome measures (the lag indicators), and the drivers of those outcome measures (the lead indicators).

For some companies, the BSC has evolved into a strategic management system. Used in this manner, the scorecard incorporates four new management processes that enable managers to link long-term strategic objectives with short-term actions. The first process – translating the vision – helps the organization build consensus around its vision and strategy. The second process – communicating and linking – facilitates management's efforts to communicate and link the firm's strategy to individual and department goals. The third process – business planning – makes it easier to integrate business and financial plans. The final process – feedback and learning – gives an organization the capacity for strategic learning.

Whether the BSC is used as a performance measurement or strategic management system, a company must address how targets and goals – the metrics used in the scorecard process – are established. While benchmarking best practices of other organizations and using stretch targets are methods discussed in the scorecard literature, we believe these approaches may undermine the credibility and usefulness of the BSC. Such measurements are simply arbitrary goals and targets. As such, they suffer from the same deficiencies when used in a BSC as when incorporated in more traditional performance measurement systems. More importantly, the use of benchmarking and stretch targets doesn't consider the current performance of the processes used to achieve the firm's strategy. Since successful BSC strategy implementation requires the improvement of critical business processes, the use of statistical process control (SPC) should become an integral part of establishing the numerical targets and goals of balanced scorecards.

STATISTICAL PROCESS CONTROL

Although a detailed explanation of SPC and capability analysis is beyond the scope of this article, the reader needs to understand some

basic concepts to appreciate how SPC can enhance the BSC. These concepts were first developed by Walter Shewhart and introduced in his text, "Economic Control of Quality of Manufactured Product." Subsequently, SPC has become one of the most important tools for improving processes (for a more detailed explanation of SPC, please refer to the book *Understanding Variation: The Key to Managing Chaos,* by Donald Wheeler).

The targets and goals used for the BSC are, in effect, specifications. The common mistake in traditional performance measurement is to confuse these specifications – no matter how important and desirable they may be – with the capability of a given process. A problem occurs if management establishes targets and goals for BSC without considering the current performance of the processes used to deliver the results. For example, if management sets a target (specification) of 95% on-time delivery (OTD) for a customer delivery process without considering the current capability of the process, the goal is purely arbitrary. Pressures to meet such targets and goals can lead to the distortion of processes and figures.

Traditional performance measurement usually entails comparing some specification target or goal to some actual result. The outcome is favourable if the target is met or exceeded, and unfavourable if it isn't met. Unfortunately, traditional analysis can't determine the reason for meeting or missing the target.

Unlike traditional performance measurement, which attempts to attach a meaning to every data point and outcome, SPC focuses on the behaviour of the time series of the underlying process. In effect, SPC incorporates the use of process behaviour charts (also referred to as control charts) and other quality tools to define the capability of the process.

ANALYZING VARIATION

Process behaviour charts allow management to analyze process variation. All processes exhibit variation. The key question for management is whether the variation is random and inherent in the design of the process (usually referred to as common cause variation), or whether forces outside the design of the process are causing the variation (usually referred to as special, or assignable cause variation). Management must respond to common cause variation and special cause variation in distinct ways. Confusing the two, or not being able to distinguish between them, can cause serious and costly mistakes.

Through the use of process behaviour charts, management can determine if the variation that is occurring is a common cause or a special cause. A process that displays only common cause variation is one that is said to be stable or in statistical control. For example, Exhibit A shows a control chart for the length of time it takes to process a medical claim. Data is shown for the number of days it takes to process each claim. The control chart shows a stable process since all of the data points fall between the upper control limit (UCL) of 26.7 days and the lower control limit (LCL) of 8.6 days. The current process average is 17.7 days.

If the process behaviour chart reveals that special cause variation is present – for example, by the occurrence of points outside the upper or lower control limits – something is occurring outside management's original design of the process. For example, Exhibit B shows a control chart for the time it takes to resolve customer complaints. Since the chart reveals the presence of points above the UCL of 7.1 days and below the LCL of 3.0 days, special cause variation is present in the process. The proper course of action when special causes are present is to investigate the signal to eliminate the cause if it is an

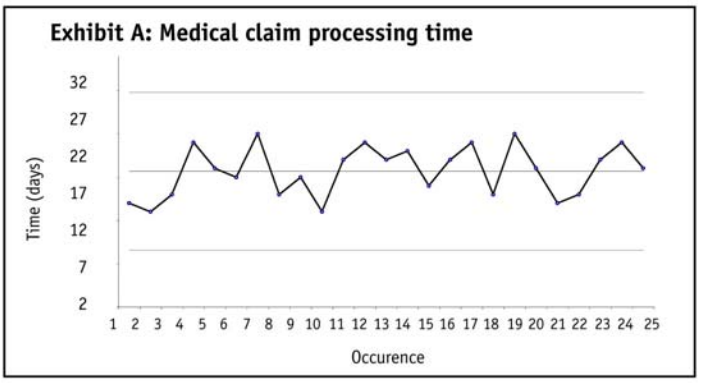
undesirable result or, in the case of a desirable outcome, to determine if and how it can be replicated in the future. When the special cause is eliminated, the process returns to a state of statistical control.

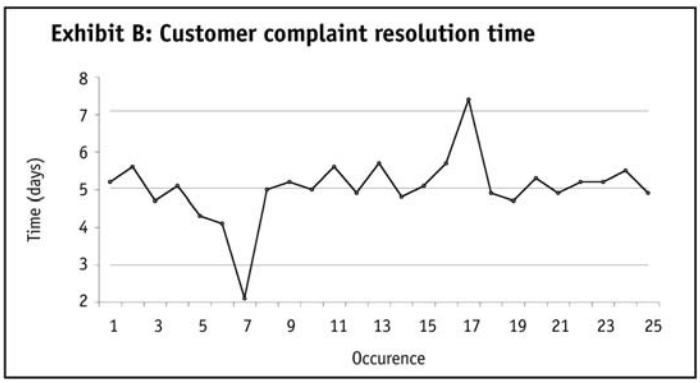
BSC AND PROCESS BEHAVIOUR CHARTS

With process behaviour charts, management can evaluate the current performance of a process and determine whether the process's current configuration is capable of achieving the numerical targets and goals for BSC measurements. If management isn't satisfied with the amount of variation or the average output level of a stable process, it must improve the process by making changes to the process inputs (people, methods, equipment, materials, and environment). Returning to the example in Exhibit A, if management isn't satisfied with the current process average of almost 18 days to process a medical claim or the amount of variation present, it has to change the process to get better results. Blaming process managers for the variation or the failure to achieve BSC results is futile. The process is performing as best it can, given its present design. Unless management changes the process, similar results can be expected in the future.

Once a process is in statistical control, only common cause variation is present. This allows management to make predictions about the future performance of this process because its outputs are predictable and within a definable capability. Since prediction is an integral part of the BSC process, efforts to bring processes into statistical control are critical to ensure that management will take the appropriate action when undesirable results occur. If a process is not stable, special causes are present; it is useless to make predictions about the future performance of the process since it does not have a definable capability.

Using process behaviour charts in the BSC process also gives management the added advantage of focusing on the distribution of process results over time. One of the dangers of traditional performance measurement systems is that they are used as the basis for reports, which compare one data point with another.





For example, if management were given a report that showed that last month the time it took to process a medical claim increased from 18 days to 24 days, it might react as if this was a signal that there was a serious problem. Management would demand an explanation or perhaps reprimand the process manager. Worse yet, they may be tempted to

alter their strategy. But as Exhibit A shows, these results are still within the upper and lower control limits of the process control chart.

Management shouldn't just focus its analysis on a few isolated data points and interpret these without considering the historical output of the process. Results must be interpreted in the context of the distribution of data shown in the process control chart. Management, in failing to analyze data in this manner, runs the risk of inviting tampering with a stable process (which can increase variation) or of blaming process managers for results over which they frequently have little or no control. Returning to our example in Exhibit A, management might not be satisfied with the results of this process, but it should realize that these results came from a stable process.

Management now must study the process to determine how it can be improved. One approach that is employed to meet this need is the Six Sigma process improvement program.

SIX SIGMA AT WORK

The Six Sigma initiative is aimed at eliminating defects from products, processes, and transactions. The concept was popularized by Motorola in the 1980s. The program's name comes from the statistical measure of six standard deviations, or six sigma from a process average, a range beyond which no more than 3.4 defects per million opportunities (DPMO) will occur when the process average drifts up to 1.5 standard deviations. The program is designed as a disciplined, quantitative approach for improvement of defined metrics in manufacturing, service, or financial processes.

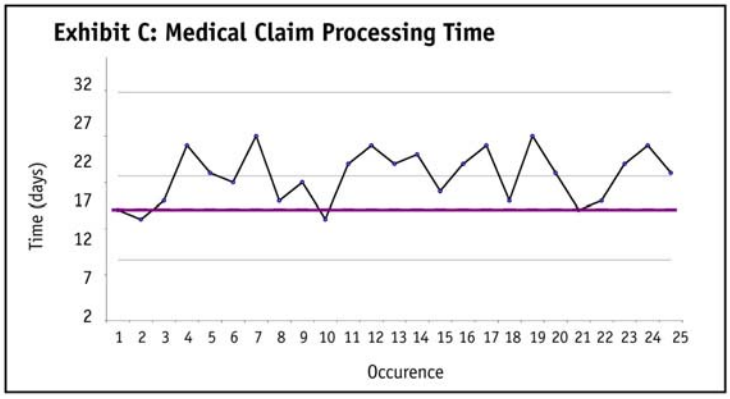
A critical element of the Six Sigma initiative is careful selection of projects based on their potential to improve performance metrics. Such projects follow a four step process:

- Selection of the appropriate measurements and collections of preliminary data;
- Analysis of preliminary data and identification of root causes of defects;
- Development of improvement recommendations; and
- Implementation of sustainable solutions.

The Six Sigma initiative is characterized by top management support, a focus on cost and waste reduction, understanding customers' expectations, and use of performance metrics that directly measure improvements in cost, quality, and yield. The program emphasizes the formal application of basic quality tools such as flow charts, cause and effect diagrams, run charts, and Pareto analysis. It also stresses training and participation for employees at all levels of the organization.

AN ENHANCED BSC

Exhibit C illustrates how SPC and Six Sigma can be integrated to enhance the BSC. Assume that an insurance company has adopted a BSC initiative and has identified the time it takes to process a medical claim as one of its key measurements to improve customer satisfaction. The company selects medical claim processing as one of its key processes to monitor in the Internal Business Process panel



of their scorecard. Based upon best practice data it sets a stretch target of 14 days for the processing of all medical claims.

Exhibit C replicates the data and control chart already discussed as Exhibit A with one addition. We have added a line that represents the goal of achieving a process average of 14 days to process a medical claim. The current average is 18 days (we round all data to the nearest day). Although this process is in statistical control it still shows a considerable amount of variation. Given the current design of the process we can expect the next claim submitted to be processed somewhere between 9 days and 27 days with the average over time being around 18 days. However, management, interested in improving the time it takes to process a medical claim, has set a target of 14 days.

The 14-day target represents a specification limit. Unfortunately the process for which the target has been established is not capable of achieving this specification. The current process average is only 18 days. Management's failure to use process behaviour charts to assess the current performance of this process has resulted in setting a target that is beyond the capability of the existing process. Periodic reports to management will show results that will at times be better than the 14-day target and at times worse.

Management will seek an explanation for the unfavourable variances and demand that action be taken. The process manager, in response to management's request, will do his or her best to explain why the targets are missed some periods and met for others. Blame will not be in short supply. Decisions about the "problem" will be made and actions taken in an effort to meet the target. Unfortunately, unless fundamental changes are made to the process, the actions taken could very likely make the variation and the results worse.

These problems are compounded when the BSC is used. The very nature of the BSC process is to put the focus of management on the real drivers of outcomes/results, a firm's processes. In effect good processes are the key to good results. Successful strategy implementation in a BSC initiative depends upon the current performance of a firm's processes. Process behaviour charts reveal this performance and can identify for management those processes that must be improved to achieve the firm's strategy.

If management had used a process behaviour chart in its efforts to analyze and improve its medical claims process, it could immediately have seen the futility of setting a 14-day goal for this process. The target line is clearly below the current long-term average for this process. More important, variation between some upper and lower control limit is inevitable. To expect that every claim be processed in 14 days is simply not realistic.

The target-setting problem is exacerbated when firms tie performance evaluation and reward systems to arbitrarily determined metrics. Process managers are now held accountable for targets that are clearly beyond the current performance of the process. This scenario invites the possibility of wrong decisions being made in an effort to achieve the target, which could further undermine the BSC process.

A better approach would be for management to use a process behaviour chart to analyze the current behaviour of the medical claim process. Their scorecard processes would have been enhanced in the following ways: (1) management would clearly see that their goal of 14 days was beyond the current performance of the process. In effect, it was

nothing more than an arbitrary target; (2) it would call attention to the fact that if the goal was to reduce the current average from 18 to 14 days, the proper course of action would be to engage in some process improvement initiative following the outline of the Six Sigma program discussed earlier to not only improve the process average but to also reduce the amount of variation in days to process a claim; (3) management would be able to analyze the variation from a process to determine if it is just a common variation or a special variation so that the appropriate course of action could be taken, thereby saving the organization valuable time, talent, and resources, and (4) the futility of blaming process managers for what is beyond their control would become clear.

In situations where management sets BSC goals and targets for processes that are not in statistical control – where special cause variation is present – the process isn't in statistical control, so it doesn't have a definable capability. Setting goals or targets for these processes is a waste of time since their performance isn't predictable. Again, process managers and employees attempting to achieve results for these out-of-control processes waste valuable time, talent, and resources. Without the use of process behaviour charts, management has no way to determine the current performance of its processes or whether processes are even in control. Blame, fear, frustration, a loss of confidence in the BSC initiative are just a few of the costs that can result from a failure to use process behaviour charts to support a BSC initiative.

Of course, there is nothing wrong with using measurements based on the current performance of stable processes to set improvement goals. Returning to our example in Exhibit C, management has set a BSC target of 14 days to process a claim. The only way to achieve this goal is through a process improvement initiative such as Six Sigma, which results in reducing variation and improving the process average. Setting this BSC target and monitoring the results of the improvement effort through the use of a process behaviour chart is a way to assess this BSC initiative.

The BSC process can be a powerful tool to align, communicate, and link a firm's strategy to its performance measurement system. However, the credibility of the BSC process can be undermined if firms try to use benchmarking or stretch targets to establish numerical targets for BSC processes. These arbitrary goals and targets invite fear, frustration, and distortion of the system or distortion of figures. Since one of the important benefits of the BSC is to link the firm's measurement system to its strategy, it's extremely important to determine the current performance of those key processes that are the performance drivers, the lead indicators of the BSC outcome measures. The only way to determine the behaviour and current performance of these key processes is through the use of process behaviour charts.

All of the numerical targets and goals for key BSC processes should be determined through the use of process behaviour charts. Such determinations not only prevent the problems associated with arbitrary goals and targets, but also give management important feedback about the behaviour and current performance of important processes essential for monitoring progress associated with the organization's strategy. Process charts and Six Sigma can significantly improve an organization's chance for implementing a successful BSC initiative.

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Can Your Board Really Cope with Risk?

By: PROFESSOR BILL WEINSTEIN, DR. KEITH BLACKER AND PROFESSOR ROGER MILLS

How good is your risk management? Professor Bill Weinstein, Dr. Keith Blacker and Professor Roger Mills – all of Henley Management College – describe the ever-growing pressures on boards to improve this function, and analyse how that can best be achieved.

Recently, spurred by the evidence that stock market movements can destroy value massively from the outside, while employees' (including directors') misbehaviour may do so from within, we set out to analyse whether or not company boards are equipped to cope with risk. This article summarises the conclusions and recommendations of that original paper.

Boards are undoubtedly desperately seeking protection against risk. They realise that they cannot escape blame – or at least, mistrust – even when the source of the value destruction lies elsewhere, such as the misinformation or misdeeds attributable to auditors, analysts, consultants, supporting banks. In the event of a scandal, the toxic effect can waft all the way to the boardroom.

In addition to shouldering blame, in the event of poor risk management and company failure the board is also responsible for the impact on a wide group of stakeholders – employees, suppliers, customers, bank lenders, pension rights holders, and investors.

The buck stops with the board – in particular the chairman, chief executive officer (CEO), chief finance officer (CFO) and – if there is one – the chief risk officer (CRO). Hence, ultimately, risk management failure impacts on the board's standing and on the value of the company.

PUNISH THE INCOMPETENT OR CORRUPT?

One popular proposal is that punishment should be visited upon the incompetent or corrupt. Those in favour claim that extending directors' liabilities and increasing the severity of punishment will provide the necessary deterrent and result in competent management of risk.

However, making boards effective at risk management requires setting their own risks and rewards appropriately. And among the familiar objections to the above remedy is that too many of the 'right' people would be deterred from accepting board directorships (especially non-executive ones, which would carry liabilities disproportionate to the holder's knowledge of, and involvement in, the company).

In any case, the above point is only part of a larger analysis and debate about how boards can cope with risk management challenges. Yesterday's 'reasonable expectations' of a board's competences are no longer today's or tomorrow's. Indeed, two key questions in this debate are:

- do boards need better or different types of people – i.e. the business equivalent of forensic doctors? And

- do boards need different processes and relationships, internal and out-reaching?

A BOARD HAS WIDE-RANGING RISK EXPERTISE...

Assuming a board composed – as it should be – of people with wide-ranging and diverse talents, its risk management expertise (itself a multiplicity of diverse skills), is as various as the types of risk impacts and risk-creating situations one can find. This variety of skills is underlined by distinguishing the phases of risk management such as:

- anticipation/identification;
- evaluation of scale, timing and probability or frequency;
- impact analysis; and
- mitigation in advance or after-the-event (including the highly specialised area of recovery from disaster or catastrophe).

Director A may be unusually versed in sensing major shifts in the external environment which point to strategic risks whilst Director B may have exceptional experience and insight into the fine details of operational risk, and so on.

...BUT SHARPER AND DEEPER QUESTIONS REMAIN

However, even such skills diversity is not sufficient protection for boards whose directors now face ever greater liability threats and more exacting accountability burdens. Hence boards are now enlisting external advisors to install risk management functions and information processes; seeking comfort through more mechanisms and hoping that risk must now, as a result, be under control.

But while there have been improvements, some sharper and deeper questions remain.

These questions relate to several areas of competence, or skill sets, and are as follows:

1. *Do sufficient board members have the ability to spot, and avert, a fellow member's unproductive or unhealthy ambition?*

In other words, can a critical mass of directors within the board spot the signs that the ambitions of a single director such as the CEO or CFO constitute a risk of excess or over-reach for the business? Can directors of sufficient number or weight grasp an evolving situation of dissension which could muddle priorities and thereby threaten the value of the business? This skill-set focuses strongly on individuals and small groups within a board and on their qualities both individually and interactively.

Skills required: tenacity and inquisitiveness.

2. *Is the risk-reporting process as effective as possible?*

The actual processes of risk management, such as identification and evaluation, are often delegated by the board to designated risk staff and/or internal audit. The board's responsibility is to set up and ensure the sustainability of quality in risk reporting and control systems. The board sets policies and guidelines whilst detailed monitoring of specifics is delegated downwards. The integration and comparison of various risk analyses is often vested in a senior executives' committee to whom a board has delegated the task, albeit with a board-level director in the chair.

Thus only certain issues are expected to reach the board. In a period such as the present one, when risk issues have hit headlines and wallets, boards will probably have more of them on the agenda.

But in reality the challenges are momentous today: how does a board know that the

information processing is working effectively? How does it know when to trust the interpretations submitted? How does a board come to know when vital information is being filtered out or distorted in interpretation? How does a board get to know, before too late or never, what it does not know?

Skills required: ability to create, develop and fine-tune an effective risk-reporting process, incorporating real-time reporting.

3. *Is the board fully conversant with all the organisation's key functions and activities as well as – in advance – all value impacting decisions? And are non-executive directors well informed about the business?*

In addition to skill set no. 2, a board must be conversant with the key functions and activities of the business, as well as decisions – marked in advance – of potential magnitude in their impact on value.

Delegation is too little. Boards must be able to grasp consequences, asking the right questions bearing on risk and return over more than one time horizon. For example, the impact of a decision on outsourcing must be subject to highly informed interrogation (like Railtrack, the business may not be able to outsource responsibility for the work associated with accidents, delivered by sub-contractors).

To be in such a position, a board must insist on information being presented not as a plethora of data, but in terms of what needs understanding and interpretation of gains and losses – and different combinations of them tied to different and disputable probability estimates. It must also demand to be informed of – and/or search out – changes in financial structuring, the handling of sales revenues and expenses, and much else that is behind profit and loss statements, balance sheets and cash flow analyses.

All this involves hard work and may mean more pressures, from the main board, for the CEO's committee, the executive committee of the board or its audit committee. It may require re-alignment between the board and these bodies.

These increased demands will also mean that non-executive directors (NEDs) will either need to know the business very well in order to interrogate proposals and processes with sharply probing intelligence, or be dispensed with altogether. What are now NEDs could be part of an advisory council or of several councils each covering perspectives on subjects such as industry structure, long-term economic and social trends, technology and science, and the like.

In short, the judgements of a board comprising people of wide-ranging skills are valuable, but of little weight unless that board can substantively engage in risk assessment and control to a very high level – the level commensurate with their responsibilities when things go wrong.

Skills required: tenacity, acumen and an inquisitorial approach.

4. *Has an active learning process been established to enable a board to understand better what the corporate radar-screen is telling it?*

To contribute to the development of a risk reporting process that effectively protects directors themselves against risks, as well as their company, an active and collective learning process would be required.

To sharpen their demands whilst containing the volume of information, boards must learn to sense, assess and otherwise manage risk.

Areas of their business, such as treasury, may have been relatively independent hitherto, with the board's awareness of key investment decisions limited to knowing of the impacts afterwards, from time to time. This generalised and loose acquaintance will not suffice. Ability to interpret expert knowledge is required, since without it boards are dependent upon people who may not share the same exacting approach to risk or may apply a narrowly technical view of risk.

The skill-set envisaged in this context is the ability to ascend a learning curve. It would probably be facilitated by boards engaging in simulations, scenario exercises, and the modelling of options in sensitivity analyses.

Skill required: the ability to follow a learning curve.

5. *Has maximally efficient delivery of the relevant information been arranged?*

Boards will decide for themselves how much information is to be presented, and in what form, but they should take a lead. For example, they must structure assessments so that attention can be drawn to the board's need to confirm or change its appetite for, or tolerance of, risk.

Again, information presented must highlight checkpoints to draw attention to deviations from previously set limits and targets. If directors do not receive appropriate information, they must ask why and ensure there is a corrective follow-up. Presentations need to be shaped to board requirements for risk assessment. The board determines what it wishes to be sensitive to: that must be backed by a simple reporting style that provides signals in a timely way.

Skills required: clarity, focus, leadership.

STRENGTHENING THE WEAKEST LINK

The focus in this article has been on a board's need for close and thorough attention to whatever subjects it must review to minimise risk. But that also entails a board establishing and supporting a system that prioritises information flows and accountabilities right through the organisation. A board is no better secured against risk than the weakest link in the organisation. Thus more sub-board time and energy has to be dedicated to risk analysis and reporting – according to formats and contents needed ultimately at board level.

Such an environment is more controlling – a tendency which has to be set against or with the grain of an organisation's internal environment, especially those that have emphasised a culture of trust, and/or free-wheeling creativity and experimentation. As well as being dangerous and ineradicable, risk is also necessary for the profitable growth of business and the stimulus of competition. Risk management is not intended to stifle risk taking.

Furthermore, a board cannot depend on ever-tighter risk management mechanisms in the belief that the reporting procedures ('box-ticking') will actually illuminate the key areas and causes of risk. Those areas lie with human fallibility, which can and does elude risk reporting and response mechanisms at crucial points.

Hence boards need – or must develop – a sixth sense of when situations or people may undermine their dependency or confidence in mechanisms.

TWO REQUIREMENTS AT BOARD LEVEL

Can today's boards cope better with risk than many did in the past? Doubtless they will be trying harder, given the impact of scandals, investor mistrust, the Basel II Accord, and national regulators such as the Financial Services Authority (FSA) in the UK and the Securities and Exchange Commission (SEC) in the US.

And professional bodies will impose more stringent standards upon auditors, investment institutions and analysts, and the accountants. For its part, this article has set out two types of requirement at board level, namely:

- a higher level of board 'grip', including greater comprehension of value-impacting decisions and practices. Boards must act as deliberate learning groups that are dedicated to more exacting, probing, aggressively inquisitorial and more informed means of aligning their deliberations and what is reported to them with the need to protect directors and their companies against risks – whilst risks are taken. 'Best practice' moves upwards; and
- a sustained commitment to the good of colleagues and the wider organisation, through the medium of a culture of a balanced psychological contract, which would diminish the risks of human deviation from risk management best practice. Whilst imposing and inculcating higher quality reporting and interrogation requirements and practices, directors and their managers would know how to avoid such undesirable side-effects as sullen counter-resistance against controls and the erosion of any existing informal culture of trust, on the one hand, and systematic bias against risk, innovation and creative initiative, on the other.

Not surprisingly, there emerges from this diagnosis a higher-order challenge to boards – i.e. how to balance the tensions between these different, at times conflicting, requirements.

Dissecting, debating, holding the balance between these two clusters of requirements will be a tough test for any board. Let's hope that more boards will be up to it, in the future.

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When Our Chip Comes In…

By: GAVIN REID AND JULIA SMITH

How do venture capitalists make informed decisions when appraising investments in high-tech firms whose inventions are still in the early stages of development? Gavin Reid and Julia Smith report on their CIMA-sponsored project to identify emerging practice in risk management.

Venture capitalists are becoming distinctly jittery about current proposals to force the consolidation of accounts of all firms within their portfolios. The new procedures will take effect in January, yet many experts believe that consolidation doesn't make much sense. The issue of how to evaluate and account for the risks inherent in early-stage high-tech firms is therefore of topical importance.

The government and the UK accounting bodies are interested in promoting high-tech investments. For example, the DTI issued a consultative document on equity gaps in small and medium-sized enterprises, promoting the case for venture capital funding at regional level to support new high-tech businesses. The accounting bodies are pressing for reforms in the treatment of intellectual property such as that found in high-tech firms which leads to patented products. They favour simplifying intellectual property taxation with a view to encouraging innovation. For quoted high-tech companies, they favour an improvement in risk management by directors to secure a low cost of capital and increase shareholder value.

From a financial reporting point of view, venture capitalists are interested in how firms value the intangible assets tied up in their intellectual property, as protected by patents, licences, trademarks etc. FRS10 recommends three ways to value an intangible: the amount it could be sold for; the difference between cost and fair value if it has been purchased; or by reference to any active market where frequent trading of such an asset occurs. In the US, intangibles are covered by FAS142, which has changed how goodwill is treated. In short, it means that investors now have to look much harder at a company's accounts to determine the long-term value of particular stocks.

In the case of high-tech firms that produce goods for untested markets, the valuation methods suggested by both these standards may prove unsuitable. So how are intangibles such as intellectual property valued when the inventions are new and untested? And what approach do investors use to evaluate potential investments in high-tech companies?

The dotcom meltdown of 2000 made UK venture capitalists wary of high-tech investment to the detriment of the country's science base. For instance, 3i recently confirmed a dramatic cutback in venture capital and private equity investments, and the pattern is similar throughout Europe. Although risk is likely to have been a major reason for this, incomplete alignment of incentives, financial structure and human capital, among other things, have all played a role. As well as these internal factors, there have been external problems including spill-over effects – for example, a lack of supporting infrastructure and a failure to supply venture capital, entrepreneurship and innovative products.

From the investor's point of view, a high-tech venture can seem unstructured, risky and hard to control. In its development form, it can seem too much like a research project. The problem of cost overruns on such projects is endemic and investors often feel that they are being asked to bear all the risk without any clear sign of the prospective rewards.

Such an involvement undoubtedly embodies a considerable business risk. This is caused by the complex, competitive environment in which the high-tech companies operate. In a sense, competing firms are racing to be first to gain an entitlement to the intellectual property embodied in a new technology. So-called action-reaction effects come into play here: firms will redouble their efforts if they are close to their rivals, but will quickly give up if they feel outstripped in the race. Reading how other firms will behave in these situations and crafting your strategy appropriately are key aspects of this form of competition.

Another important category of risk is agency risk. This generally arises from an incomplete alignment of incentives between economic agents. In the case of our research, the agents involved are the venture capital investor and the high-tech investee. The investors are risk specialists who know a little about technology and a lot about monitoring and control. They are willing to back their judgments with large injections of equity finance. Typically, the investees are risk-averse, immersed in technological developments and starved of cash. They would prefer a less risky life and more backing. They also need guidance on commercial imperatives.

In theory, a kind of contract should be struck in which the investee gives the investor access to potentially valuable intellectual property and the management skill to create it. In exchange, the investor bears some of the risk and provides an infusion of equity finance. In practice, it may be hard for the investor to evaluate the investee's claimed ability to produce valuable intellectual property. The mere fact that backing has been secured tends to reduce the investee's incentive to be creative in this respect unless their activity is tightly monitored.

Lastly, and most importantly, there are innovation risks. The final form of an innovation, the point at which it is proved and the market value it might have are all subject to uncertainty. The assigning of risk has to be subjective, but it needn't occur in a vacuum. For example, there may be technologies related to the innovation that can provide useful comparisons on matters such as development costs. Technology foresight specialists may use a range of methods – for instance, polling opinion among other technological experts in the field – to estimate the chances of success for the innovation.

But it's still perhaps too stringent to assign a numerical probability to an innovation. Instead, it may be satisfactory to think in terms of risk classes rather than point estimates of probability. Simple classifications of risk such as high, medium and low may be adequate, if not perfect, substitutes for statistical estimates of probability.

It has been suggested that British investors have tended to overlook the potential of new high-tech companies. These firms may not sit comfortably within their existing frames of reference for risk assessment. They therefore tend to be too cautious in their appraisals and set excessively high risk-adjusted internal rates of return (IRRs). It is not unusual to see hurdle IRRs of 45 per cent – and rates in excess of 90 per cent are not unknown. One interpretation of this evidence is that British investors invoke

different, and usually more stringent, investment criteria than their US counterparts tend to set.

Figure 1, below, illustrates the seven main determinants of total company risk. Of these, only goods markets and markets for factors of production lie logically within one of the risk classes we have discussed – namely, business risk. So in the high-tech context, where venture capital and innovation play a crucial part in the risk exposure of a company, a standard diagram such as this one omits a lot.

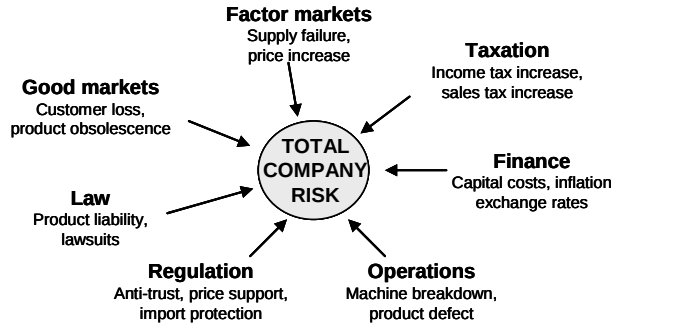
We allocate total risk into the categories of innovation, business and agency risk, and find that the main category that venture capitalists can attenuate is agency risk. They do this by requiring improved management accounting systems. But success in this area has been incomplete, and attention to both business and innovation risk has been severely limited. This lack of overall success in risk handling has been a major cause of failure to provide adequate levels of outside finance for high-tech ventures in the UK.

An important finding of our work is that the picture of total risk provided by Figure 1 does not suffice in the high-tech world. Innovation and agency risk must be added to it. Our investigation was fieldwork-based, focusing on the reality of modern methods of risk assessment. We held face-to-face interviews both with leading UK venture capitalists and with entrepreneurs whose firms had attracted venture capital and were bringing high-tech products to market.

We'd found in our previous work that increased risk created a demand from venture capitalists for more sophisticated management accounting systems within the innovating firm. Indeed, the provision of outside equity, possibly in staged form, typically hinged on the implementation of improved systems. The way in which the supply of new information evolved was analysed in 1997 by Falconer Mitchell, Gavin Reid and Nicholas Terry, who discovered that the variety and extent of the procedures adopted increased, as did the frequency of the provision of information. They found that this stimulated internal accounting changes for monitoring and control purposes within the investee firm, which in turn supported the use of such information for improved internal decision-making.

Our latest work has found that both investors and investees think of risk within the same framework. This can be conveniently encapsulated in our categories of business, innovation and agency risk. But they attach different levels of importance to these three categories. For instance, investors focus on agency risk, and are particularly worried about issues such as the delegation of responsibility, incentives for effort, risk-sharing and the use of information systems. On the other hand, investees downplay agency risk and emphasise business risk. This suggests that the relationship between the parties is positive, in that risk is being shifted from investee to investor. Responsibility is apportioned so that the investee

1. DETERMINANTS OF TOTAL COMPANY RISK



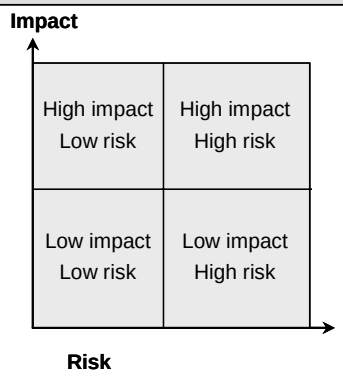
Source: A Carey and N Turnbull, 2000

focuses on making technological breakthroughs with a view to getting to market, while the investor focuses on the perceived novelty of a high-tech product in the marketplace and its potential to generate sales. The case study in the panel above shows one example of how an investee working in a high-tech area can manage risk.

Investors use a lot of textbook devices, such as IRR, payback and net present value, but they tend to neglect a range of more sophisticated approaches that could improve investment appraisals. But we have also found that scorecarding methods and a variety of tabular displays serve as adequate, and sometimes highly efficient, guides to risk appraisal. This is certainly true if they are compared with traditional approaches such as intuition and "playing a hunch".

In essence, most rational formalisations, even if they are very simple, do beat the intuitive approach in terms of decision-making quality. For example, an extremely simple framework such as that shown in Figure 2 can provide a good way of prioritising risk. It could be used as part of the background analysis for risk reporting of the sort recommended in the 1999 Turnbull report. On the horizontal axis is risk, which requires only that the broad categories of high and low risk are ascertainable, so only a qualitative assessment is required in this case. On the vertical axis is impact on the company of risk factors. Again, the framework requires only that high and low impact are distinguishable.

2. RISK AND IMPACT CATEGORIES



Source: A Carey and N Turnbull, 2000

This basic approach will often outperform playing a hunch simply because it requires the decision-maker to formalise a gut feeling by reference to attributes – impact and risk – that can be discussed in terms of evidence and judgment. Before introducing sophisticated risk management tools, it is important to ensure that the more prosaic methods have been fully explored and exploited.

Research suggests that the valuation of intellectual property could offer many benefits for those UK firms that make a long-term investment in resources, systems and people in creating information assets. But, although intellectual capital and knowledge management initiatives have gone some way towards popularising the need for better management of information assets, on a practical level they have found little real understanding in the UK, compared with the US, of the potential of information assets for creating wealth.

Our work has focused on a topical area of interest to practitioners and academics alike: venture capital investment in high-tech firms. The venture capital industry is worried that investors in private equity and venture capital funds won't be able to make an accurate assessment of the performance of their investments using consolidated accounts. We have found that such investors develop their own ways of evaluating and managing investments in high-tech companies. But the question of whether the financial reporting statements as they stand can give an adequate measure of these investments remains open, and it is the subject of ongoing research.

CASE STUDY MAKING LIGHT OF RISK ASSESSMENT

One firm in our study produced light-emitting polymers for flat-panel displays and lighting. When considering the risk/return trade-off for this technology, its director said that there was a point at which no return could compensate for the level of risk exposure. He said his firm was in he business of developing intellectual property and had not yet launched any new products. A discount rate was therefore not something that was considered relevant – indeed, risk classes were not used.

The company set a payback horizon of three years on new projects in order to please investors and ensure that money would be forthcoming in future, since "funding would get more difficult if you looked at four or five years", according to the director. The investors also determined a 30 per cent internal rate of return and the management team were incentivised with stock options.

There were points at which the development of a new product was deemed too risky or too complex to warrant pursuing any further. For example, the firm would always want to ensure that it had absolute rights to the intellectual property before moving into a new niche market. It would perform sensitivity analyses on professional fees – eg, for patents – and on local markets. Aspects of employment law were an important consideration in California, for instance, whereas cultural differences were an issue in Japan. These variables were allowed to range widely in the sensitivity analysis, because the firm was "taking big bets".

Break-even was a fairly important reference point for the company, as "it signifies that you've got out of the loss-making development side and can look forward to profitability", according to the director.

Although the company attempted some sort of revenue prediction, this was not enough on its own to allow it to decide whether or not to proceed with a new project. Further qualitative analyses were therefore performed on the management team (agency risk), the extent of intellectual property backing (technology risk), how well established the market was and the level of competition the company was facing (both business risk). Any project considered to have a below-average probability of success was not pursued.

Financial modelling was used with the main aim of predicting cash flows and determining funding needs. It was also used to try to forecast resourcing requirements in terms of both machinery and staffing levels. The company needed a large number of scientists, but it tends to be hard to hire these people at short notice, so it was important for the firm to plan for their recruitment up to six months in advance.

Although the company chose not to use any form of scorecarding in evaluating options, it did use scenario analyses to help it plan, which required both quantitative and qualitative information. The latter included feedback from a local university, which was happy to comment on ideas proposed by the company.

Further reading

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F Mitchell, G Reid and N Terry, "Venture capital supply and accounting information system development", *Entrepreneurship Theory and Practice*, Summer, 1997.

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Forum: Public-Private Partnerships

PPPs: Nature, Development and Unanswered Questions

By: JANE BROADBENT AND RICHARD LAUGHLIN

Public-private partnerships (PPPs) are the newest and latest "new public management" development for the public services. PPPs are becoming a worldwide development, although the origins can be traced to the United Kingdom's private finance initiative (PFI), which remains the most advanced and developed form of PPP. This paper explores the development of PPPs, concentrating first on the PFI and then tracing the increasing presence of PPPs in Europe, the Americas and Australasia.

For many governments throughout the world, public-private partnerships (PPPs) are rapidly becoming the preferred way to provide public services. PPPs can be seen as the latest form of what Hood (1991, 1995) has described as "new public management" (NPM). Hood explained that NPM involves a shift away from older forms of public administrative management practices to those drawn from the private sector. He traces these developments to the late1970s, although it was in the 1980s that NPM gained considerable momentum. While NPM continues to dominate public management, many are arguing that the "new" is rapidly becoming "old". PPPs, however, bring a new impetus to NPM. They are led this time not by New Zealand, as was the case with earlier forms of NPM, but by the UK. They are developments that are part of NPM but they take it into novel realms. This paper provides an introduction to the nature and international development of PPPs, and seeks to clarify a range of related research questions.

PPPs are long term relationships involving the private sector in the provision of public services that in many cases had previously been entirely the responsibility of the public sector. Public services such as health, education, water, transport etc. are important to the survival of most societies; non-delivery of these services can bring serious social welfare problems. These complex services are often unattractive to the private sector because

of their considerable infrastructure demands. As a result, many governments have deemed certain public services unsuitable for private sector involvement as sole or part provider. PPPs challenge these assumptions. Their proponents actively encourage private sector involvement and argue that partnerships enhance, rather than diminish, social welfare outcomes. PPPs can also be made attractive financially to encourage private sector involvement.

A movement to privatisation of public services has been a policy priority in a number of countries. In the United States the public sector has always been small or "hollowed out" (Rhodes 1994) and most public services are provided by private companies. However, given the importance of these services, the US (as is the case in other countries where the public sector is small) has been reluctant to surrender all control over their provision. This has resulted in the creation of an extensive regulatory framework to ensure that the services provided are in the public interest and satisfy social welfare concerns. However, as Baker (2003) indicates, if this regulatory framework falters, as it did in the US in connection with electricity supply, disasters such as the Enron collapse are inevitable. Nonetheless, the privatisation ideology of the US influenced the thinking of many governments from the late 1970s to the early 1990s. Countries such as the UK, Australia and New Zealand, where there were large public sectors, pursued deliberate policies to privatise large parts of publicly owned service units. While the UK and Australian privatisation programs were far from an unqualified success, New Zealand fared even worse. Newberry and Pallot (2003) suggest that New Zealand's reluctance to move into PPPs may be because of the potential association with this privatisation policy. Fortunately, most countries actively pursuing a privatisation policy have escaped mishaps of the scale of Enron. Nevertheless, the criticisms that accompanied the extensive power blackouts in Auckland, New Zealand, and the scares accompanying the discovery of cryptosporidium in the Sydney water supply in 1999 demonstrate the potential for controversy.

IT WAS NOT NECESSARILY A FEAR OF FAILURE THAT ENDED THE EXTENSIVE PRIVATISATION POLICY BUT, RATHER, THE FACT THAT THERE WAS LITTLE LEFT TO SELL.

However, it was not necessarily a fear of failure that ended the extensive privatisation policy but, rather, the fact that there was little left to sell or, perhaps more accurately, little else that it was politically possible to sell without alienating public opinion. It was at this point that PPPs started to emerge. These were faithful to the fundamental belief in the importance of involving the private sector in the provision of public services, but in such a way that avoided changing the ownership arrangements. For example, with PPPs, overall control of health and education could remain with the public sector but the private sector could be involved in some aspects of the supply of such sensitive services. This strategy was intended to avoid any negative public perception that PPPs were the same as the earlier privatisations.

The PPPs that emerged, first in the UK and then elsewhere, have taken at least four different forms, each involving public service provision and centered on a building or other type of infrastructure. A project could entail the provision of an entire service – for example, private health care and the

supporting services such as portering, cleaning, etc – or the ancillary services alone. The precursor to PPP is "outsourcing"[1] certain parts of the public service provision to the private sector. Compared with outsourcing, the four types of direct PPP are more complex. A BOT (BuildOperate[2]Transfer) scheme involves the private sector building a facility, operating it over the period of the contract and transferring the property element to the public sector at the completion of the contract. Ownership during the period of the contract is less certain in this case, although there is a general assumption that it remains with the private sector. A BOO (Build Own Operate) scheme is similar to a BOT scheme, except that the building is not transferred to the public sector at the end of the contract period; the private sector ownership of the facility is clear. A BOOT (Build Own Operate Transfer) scheme is a BOO scheme but with transfer of ownership at the end of the contract, making the ownership rights at different points in the contract clear. A DBFO (Design Build Finance Operate) scheme is amore complex form of PPP. It involves the public sector providing to the private sector an explicit output specification.[3] From this specification the private sector supplier designs a facility which it builds, using its own finance and operating it for the contract period. Ownership of the property element during the contract and after it has been completed is unclear. DBFO contracts, involving only partial provision of services – leaving frontline services such as healthcare or education entirely with the public sector – have been predominant in the UK. DBFOs are highly problematic on many fronts, not least on who owns the asset (Broadbent and Laughlin 2002, Rutherford 2003).

In all cases the public sector makes monthly or other periodic payments for the services throughout the contract period. These payments are similar to lease payments, with the feature that because of the length of the contract, amounts may be renegotiated at intervals. The effect is that the initial capital cost is borne by the private sector and reimbursed through the periodic payments by the public sector.

PPP DEVELOPMENTS IN THE UK

The term public-private partnership to describe UK developments was introduced in 1997 following the election of the Labour government. Previously, arrangements of this kind fell within what was called the Private Finance Initiative (PFI). The PFI remains not only the most common dominant descriptor but also the most extensive and advanced form of PPP.

The PFI was introduced by the Conservative government in 1992 in response to a shortage of resources for infrastructure investment, which had led first to an extensive privatisation program that by the early 1990s was running out of new possibilities. The PFI typically utilises a DBFO scheme which can entail either total provision of public services (eg, roads, bridges, tunnels) or a partial set of services (eg, the building and related facilities management support for the public provision of medical care). It involves extensive and complex contracts between the public and private sectors which typically cover a period of 30 years but can be up to 60 years. From1997, the Labour government took the PFI forward with considerable enthusiasm, localising it in the context of the "Third Way" (Giddens 1998), an ideology that seeks to combine the best of public and private provision rather than regarding the two as mutually exclusive. As a result, PFI developed in areas where the Conservative government had not been successful. Before 1997, completed PFI projects were largely infrastructure ones related to transport systems – most notably the Channel Tunnel linking the UK with continental Europe. Since 1997 the

Labour government has expanded the PFI into the more social and sensitive areas such as health and education.

The step change in PFI development over the years has been driven, we believe, by increasing familiarity with the practicalities involved and more especially an increasing political commitment to the initiative. In 1995, the nine PFI projects that reached financial close were worth a total of £667 million.[4] In 2002 there were 65 signed deals worth £7.6 billion. By April 2003 there had been 451 projects completed, providing more than 600 new public facilities. In all, 563 PFI projects had reached financial close, with a capital value of £35.6 billion, more than 80% of this since 1997.These projects are in all areas of central and local government. Although the PFI is a major priority for the Labour government, it still constitutes only a part of all capital investment. Thanks to some sizable capital transfers coming from the Comprehensive Spending Reviews (CSRs), the PFI will constitute 11% of all capital expenditure in 2003/04. In previous years it has been virtually the only source of capital investment. While the CSRs have considerably improved the possibility in some areas for capital developments, it remains true that in others it is PFI or nothing.

The PFI in the UK is characterised by the strong central control exercised over its development. In the early days of the PFI, the Conservative government passed over its direction to a Private Finance Panel (PFP) run by businessmen who were at a distance from the government. When the Labour government came to power it instituted a review of the PFI. As a result the PFP was replaced by a new body within the treasury, the heart of government. Following the change the adoption of the PFI increased in magnitude as well as in its spread across government departments. It is interesting that in 1999 the development of the PFI was handed over to a quasigovernment agency, the Office for Government Commerce (OGC), and that the period that followed was the least productive since the Labour Party tookover.[5] In April 2003 the development of the PFI was returned to the treasury and already it is apparent that there is an increase in both policy statements (HM Treasury 2003) and signed deals. The UK lesson seems to be that central control, often at the heart of government, is essential if PPPs/PFI are to be implemented widely.

Another key element of the UK situation is standardisation. Some early PFI deals involved considerable once off legal and accounting expenses as well as long delays between start and completion. There has since been a consistent attempt to standardise PFI processes, from contracts to decision criteria. There is now an organisation of advisers/partners with quasigovernment connections called Partnerships UK who are available to work with those wanting to undertake a PFI project. Staff from Partnerships UK help to interpret and use standard national guidelines in the hope of easing the complexity of the decision processes.

Central control and standardisation seem to be behind the extensive implementation of the PFI in the UK. It has also been necessary to develop a clear accounting focus, and here many problems have arisen. Around the PFI is uncertainty about whether it is a macro fiscal device to avoid being counted as national borrowing or whether it has clear micro value for money benefits despite the effect it has on the macro finances. This dilemma is reflected in concerns related to both the financial accounting and the balance sheet treatment of the PFI and the management accounting value for money judgment. In the late 1990s the balance sheet treatment, and hence financial accounting, was a dominant concern causing

tension between the treasury and the Accounting Standards Board (Broadbent and Laughlin 2002). From the late 1990s, however, the debates have shifted to the management accounting value for money treatment and the use of the "public sector comparator", which is being refined and redefined (HM Treasury 2003) after a recent devastating critique by the National Audit Office.[6]

PPP DEVELOPMENTS IN OTHER PARTS OF THE WORLD

Europe

Diverse opinions about the appropriateness of PPPs, and varying levels of political commitment to the concept, have led to uneven development across the world. Other European countries, while not as active as the UK, are seen as being very committed to PPPs:

- Portugal was an early advocate of PPPs, starting with roads and major infrastructure, and is now involved in PFI type hospitals with all clinical and support services being part of the PPP contract.
- The Netherlands created a PPP Knowledge Centre in 1999. Developments such as the high speed train link (HSL Zuid) and more recently a waste water project have been completed, but participation has slowed since a change to a less sympathetic government.
- Ireland has been a PPP advocate for some time, with a number of projects such as the National Maritime Museum in Cork, roads and schools being completed. Recently the government formed the National Development Finance Agency to take forward the development of PPPs.
- Italy, after a slow start and a concentration on transport infrastructure, is now moving into social areas such as schools. Increasing interest follows legislative support (the 1998 Merloni Law enabled and eased private sector involvement) and the election in 2001 of a PPP supportive government under Silvio Berlusconi.
- Finland is increasingly using PPPs, initially inroad projects and recently in schools and is, as Turner (2003) reports, exploring PPP possibilities in health and defence.
- Germany is showing similar interest. Activity has been in roads, tunnels and airports and the government has expressed willingness to expand into social services such as schools.
- Greece, as Turner (2001) points out, has used PPPs in developing infrastructure in connection with the 2004 Olympic Games.
- Spain is using PPPs to develop its infrastructure.
- France, on the other hand, with its very different economic structure, has shown little interest in using PPPs to develop public services.
- Central Europe, the Baltic states and southeast Europe exhibit growing interest and some activity, mainly on major infrastructure PPPs. Richard Kenton of the International Project Finance Association (IPFA), who has been active in advising European countries on the possibilities for PPPs, sees most interest in Poland, the Czech Republic and Hungary and considerable potential in Estonia, Bulgaria and Romania.

The key factor driving the adoption of PPPs in Europe seems to be political will. Where it is present, in countries such as Ireland, Portugal and Italy, implementation in infrastructure and increasingly in social areas has been considerable. Where it is absent, as in France, then PPPs are unsurprisingly not possible. Richard Kenton of IPFA is sure that this is the

key to development and is not convinced that European governments, even the more enthusiastic, are quite in the same position as the UK to take a positive central lead on the development of PPPs. He suggests: "In order to properly progress the role of private finance in Europe, countries must ensure that political will prevails; all too often IPFA is asked to develop European markets in countries that have not yet decided if they are comfortable with the concept of private finance. European governments are generally far more decentralised than the UK with the decision making process therefore being made more complex" (Kenton 2002, p. 23).

The rest of the world

In North and South America interest in PPPs has been variable. It has been muted in the US, more extensive in Brazil and Mexico and more extensive again in Canada, particularly in British Columbia. The US has not been ideologically committed to an extensive public sector, relying more on the perceived benefits of "the market". However, some interest has been expressed in exploring PPPs in areas such as space and defence, to share the heavy upfront costs involved in these areas. Brazil and Mexico, with extensive infrastructure needs, are looking to PPPs to possibly solve these problems. Canada has engaged the private sector for some time on major transport projects but British Columbia has wanted to extend PPPs into other areas of public service provision. It has set up Partnerships BC to guide this development. Other provinces, notably Ontario and Quebec, are looking to develop similar bodies.

In Africa, South Africa has been at the forefront and has established an administrative structure and legislation to pursue PPPs. A number of projects have been proposed, although few are yet under way.

PPP developments have also been occurring in the Pacific Basin, with considerable activity in Australia and Japan. New Zealand, although an early leader in NPM, has been tentative about PPP developments. It is also interesting to note the leading role of the Australian state of Victoria, not only in previous NPM developments but also in PPPs. The recently formed Partnerships Victoria is very active and the volume and sophistication of the PPPs that have followed mark this state as the leading force in PPP developments in Australia. New South Wales and Queensland, however, are watching Victoria closely and are moving forward on developing PPPs. In Japan progress has been slow but the Koizumi government, which came to power in 2001, is now giving PPPs priority. The administrative apparatus is in place to support the developments that are likely to occur in the near future.

To return to New Zealand, Newberry and Pallot (2003) indicate that this country is a special case. Legislation is in place to enable and even favour PPPs but this has had to be done surreptitiously because of political antagonisms resulting from the privatisation problems of the 1980s. However, an increasingly more conducive political climate seems to be emerging.

In summary, PPPs are clearly a worldwide development even though the nature of the development is far from uniform. The policy links and exchanges across Europe and commonwealth countries are notable. Much of the early adoption of PPPs is by countries with these existing links, possibly due to the ease with which ideas can be transported between these nation states. Nevertheless, as with NPM, the commonality of terminology should not hide the diversity of practice. Europe illustrates this lack of uniformity: where there is a political will to pursue this development, possibly through central control (see Laughlin

and Pallot 1998) then developments are apparent; but where these conditions are not in place little adoption occurs. The UK is clearly the leader in PPP development because it has both the political will and the political possibility, with its highly centralised government system, to generate and sustain change. Australia, with its more complex federal system, is not in this position. However, if political attitudes are changing in New Zealand, then PPPs could develop there more rapidly than in other countries because New Zealand, with a centralised political system similar to that of the UK, could institute change reasonably quickly.

UNANSWERED RESEARCH QUESTIONS

Broadbent and Laughlin (1999), when exploring the UK's PFI, came to a conclusion that there were many unanswered research questions. Some of these remain unresolved, providing an "agenda for the future". Five research questions come to mind.

(i) What is the underlying nature of and rationale for deciding to pursue PPP developments in different countries?

The political processes behind the definition of PPPs, as well as the rationale for pursuing them in various countries, are diverse and not well understood. Can PPPs only develop if there is a political will and the opportunity for central government control? What political processes are necessary to ensure that PPP is a viable alternative? What government and quasigovernment bodies need to be in place to ensure that the political will becomes a practical reality? Are PPPs really a macro fiscal device or are they pursued because they generate value for money? Questions such as these need to be explored to determine which developments are unique to a particular country and how they may be transported/exported from one country to another.

(ii) What processes and procedures guide and aid the decisions to undertake PPPs in different areas of public service provision in different countries?

An increasing body of guidance is being developed in the UK and Australia on how to make value for money judgments about whether to pursue a PPP. In the UK this is central government advice, which is then interpreted and refined as it is applied to particular decisions in central and local government departments. Pursuing a PFI in, for example, health, education, prisons or transport produces nuances in interpretations of national guidance, leading to differences in implementation. Australia, with its federal and state systems, seems to have decision processes which vary across state borders. Numerous other countries are embarking on PPPs and we need to know how their processes compare.

In the UK and Australia, the public sector comparator (PSC) seems to be central to decisions on whether to pursue a PPP. Is this so in all countries and how is it applied in different jurisdictions? The answers to questions such as this will help refine the decision processes and ensure the adoption of schemes that are best value for money.

(iii) What procedures and processes are in place to provide a post project (decision) evaluation (PPE) indifferent areas and in different countries?

Considerable effort has been expended in the UK in formulating pre-decision criteria for considering a PFI but little progress has been made in deciding how to evaluate the project once it is on its (up to 60 year) contractual

journey. This is important; having exhaustively explored whether to pursue a PPP, it seems almost irresponsible to fail to analyse whether predicted outcomes actually occur. Broadbent, Gill and Laughlin (2003), in looking at the PFI with specific reference to health projects, indicate that there are disturbing conceptual and practical gaps in the system design. The UK National Audit Office is taking an increasing part in this design and its operation, given its unique audit and evaluation role over government departments and their activities.

A number of questions arise. What are the intentions for PPEs that are in place in particular areas and particular countries? Is it possible to design a generic national or international PPE system which has the support of national governments and auditors general? What role do audit offices and auditors general see for themselves in the design and operation of these PPE systems?

(iv) Do PPPs have real merit and worth, generally and in specific cases, nationally and internationally?

While PPE systems will provide important insights into how successful PPPs have been, relative to pre-decision expectations, this does not answer categorically whether the specific PPPs have real "merit and worth". There is a need for further discussion about whether the PPPs are of value for delivering public services. It may well be that these wider welfare issues will be answered through the pre-decision and post-decision processes. However, making this merit and worth judgment a separate activity provides an opportunity to introduce wider social welfare considerations.

(v) What can we discover through an international comparison from national PPP regulation and guidance, pre-decision processes, post-project evaluation systems and merit and worth judgments?

While each of the above research questions involves international comparisons in specific areas of concern, there remains a more general need to explore what can be learned through a comparison across all areas. This would contribute to the debate about the general applicability of PPPs and how they can contribute to the welfare of nations, individually and collectively.

CONCLUSION

Researchers have a responsibility to understand this rapidly expanding policy development and, through analysis, assist with its development and evaluation. PPPs are the latest "new" development of "new public management". It could be easy to dismiss the development using what the Institute of Public Policy Research (IPPR 2001) describes as the "public good and private bad" argument. Our own view is that, as with other forms of NPM, there is a need for a "level playing field" approach and an acknowledgement that the jury is still out on PPPs. There is already a belief, certainly in political circles, that the existence of PPPs and the political support for them is proof enough of their value. We, like the IPPR, believe that such claims are simplistic, as are those that reject PPPs out of hand. The research questions above adopt the evenhanded view that we do not yet know enough about PPPs to draw definitive conclusions.

NOTES

1 However, outsourcing, as English and Guthrie (2003) indicate, is deliberately excluded from the PPP category in Australia. No such restriction appears to apply in other countries.

2 The "Operate" element in BOTs, BOOs, etc. could involve the provision of entire public services or the supply of support, rather than full professional, services.

3 While this is the only PPP mode that explicitly talks about the "design" issue, in BOO, BOT and BOOT alternatives there is an implicit expectation that the private sector partner will have control over design, working from an output and outcome specification supplied by the public sector.

4 All statistics in this paragraph are taken from HM Treasury (2003).

5 The OGC is a body created to save money for the UK government by more efficient and effective procuring of necessary services. PFI was only one of a range of procurement possibilities that the OGC put forward and may not have been seen as a priority. Certainly the amount of central leadership over PFI declined during the time PFI was the responsibility of the OGC.

6 The PFI Report in July 2002 (Issue 65, p. 36) quoted Jeremy Colman, the deputy auditor general responsible for PFI, as describing the public sector comparator, theoretically and in its application, as in some cases "pseudoscientific mumbo jumbo".

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Ensuring the Transfer Price Is Right

By: SIMON TEMPLAR

Setting an appropriate price in the internal supply chain is vital for an organisation's optimal operation. Simon Templar explains some of the issues involved.

"A fist fight determined the intra-company transfer price policy that is in effect today in a major oil company. The issue was the price at which gasoline would be transferred from the company's refinery to its marketing division."

The above fascinating and somewhat bizarre revelation (Dean, J, Harvard Business Review 1955), highlights the important relationship between the transfer pricing policy of an organisation and its internal supply chain management operation. Fisticuffs aside, setting an inappropriate transfer price between internal buyer and supplier can have serious implications.

When procuring internal products or services – whether an intermediate product in a manufacturing process, a training course from the human resources department or computer equipment from the IT division – the following issues need to be considered:

- what the appropriate price to pay for the internal product or service is;
- whether to procure the product or service internally or externally; and
- how to reduce the risk of potential conflict between internal buyers and suppliers.

Informed by my own ongoing doctoral research into transfer pricing and supply chain management, this article aims to explore the significant relationship between transfer pricing and the organisation's internal supply chain. (International transfer pricing and taxation is not covered here.)

WHAT IS A SUPPLY CHAIN?

Until something goes wrong the majority of people will be oblivious to the workings of the many thousands of different supply chains that ensure their day-to-day existence. Products that are moved down these supply chains include:

- petrol at the garage forecourt;
- bread at the supermarket;
- electricity at the flick of a switch; and
- health care at an 'accident and emergency' department.

The concept of the supply chain is, of course, an ancient one. It was defined in 1997, by a Department of Trade and Industry Supply Chain Network Group as: "the strategic management process, unifying the systematic planning and control of all technologies, materials and services, from identification of need by the ultimate customer.

"It encompasses planning, designing, purchasing, production, inventory control, storage handling, distribution, logistics and quality. The objectives are to optimise performance in meeting customer service requirements, minimising cost, whilst optimising the use of all resources throughout the entire supply chain."

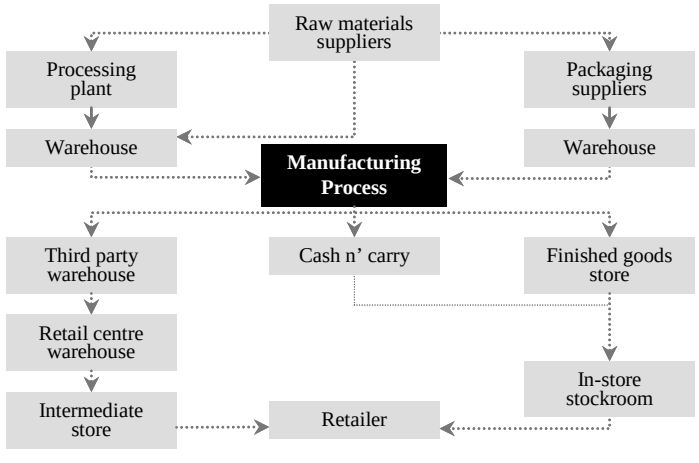
This definition highlights three important points:

- supply chain activities are derived to meet customer demand for a specific product or service;
- a supply chain is composed of a number of inter-dependent activities; and
- there is a trade-off between maximising customer service, asset utilisation and minimising the overall cost of the supply chain.

The Supply Chain Council (www.supply-chain.org) highlights five fundamental activities which underpin every supply chain operation: plan, source, make, deliver and return.

Figure 1 illustrates the important nodes and linkages of a typical food and drink supply chain starting from the raw material suppliers and ending with the delivery of the finished product to the retail outlet. These infrastructure nodes and linkages represent a considerable amount of investment in terms of both human and financial (fixed and current assets) resources. An organisation's supply chain can be wholly owned by a single business (ie vertically integrated) or a combination of different business entities that specialise in providing specific activities that make up the chain (eg raw material suppliers, manufacturers and logistic providers).

Figure 1 Food and drink supply chain



Source: DTI (1995)

The fascinating thing about supply chains is defining their scope. In the dairy industry, the supply chain could start with milk from the dairy farms, which is accumulated and stored before being collected by a tanker, transported to a dairy to be processed and then packaged. Or it could start with the sourcing of the cattle feed. And the journey to the end consumer will differ according to the distribution channel – whether via a supermarket chill cabinet or by doorstep delivery.

There are a number of different relationships which need to be considered and managed within a supply chain. According to Harland (1996) supply chain management can be classified into four discrete levels:

- the internal supply chain that integrates business functions involved in the flow of materials and information from inbound to outbound ends of the business;
- the management of dyadic or two party relationships with immediate suppliers;
- the management of a chain of businesses including a supplier, a supplier's suppliers, a customer and a customer's customer and so on; and
- the management of a network of interconnected businesses involved in the ultimate provision of product and service packages required by end customers.

Importantly, this classification recognises the internal supply chain transaction and thus the requirement for some form of accounting mechanism to record the exchange between the internal

supplier and customer and so place a value on the exchange.

TRANSFER PRICING AND THE MANAGEMENT OF THE INTERNAL SUPPLY CHAIN

According to Drury (2000), "the established transfer price is a cost to the receiving division and revenue to the supplying division, which means that whatever transfer price is set, will affect the profitability of each division. In addition, this transfer price will also significantly influence each division's input and output decisions, and thus total company profits."

This transfer price can be determined in a number of different ways, as illustrated in the box, below. A 1993 survey by Drury et al into management accounting practices used in UK manufacturing organisations found that, overall, negotiated transfer prices were the preferred method with 59% of respondents confirming that they had used this method.

However, whatever method used, the key factor in determining the transfer price will be the financial information and assumptions used in the calculation.

Transfer pricing methods

Pricing method	*Calculation method*
Market-based	List price of a similar product
Marginal cost	Using variable costs
Full cost	An approximation of full cost
Cost-plus	An approximation of full cost plus a mark-up
Negotiated	Negotiated between the seller and buyer

FINANCIAL INFORMATION AND SUPPLY CHAIN MANAGEMENT

Research studies – Pohlen and La Londe (1994); La Londe and Pohlen (1996); Christopher (1998) and Cooper and Slagmulder (1998) – identified that managers accountable for the management of supply chain operations lacked the appropriate tools to provide them with relevant supply chain costing information. Hence supply chain managers now increasingly demand that finance provide appropriate information enabling them to manage effectively the upstream and downstream relationships with their suppliers and customers. According to Christopher (1994) the provision of timely, relevant and accurate cost information enables managers to make better-informed operating decisions and deliver increased customer value by driving down costs throughout the whole supply chain.

Porter (1985) argued that understanding the relationships between activities and their costs will generate a considerable competitive advantage to the organisation that can get it right.

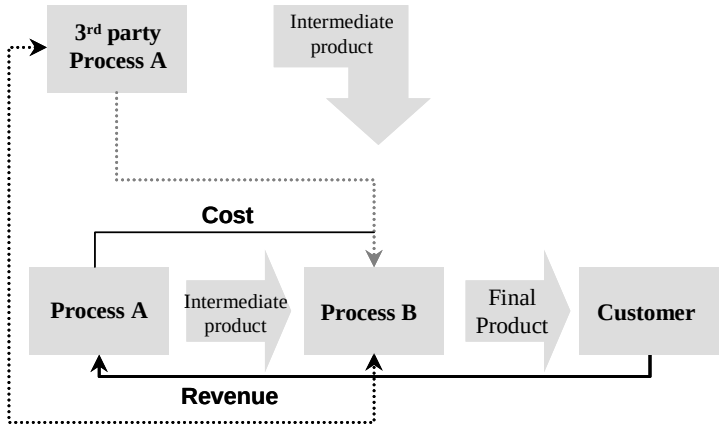
Traditional cost accounting approaches have obscured the visibility of different process costs in products and services. These approaches according to Christopher (1998) employed arbitrary apportionments and absorption rates based on volume to distribute indirect costs (overheads, common costs, shared costs etc), so reducing the visibility of process/activity costs.

The result is an apportionment of indirect costs to cost centres which may bear no relation to a given cost centre's actual consumption of these indirect costs.

Supply chain costs are often amalgamated in a variety of functional cost centres such as procurement, finance, marketing and manufacturing, making it difficult to calculate the total cost of the supply chain operation. Yet research by Develin (1999) discovered that overhead costs now account for 37% of total cost in manufacturing

organisations and 66% in service organisations. Thus the method used to distribute indirect costs to internal products and services will have a considerable impact on the calculation of the internal transfer price and therefore considerable implications for the sourcing decision.

Figure 2 The impact of transfer pricing on supply chain management



THE IMPACT OF TRANSFER PRICING ON SUPPLY CHAIN MANAGEMENT

The transfer price charged for an internal product or service can have a direct impact on the sourcing decisions in terms of whether to manufacture a component in-house or buy it in from an external source as illustrated in Figure 2.

The manager of Process B has two alternative sources for the intermediate product – either source internally from Process A, or procure the same product from an external supplier. The transfer price and the organisation's performance management targets will have a direct impact on the manager's sourcing decision.

How to improve your transfer pricing policy

- Managers need to be aware that the transfer price is revenue for the internal supplier and a cost to internal customers.
- Managers need to know which method has been used to calculate the transfer price.
- When comparing make or buy decisions managers need to have visibility of the costs that make up the transfer price so they can compare like with like.
- Traditional methods of apportioning and absorbing indirect costs will reduce the visibility of process costs in products and services.
- Internal customers need to be aware of the implications to the organisation as a whole if they decide to source externally instead of internally.
- Imposed transfer prices can sometimes (but not always) lead to dysfunctional behaviours within an organisation; negotiated transfer prices can reduce the risk of conflict.

TRANSFER PRICING AND PERFORMANCE MEASUREMENT

Cook (1955) highlighted the issue of transfer pricing in terms of performance measurement and goal congruence. Failure to establish individual business unit goals which dovetail with the organisation's goals can result in the business units following 'beggar my neighbour' policies, resulting in a sub-optimal overall performance for the organisation: "a company, in decentralising, expects to increase its profitability by giving direct profit incentives and evaluations to more people in management; if this is to be successful, the company must ensure that one profit centre is not led to increase its profits by reducing the profit of the company as a whole."

If the transfer price is set too high and a cheaper substitute product exists externally, then an

internal buyer would prefer to source the product from outside the organisation; this would be detrimental to the internal supplier. Conversely if the internal supplier can get a higher price for its product externally should it supply the internal customer? If the internal buyer or supplier is prevented from sourcing or supplying externally, then a potential conflict situation could arise.

Typical conflicts between the centre and the divisions will be linked to the imposition of mandatory transfer prices, restricting the sourcing option to internal suppliers or imposing divisional return on investment targets so reducing divisional autonomy. Dysfunctional behaviours associated with intra divisional conflicts can include reluctance to share information, lack of trust and 'beggar my neighbour' policies, which can have a negative impact on motivation, moral and organisational profitability.

For details of the references in this article, see www.icaew.co.uk/fmfac

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