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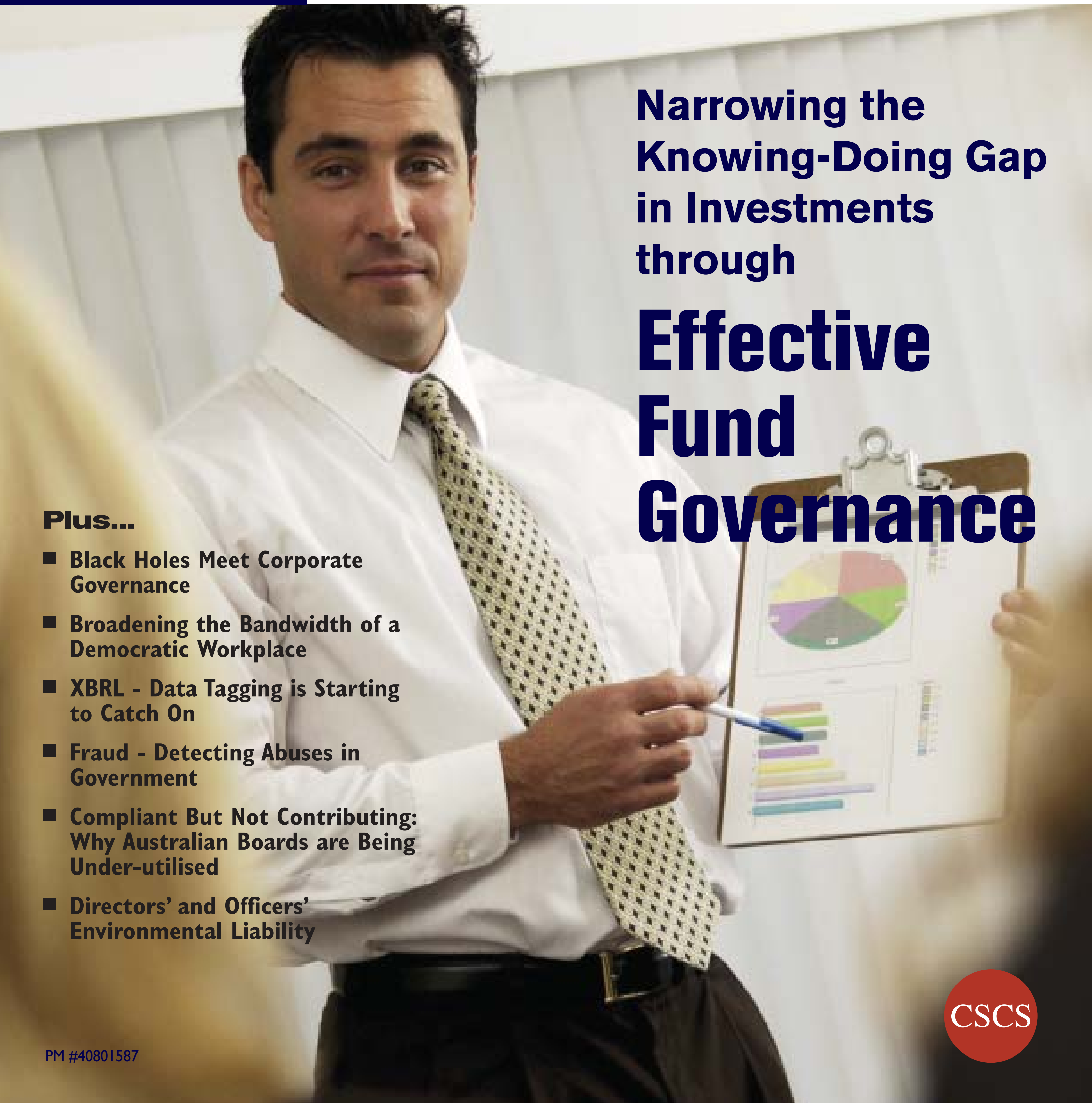

Narrowing the Knowing-Doing Gap in Investments through Effective Fund Governance

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Black Holes
Meet Corporate Governance

By: Ron Lutka, CMA, ACIS, P.ADM., CorpS

Black holes in organizations are not new. Corporate governance is not new. Remarkably, the two have never formally met. A black hole in an organization can be defined as:

> An area of an organization where there is, unbeknownst to management, an abundance of undesirable activities or a lack of desirable activities, both of which destroy organizations.

A black hole includes three basic components:

1. ***Destruction*** in some form occurs within the organization, whether in the form of undesirable activity or a lack of desirable activity.

2. There is an ***abundance*** of undesirable activity, or a lack of abundance of desirable activity, not merely an occasional occurrence.

3. Management might or might not be aware of the destruction, but management definitely has an ***absence*** of awareness of the root cause of the destruction.

Organizational Functionality

The grease that lubricates an organization, and allows it to function as management intended, is 'organizational functionality'. This functionality can become suddenly and seriously impaired by black-hole creating items. For instance, a big change event can jolt the organization and fracture its fine workings. This is often the case when organizations merge, sales suddenly boom, new territories are opened, the organization moves locations, or a new product line is developed and launched.

Organizational functionality can also be seriously impaired over time by black-hole creating items: slowly good people leave the organization; slowly failure to pass on information to successors impacts the organization; slowly employees grow indifferent to their work; slowly too many variables creep into the organization and choke organizational functionality.

Dynamics of organizations can be misunderstood, or not understood at all. The failure of business and industry to recognize key dynamics has permitted black holes to form and fester unchallenged.

Below are three examples of dynamics of organizations that, if understood, would encourage management to eradicate black hole-creating items:

1. Management can do no better than the data it is presented with or the data it seeks out.
2. Organizations can be opaque or transparent.
3. Syntropy (a tendency toward harmonious association in an open system) and entropy (a tendency toward disorder or randomness in an open system) are in a constant battle. If there are fewer syntropy forces than entropy forces the organization can become confused and chaotic and lose its focus and form or even fall apart.

Simple Yet Essential Basic Activities

Black hole-creating items are usually failures of simple yet essential basic activities that in volume cause a drag on an organization's performance. The performance of activities is composed of actions. When actions fail, the activities can fail. In turn, the organization can fail to meet its goals and objectives.

For example, the 'wrong action' of late deliveries can lead to expensive lawsuits. The 'omitted action' of failure to oil machinery can lead to the shortened life of capital equipment. The 'incomplete action' of not giving manufactured furniture a second coat of lacquer can lead to an inferior product. In volume, such failures of simple yet essential basic activities can cause cash flow problems and reduced margins. In severe cases, they can threaten the organization's survival.

Two organizations that I became involved with had black holes in their accounts receivable departments. Both organizations failed to issue credit notes totalling tens of millions of dollars that were due to customers. They failed to issue credit notes for price protection, co-op advertising, returned product, damaged product, short shipments, damages to facilities during installation, late delivery, incorrect pricing and tax charges, and more. This, in turn, caused severe cash application problems. Accounts receivable clerks could not properly apply customer payments to the A/R sub-ledger since credit notes had not been issued even though they were due. The organizations' A/R sub-ledgers and their customers' sub-ledgers soon were no longer synchronized.

> Company A wrote $19 million off its A/R sub-ledger.
>
> Company B wrote $17 million off its A/R sub-ledger, plus an additional $23 million from elsewhere on the balance sheet because the black hole had spread to other departments.
>
> Company A had a wealthy foreign parent. It survived. Company B, a tier 1 TSE listed public company, filed for corporate bankruptcy — the ultimate price to pay for ignoring a black hole in an organization.

Compliance Officer

In my book, *Black Holes in Organizations*, I propose a position of 'compliance officer'. Compliance officers are not new to organizations; however, the compliance officer role I propose would be significantly different from the compliance officers in industry today. Perhaps we should name this new position "Compliance Officer - Functionality".

The following excerpt from the book clarifies this point:

> *"I am proposing a compliance officer who will not have his attention riveted on government and other regulatory rules, but rather on organizational functionality. Specifically, this officer will maintain an eagle eye, searching for black hole-creating items so that organizations operate as management intended. He will continuously and systematically comb through the organization searching for black hole-creating items and then ensure they are terminated early.*
>
> *"A compliance officer helps to hold the form of the organization as it moves forward. There will come a day in the future of large organizations when failing to hire a compliance officer will be perceived as a serious governance shortfall. This perception will be a natural outcome of organization personnel grasping the existence and the character of black holes and its subsequent damage, then ridding the organization of the black holes. They will never want one to surface again. Pain has that effect."*

Allow me to reinforce one point here. This compliance officer works to keep the organization in compliance with management's intentions or operating as management intended.

Chief Governance Officer

Who is going to save the day? GovernanceExcellence (www.governanceexcellence.net) is in the process of defining and introducing a new corporate governance position, that of chief governance officer. It would seem appropriate for the newly defined role of 'compliance officer' to report directly to this newly created position. If an organization's structure does not include a chief governance officer, then the direct report should be to the chief executive officer, or to the board of directors.

Since the introduction of the chief governance officer position is new, this would be an ideal opportunity for 'black holes' to meet 'corporate governance', with the goal of eradicating black holes from organizations. Making the compliance officer part of an over-stretched internal audit department would water down the importance assigned to locating and eradicating black hole-creating items. Thus, I have a strong preference for crafting the chief governance officer role to manage the 'hands-on' compliance officer role.

The added manpower and attention to governance would allow those responsible for governance to reach down into the middle management, supervisor and worker levels to strengthen badly needed organizational functionality. Eradicating black holes from organizations would be a huge step in that direction.

Conclusion

Black holes have been allowed to form and fester within organizations for eons. Their character is now known. Their impact on organizations is now known. Today industry has the knowledge to eradicate black holes from organizations, and can do so—if the will is there.

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