

Articles of Merit Award Program for Distinguished Contribution to the Roles and Domain of PAIBs 2008

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of Accountants**

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This information paper was prepared by the Professional Accountants in Business (PAIB) Committee of the International Federation of Accountants (IFAC). The PAIB Committee serves IFAC member bodies and the more than one million professional accountants worldwide who work in commerce, industry, the public sector, education, and the not-for-profit sector. Its aim is to enhance the role of professional accountants in business by encouraging and facilitating the global development and exchange of knowledge and best practices.

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The mission of IFAC 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.

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INTRODUCTION

The Professional Accountants in Business Committee's Articles of Merit Award

The Articles of Merit Award Program recognizes published articles that the PAIB Committee judged to have made a distinguished contribution to the development and the roles and domain of professional accountants in business.

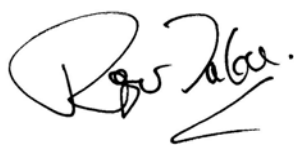
IFAC member bodies nominate outstanding articles that appeared in either their official journals or on their websites in the previous year. In selecting the winning article, for the first time in the history of the award, the judges took into account the ratings of professional accountants in business. The articles were placed on the IFAC website and readers voted on their usefulness. Mohammad Arif Nara (Pakistan), Emma Riddell (UK), Bill Langdon (Canada), Dennis Whitney (USA) and Huong Lang Trinh Mai (Vietnam) judged the 2008 nominations. The 2008 winning article is Black Holes In Accounting. It was first published in the CMA Canada's monthly members' magazine CMA Management. The article is focused on locating and eradicating undesirable activities that negatively impact the performance of an organization and on helping organizations see root causes rather than just problems. Examples of the types of black hole creating items in the accounting process include transactions not captured, erroneous and uncorrected journal entries, and the omission of assets and liabilities from the balance sheet.

This year's publication includes ten articles in addition to the winning article. We congratulate the authors and their sponsoring IFAC member bodies and thank those member bodies who submitted articles

but which on this occasion fell outside the top eleven.

Although published before the full effects of the current financial crisis were felt or understood, many of the articles usefully promote financial leadership and better practices for professional accountants in business that are relevant for today's financial and economic climate. Ignoring Strategic Risk at Your Peril, The Pitfalls of Pay-for-Performance, Measuring the Success of the Board, and Financial Leadership: What's It All About? all cover topics and issues that have been highlighted as challenges for improving organizational performance and sustainability (from a financial sense). There is also plenty of helpful advice on applying good practices in various fields such as the broad based article, Anatomy of a Plan, Better Practices For Management Accountants, an article covering finance and accounting outsourcing, Wheels of Change, and Pricing Power: Using Price Strategy Roadmaps and Tools to Maximize Bottom-Line Results.

All eleven articles, and those published in previous years, are available online at www.ifac.org/store. I also encourage you to view the recent fruits of the exciting PAIB Committee work program, including the Sustainability Framework that we have developed – available at www.ifac.org/paib. The PAIB Committee is grateful to those member bodies and professional accountants in business who continue to support this award program and we look forward to your nominations in 2009.



Roger M Tabor

Chairman, IFAC Professional Accountants in Business Committee

Articles of Merit

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BLACK HOLES IN ACCOUNTING

Black holes — areas of undesirable activities that go unchecked — can destroy an entire organization

By Ron Lutka, CMA

Black holes in organizations can be defined as: “An area of an organization where, unbeknownst to management, an abundance of undesirable activities occur or a lack of desirable activities occur in abundance, both of which destroy organizations.”

The above definition contains three important characteristics:

1. Destruction must be occurring to the organization.
2. There must be an abundance of undesirable activity or a lack of desirable activity in abundance, not merely an occasional occurrence.
3. Management must have an absence of awareness of the root cause of the destruction.

Destruction must be occurring to the organization. Fading margins, cash shortfalls, lost sales, increasing costs are typical problems one can find in organizations.

A common area for black holes to form is in the reporting function. Since accounting is heavily skewed toward reporting, there are ample opportunities for black holes to form. For example, if the margins reported to management are prepared from inaccurate cost and sales data, then of what value are the reported margins?

There must be an abundance of undesirable activity or a lack of desirable

activity in abundance, not merely an occasional occurrence. For the failure of basic activities to negatively impact the performance of an organization, the failures must occur in volume. Issuing an incorrect dealer commission cheque one month is not a black hole-creating item. However, issuing incorrect dealer commission cheques to 22 dealers each month for seven consecutive months can be. Similarly, applying the wrong discount to a customer invoice doesn't create black holes; however, applying the wrong discount to 300 customer invoices can.

In addition, the broad range of black hole-creating items that are “in play” has an effect on the possibility of black holes forming. The likelihood of a black hole forming increases as more types of failures of basic activities occur. Management must have an absence of awareness of the root cause of the destruction. This is what makes black holes so vicious, and why companies often don't know the real reasons they are starting to list or have gone under.

Items that create black holes become more prevalent over time as they compound unrestrained. One black hole-creating item, such as not removing the splinters from the shelving unit prior to delivery, repeated over and over each workday, causes other black hole-creating items to form — such as damages caused to returned product during the unpacking and warehousing process or reduced cash

inflow. The damage can manifest, unnoticed, to the point where the survival of the organization is threatened.

Flow and formation of black holes

Actions constitute activities. Activities constitute business processes. Business processes constitute quality products produced and delivered at an affordable price. Quality products produced and delivered at an affordable price constitute profits. Profits constitute survival.

The failure of basic activities in volume leads to the formation of black holes that threaten an organization's survival. These failures cause or aggravate problems higher up the hierarchy of activities. Management often sees the problems but not their root causes.

Within the area of basic activities, repetitive actions are high in number. Therefore, someone interested in eradicating black holes from the organization must delve into such areas to eliminate the root causes.

Since black holes in organizations form when basic activities fail, the investigation into the root causes of black holes must take place in the trenches, below business processes and at the level of actions and activities.

Locating and eradicating black holes

Black holes are pervasive and elusive, having developed immense survival power, and they must be cornered before they can be eradicated. Therefore, a systematic approach is required to locate items that create black holes. The systematic approach must be designed to unearth irrational thoughts and actions that are often an integral part of, if not the genus of, black holes.

Eradicating black holes is best accomplished on a gradient, resolving small black hole-creating items as they are discovered, rather than conducting a company-wide review to find all possible black hole-creating items and then setting out to eradicate them in one dramatic swoop. If black holes are not approached on a gradient, the process required to eradicate them can overwhelm anyone attempting to do so. This gradient or "peeling back the layers of an onion" approach is fruitful because it:

- Untangles a complicated and irrational web
- Views the problem in small increments
- Makes each step less complicated and less irrational

After eradicating a handful of black hole-creating items in one area, that corner of the organization could have shifted enough to render a large portion of any company-wide review irrelevant, or at least less relevant. Therefore, the review process should not get too far ahead of the repair process. In addition, after many small black hole-creating items have been located and eradicated, larger items can be tackled because the organization will be more transparent and better aligned, allowing for better decision making and better execution when undertaking larger repairs.

Below are examples of the types of black hole-permitting and black hole-creating items that can cause black holes to form in the accounting process.

Holes in the net

Balance sheet accounts not reconciled.

Errors and fraud have an opportunity to grow when balance sheet accounts are not reconciled to sub-ledgers, supporting documentation and to physical assets.

Though a poor practice, it is not rare for large and small companies to leave a bank account not reconciled for close to a year, despite the fact that such omissions raise auditor concerns. Failure to reconcile balance sheet accounts is not in itself destructive; however, it allows destructive actions to remain unnoticed and unresolved.

Transactions not reconciled. Opportunities exist to catch errors and fraud by reconciling non-balance sheet accounts in addition to reconciling balance sheet accounts. Reconciling sales to goods shipped, reconciling work orders issued to work orders completed and reconciling raw materials purchased to raw materials used are examples of reconciliations that can help catch destructive actions.

In one instance, reconciling work orders issued to work orders completed enabled a company to catch installers “cherry picking” easy installation jobs and neglecting to perform the difficult ones. In another instance, reconciling raw materials purchased to raw materials used helped a company spot a contractor who, in collusion with a company engineer, was intentionally over billing for raw materials.

Poor audit trails. The better the audit trail between the numbers reported and source documents and physical universe assets, the less likely it is that a black hole will form in the accounting function.

Non-standardization. Errors occur more easily in a non-standardized environment; however, non-standardization is not an error. When routine work is standardized, the workers do not need to determine how a function needs to be performed. Rather, they execute what has been previously determined and set as a standard, whether

by themselves or by another party. Standardized workflow makes it easy for practitioners to know what to do and when to do it. Unusual or atypical items, as well as problems and mistakes, are easier to identify by those performing routine work. They can then handle the errors, preventing them from creating black holes.

Limited knowledge of systems. In an attempt to become more efficient, some organizations employ computer generated journal entries. These journal entries are generated each month based on pre-programmed logic such as booking \$100 to an expense called “damages during shipping” for each vehicle sold. These journal entries may become inaccurate over time because such journal entries usually have no owner overseeing their integrity. Unfortunately, this black hole-permitting item is common within organizations. Computers are wonderful workhorses. However, like all other aspects of organizations, they require management. Tax rates and tax eligibility change, duty rates and duty eligibility change, errors occur, procedures change. If nobody understands the basis and calculations behind computer generated journal entries, and if the integrity of such calculations is not tested regularly, black holes can form.

Creating black holes in accounting

Transactions not captured. Customer returns not captured and entered into the management information system is an example of a black hole-creating item. Actual damage occurs because of this “lack of desirable activity” when a liability is not recorded on the company financial records and in the customer account. For instance, crediting the customer account for the return would reduce the near-cash asset “receivables”

and reduce sales, which are important for management to be aware of for cash flow forecasting. Also, to not credit the customer would anger the customer and cause the customer to doubt the integrity of the company. Potentially, customer relations could weaken and the customer could be lost.

Erroneous journal entries remain uncorrected. Erroneous journal entries left uncorrected can snowball into many misunderstood recordings on the general ledger. A problem of reversing the wrong amount out of an accrual account one period can compound when the balance remaining in the accrual account is reversed out in a subsequent period. The original incorrect reversal can lead to a subsequent incorrect reversal. Although the accrual account is now correct, the offsetting accounts likely remain incorrect. This in turn can lead to a chain of subsequent incorrect journal entries. When someone discovers that an account is incorrect, they must properly trace back the sequence of errors or they will likely create another erroneous journal entry. A black hole can begin to form in this way.

Assets and liabilities omitted from the balance sheet. A classic example of a black hole-creating item is the inaccuracy of, or absence of, recording assets and liabilities that arise because of contractual arrangements. For example, a distributor who earns a bonus when certain sales volume milestones are met acquires an asset that might erroneously be omitted from the company's financial records until a cheque is received. Conversely, violating a clause in an agreement can cause an organization to incur a liability. This liability can easily be overlooked and not be recorded on the company's books. Delayed or omitted recording of a negative tax assessment is another

example of a liability that might be erroneously omitted from the balance sheet.

Recording of transactions not kept current. Fixed assets put into use during the period but not recorded accordingly render the accounting records inaccurate. As do deposits made at a bank but not entered into the general ledger during the same accounting period. Not keeping current with accruals for warranty provisions, write-offs if they become necessary, and with provisions for marketing allowances and concessions are additional time-sensitive ways accounting records can become inaccurate and lead to the creation of destructive black holes.

Mergers and acquisitions occurring faster than the organization can absorb. Organizations have a finite ability to absorb change. No matter how many resources are applied to preventing disconnections, misalignment, confusion and other potential black hole-creating items from developing, they will develop during a complex merger or acquisition. Unless sufficient time is allotted for accounting personnel to re-align the data capture and accounting process before the next big-change event occurs, a black hole can form.

Take for instance a distributor that acquires a manufacturing operation whose employees need to be set up on the distributor's payroll system. This requires analyzing each employee's eligibility for benefits. If the manufacturer has a union shop, accruals need to be determined and set up by the distributor for things such as supplemental employee benefits funding in accordance with the union agreement. The manufacturer's suppliers and customers need to be notified of the distributor's purchase of the manufacturing business. In addition,

contact names and other information must be exchanged and ways of conducting business must be shared. If consolidation of operations takes place, then numerous other actions, activities and processes must be put in place, understood and aligned before the organization is functioning optimally again. Any combination of failures in the process can, potentially, create black holes.

Poor accounting system design. Too many or too few general ledger accounts can be black hole-creating. Numerous redundant balance sheet accounts, for example, can choke a thinly staffed accounting department. Staff will not have time to reconcile all the accounts.

Underutilization of sub-ledgers cause valuable details to be lost and administrative tools to be absent — such as the aging ability of an accounts payable sub-ledger or the details associated with fixed assets. Anyone who has tried preparing a tax return without a proper fixed asset sub-ledger knows what a black hole looks like.

Areas outside accounting can affect accounting. Accounting's ability to

produce an accurate set of records depends, to a degree, on other departments. Work orders and other documents not forwarded along the management information system in a timely manner distort information reported. Poor execution of data captured by personnel outside the accounting department weakens the value of the data that is reported. An executive who fails to approve a valid customer claim alters the integrity and usefulness of the financial statements. Just as accurate and reliable accounting and reporting are, to a degree, dependent on non-accounting employees, so too is the avoidance of black holes. In both cases, the assistance of non-accounting personnel must be solicited.

CMAs are heroes when they save the organization money and villains when they enforce accountability. CMAs have an opportunity to swing the pendulum toward the “hero” side by identifying and eradicating potential items that create black holes within the accounting department and elsewhere.

This heroic effort is important, even crucial, to the survival of the organization because black hole-creating items can threaten an organization's very existence.

Ron Lutka, CMA, ACIS, P.ADM, (author@blackholebook.com) is the president of Corporate Streamlining Company Inc. based in Richmond Hill, Ontario and the author of Black Holes in Organizations (www.blackholebook.com).

FINANCIAL LEADERSHIP: WHAT'S IT ALL ABOUT?

What is leadership?

By Jeffrey C. Thomson

Leading CFOs around the world say they need “it” to bring their teams to the next level in driving business performance within their organizations. Members of the Institute of Management Accountants (IMA®) say they need “it” to advance their careers or those of their management accounting and finance-function staff. What is “it”? “It” is Financial Leadership. Much like learning or striving to be a “good” person or a “great” organization, the notion of achieving financial leadership is a reasonable aspiration, but what does it mean exactly?

In this article we’ll explore what financial leadership means in practical terms. My intent is for this to open a discussion and be an engagement in critical thinking, not a clear-cut set of solutions or answers. In fact, one of my premises is that leadership in general isn’t a point-in-time end state—it’s a continuum of experiences, skills, and always reaching beyond your current set of belief systems and experiences.

WHAT IS LEADERSHIP?

Let’s examine this question from two perspectives: the view of a leading practitioner who clearly achieved leadership status and the view of a prominent author on the topic of leadership.

IMA Chair Emeritus Bill Brower, CMA, CFM, served as group vice president of finance at Johnson & Johnson, one of the

world’s preeminent corporations, before he retired. Bill has spoken around the world on the topic of management behaviors and functions vs. leadership behaviors and functions. At IMA’s Second Annual Global Conference in Dubai last May, he provided the “six Cs of leadership credibility” (the six Cs were also presented at another IMA conference by Charles Christy, EVP and CFO of Citizens Banking Corporation). They are:

Conviction—The passion and commitment an individual has toward his/her views or the views of others.

Character—Consistent demonstration of integrity, honesty, respect, and trust. A “table stake” for leadership—a must to be a successful leader. No questions asked.

Care—Demonstration of concern for the personal and professional well-being of others. This includes the notion of “followership.” Leadership is about influencing others to follow in terms of strategic direction, critical thinking, passion for success, etc.

Courage—Willingness to stand up for your beliefs, challenge others, admit mistakes, and change your own behaviors when necessary. Willingness to engage in “constructive contention” to professionally challenge or question the status quo or strongly held views.

Composure—Consistent display of appropriate emotional reactions,

particularly in tough or crisis situations (includes aforementioned constructive contention skill).

Competence—Proficiency in “hard” technical skills and “soft” human behavioral skills.

The premier author on leadership is John C. Maxwell, who wrote the book *The 21 Irrefutable Laws of Leadership* in 1998 and updated it in 2007. I suggest that you read this book. To whet your appetite, I'll provide you with a brief description of my six favorite “laws” that I learned (and, I hope, applied to some degree) during my years as a practitioner/CFO in telecom, an academic at the college and high school levels, and now as head of research at IMA.

The Law of Influence—This law simply says that, while not everyone has to be the leader, they can be a leader at some level if they take the view that they have the ability to influence others (subordinates, peers, supervisors, stakeholders).

The Law of Process—Leadership develops daily, not in a day. It's a continuous process, even for those we view as having “made it.” As Maxwell says, “As long as a person doesn't know what he/she doesn't know, he/she isn't going to grow.”

The Law of Addition—Leaders add value by serving others. As Maxwell says, “The bottom line in leadership isn't how far we advance ourselves but how far we advance others.” And “Inexperienced leaders are quick to lead before knowing anything about the people they intend to lead. But mature leaders listen, learn, and then lead.”

The Law of Connection—Leaders touch a heart before they ask for a hand. “It's one thing to communicate to people because you believe you have something of value to say. It's another to communicate with people because you believe they have value.”

The Law of Empowerment—Only secure leaders give power to others. “Leading well is not about enriching yourself—it's about empowering others.”

The Law of the Buy-In—People buy into the leader, then the vision. “The leader finds the dream and then the people. The people find the leader and then the dream.”

WHAT DOES THE MARKET SAY?

As a practitioner in the highly combative telecom wars for more than 23 years, I always learned to listen to the voice of “the market.” But sometimes the market (customers, members, shareholders, stakeholders, etc.) tends to be shortsighted and focused only on solving the major “pain points” or critical business issues of the day. A market view must always be balanced with a broader look to the future of the business, the future of the profession, etc. Otherwise, for example, how many of the technological advances of our day would have even been considered?

Regarding financial leadership, CFOs around the globe are generally concerned that there's a gap between the current state of reality and the aspirations for their CFO teams in helping to drive business performance inside their organizations. Figure 1 shows a simplistic demand and supply perspective regarding the CFO team's current and aspirational performance.

Table 1: CFO Surveys

RESEARCHER	YEAR	STUDY	SAMPLE SIZE
IMA	1994-2008	Various Business Partner Studies	Various
PWC, CFO Research	2005	CFO as Chief Performance Advisor	216
IBM	2005	The Agile CFO	900
KPMG, <i>The Economist</i>	2006	Being the Best...	286
IBM, Wharton, et al.	2008	Balancing Risk and Performance with an Integrated Finance Organization	1,200

From the demand side, the CFO team's stakeholders are driving the CFO team to greater heights because they are being driven by the complexities of globalization (e.g., China evolving from state-run to a market economy, convergence of U.S. Generally Accepted Accounting Principles (GAAP) and International Financial Reporting Standards (IFRS), etc.), increased customer sophistication and expectations (e.g., demand for value-added "bundles" of products and services), and the compliance jungle exacerbated by Sarbanes-Oxley legislation for publicly traded U.S. companies (compliance with federal, state, and local laws; vertical industry sector compliance such as the Health Insurance Portability and Accountability Act (HIPAA) in healthcare; organizational compliance with ethics and employee policies, etc.). Stakeholders would like their CFO teams to be more focused on decision support, helping to create wealth, and creating influence at the table as a strategic business partner while still ensuring a clean bill of health for the company financially.

From the supply side, the current reality is generally that the CFO team is still too focused on processing transactions, is less

focused on creating wealth than on accounting for

the wealth (which is the basic expectation—what some studies refer to as “one version of the truth”), and exerts influence but often only as a compliance cop making sure that financial and other rules are followed. The market seems to be saying that a “minimum” expectation is to do an exemplary job in the traditional CFO roles but that there must be a step up to the more strategic business partnering CFO roles.

Numerous CFO surveys by a variety of respectable research organizations also show a gap between the current state of reality and what stakeholders are demanding from their CFO teams. (See Table 1 for a list of the surveys.) What are some of the gap fillers? Improved business processes and further development of people skills on the CFO team, including financial leadership. Financial leadership isn't confined to the top person (the CFO and controller)—the entire CFO team is expected to bring the organization to the next level of performance in an increasingly complex global marketplace.

WHAT SKILLS ARE NEEDED?

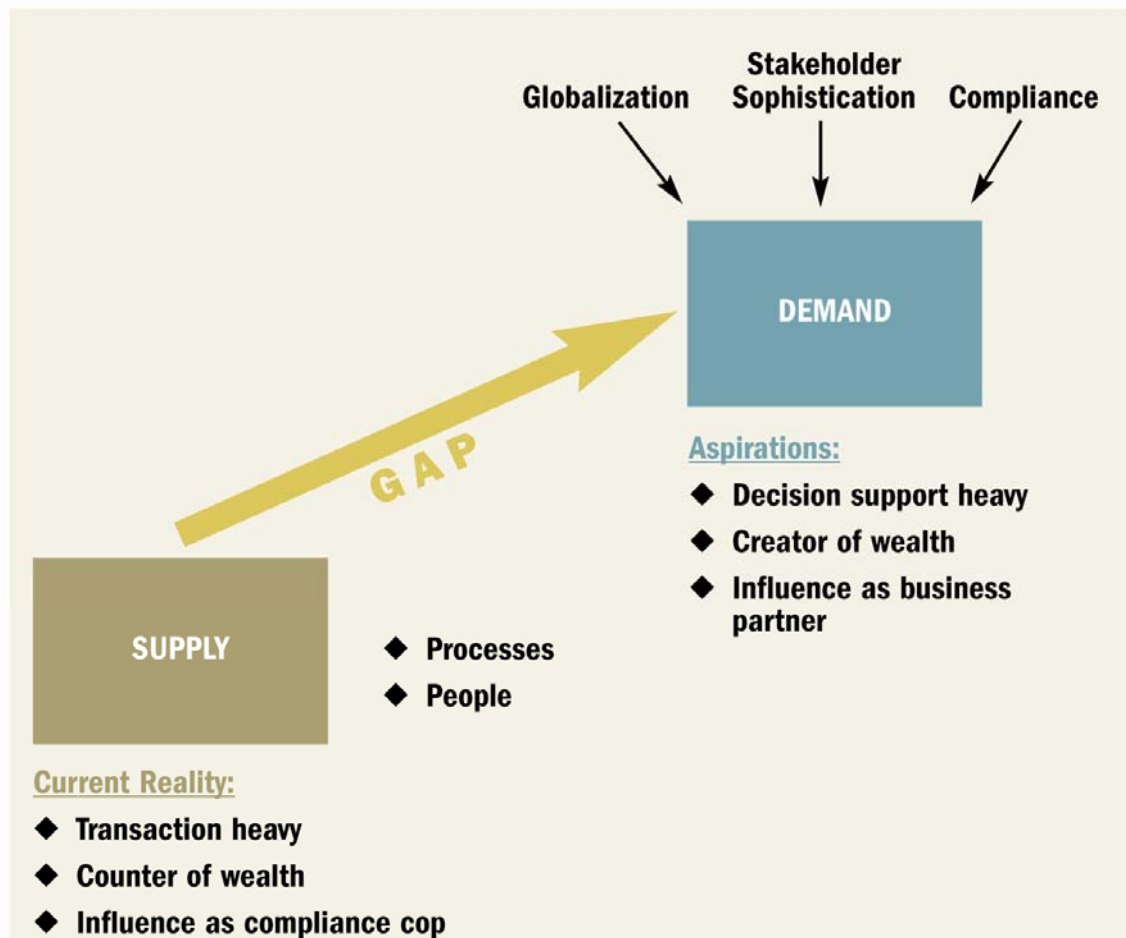
While it's a challenge to synthesize the views of literally thousands of CFOs from the surveys in Table 1 related to current priorities, future aspirations, and gaps, the brief summary is that:

- The CFO team aspires to move from a primary focus on counting wealth and serving as compliance cop to a more balanced role that includes creating

wealth and being influencers of strategy.

- To some extent, the CFO team is still stuck in the role of transaction processors, and evolving beyond this role requires a whole new set of skill sets.
- Sourcing these new skill sets is problematic, so they tend to be "home grown," i.e., developed from within the organization.

**Figure 1: Critical Business Issue:
Gap in CFO Team Aspirations**



Peter Brewer, CPA, professor in the department of accounting at Miami

University in Oxford, Ohio, and a coauthor of one of the leading management accounting undergraduate

textbooks, often asks fellow accounting professors, “How often do you use the word ‘leadership’ in your classroom?” More often than not, a vast majority say “rarely if at all,” which implies a lack of leadership training in the undergraduate curriculum devoted to harder skills, such as strategic planning, enterprise risk management, and continuous process improvement, and softer skills, such as negotiation, collaboration, and change management. Yet many affirmative responses are associated with the follow-up question, “Are leadership skills important to employers?” The implication is a gap between the demand for management accountants who can grow into strategic business partners and the current supply of training and education in this area.

Based on the surveys, what are some of the “top of mind” skill sets the CFO team needs in order to achieve the desired/aspirational status as financial leaders and strategic business partners? These skills involve strategic planning, including integration of planning, budgeting, and forecasting; “predictive” analytics, including more advanced forecasting methods, competitive analysis, business intelligence, and data mining; enterprise risk management; financial statement quality assurance; greater integration with IT, including developing on a global basis a G/L that many CFOs referred to as “one version of the truth”; project management to enable the CFO team’s leadership role on cross-functional organizational initiatives; process management for key business processes such as the customer order-to-cash process; and “softer” skills, such as negotiation, collaboration, change management, and communication. From an organizational perspective, that’s what financial leadership is all about.

FOCUSING ON THE INDIVIDUAL

Let’s now shift from an organizational discussion of financial leadership to a more practical, individual, and personal perspective (“What can I do to advance my career and my organization?”). For context, I’ll provide a work-in-progress definition of management accounting and management accountants from IMA’s Foundation for Applied Research (FAR). FAR took on this challenge because most definitions of management accounting as a profession are out of date and focused almost exclusively on the cost accountant in manufacturing when today the profession is much broader with a global reach. (Note: Although this work-in-progress definition isn’t being formally exposed to IMA members for comment at this time, I invite any early input. For example, when talking with your nonfinancial colleagues or with friends at a party, how do you describe your work as a management accountant?)

Here’s the work-in-progress definition:

Management Accounting is a professional discipline that helps management in formulating and implementing their organization’s strategy. Management Accountants are an integral part of the management team, working within the organization at many levels: from top-level management to support-level finance and accounting professionals. The Management Accountant applies their knowledge and experience in accounting and financial reporting, budgeting, decision support, risk and performance management, internal control, and cost management.

With this work-in-progress definition in mind, let’s summarize at a high level what has been discussed or inferred so far on the topic of financial leadership.

1. Recall the Law of Influence from John Maxwell's book *The 21 Irrefutable Laws of Leadership*. Leadership doesn't have to come only from the top person—the CEO, CFO, or controller. Every management accountant and finance-function employee, regardless of their level in the organization's hierarchy, has the opportunity to exert influence whether they are processing transactions such as accounts payable or receivables, closing the books, preparing budgets, or helping the organization formulate its strategy.

Influence could take the form of a process improvement to save the organization money while maintaining at least the same level of effectiveness. It could take the form of an idea to improve handoffs to operational partners on cross-functional teams. It could take the form of a proposal to cut down on the budget preparation cycle time. As Maxwell says, "The true measure of leadership is influence—nothing more, nothing less." Scott Adams, the creator of the "Dilbert" comic strip, says, "You don't have to be a 'person of influence' to be influential. In fact, the most influential people in my life are probably not even aware of the things they've taught me."

2. CEOs and other key organizational stakeholders are "telling" the CFO team that there are minimum expectations that earn someone the right to simply be at the table (vs. exerting influence over key decisions made in the organization). These minimum expectations, which used to be the standard fare for the full range of the CFO's job, include exemplary transaction processing, book close, compliance, internal controls, etc.

They tend to be the more "mundane," historically focused finance activities—those that "keep the lights on" and keep the organization solvent and in full compliance with the law. Yet key stakeholders are telling the entire CFO team that they need to step up to the challenge of being business partners to earn the right to influence critical business decisions. This stepping up includes understanding the business; involvement in areas such as strategic planning, enterprise risk management (ERM), and decision support; and the ability to influence key internal and external stakeholders via communications, negotiation, and collaboration skills.

3. Finally, financial leadership is implied in the work-in-progress definition of management accounting and management accountants. Some of you might ask, "What does the 'average' management accountant have to do with formulating or implementing the organization's strategy?" With respect to formulating strategy, it may be true that, especially in larger organizations, only the more senior-level finance professionals are actually involved in creating or formulating the organization's strategy. But shouldn't management accountants who aren't at the senior level aspire to this as they work their way up the ladder and/or increase their scope of influence? Additionally, in order for the organization's strategy to be successful, management accountants at every level need to understand how their everyday work activities contribute to strategy execution and how they can improve that contribution with process improvements, new ideas, etc.

Table 2: Financial Leadership Continuum Framework

ACTIVITY	ENTRY MA&FP (1ST Job)*	YOUNG MA&FP	SEASONED MA&FP	SENIOR MA&FP
Scope	Learn your job— “find your desk”	Learn the business	Move into operations	Run a business
Interfaces	Self/boss	Cross-functional/ internal teams	External interfaces	Investor relations, customer relationships
Analysis	Cost and budget; audit, tax, external reporting	Strategic plan, financial risk, profit analysis	Enterprise risk, supply chain, etc.	M&A, new market/ product development
Process	Individual contributor	Project manager	Process manager	Change manager/agent
Analytics/IT	Excel, data acquisition and analysis	Forecasting, ERP evaluation; financial applications	Business Intelligence, data mining	Integrated CFO/IT governance

* MA&FP = Management Accounting and Finance Professionals

A CONTINUUM

Leadership, including financial leadership, isn’t a fixed-point-in-time set of behaviors, let alone an end state. Leadership really is a continuum, an opportunity to continually grow and improve your ability to influence others for the greater good. Not every management accountant has to be the leader, but the demands of the market seem to be suggesting that, at some level and at some point(s) in time, the management accountant does need to be a leader.

An illustrative financial leadership continuum framework is provided in Figure 2 and Table 2. In Figure 2, the vertical scale represents a variety of “hard” skills (e.g., more technical skills such as financial reporting, budgeting, etc.) and “soft” skills (e.g., more “human interaction” skills such as communications, collaboration, and negotiation). The horizontal scale represents sample phases of a management accounting and finance professional’s career (e.g., entry-level job, young professional capturing the next two to three jobs, etc., potentially moving into the more senior-level finance jobs over

time). The expectation is that the hard and soft skills will increase in complexity, scale, and scope—the “step up” depicted.

For example, in Table 2 (interfaces row), entry-level employees may tend to interface most often with their boss and a few peers. In the next phase of their career, they will get involved more in cross-functional projects (e.g., managing business cases) and ultimately, as a senior finance professional, interface with outside stakeholders such as customers, investment analysts, etc. In another example from Table 2 (analysis row), the entry-level finance professional may get involved with book close, transaction processing, and/or budget work, evolving over time to more complex and forward-looking activities such as strategic planning, merger-and-acquisition (M&A) work, risk management, decision analytics, etc.

IMPROVING AS A FINANCIAL LEADER

Now maybe you’re asking, “How can I improve as a financial leader, regardless of where I am on the career continuum?”

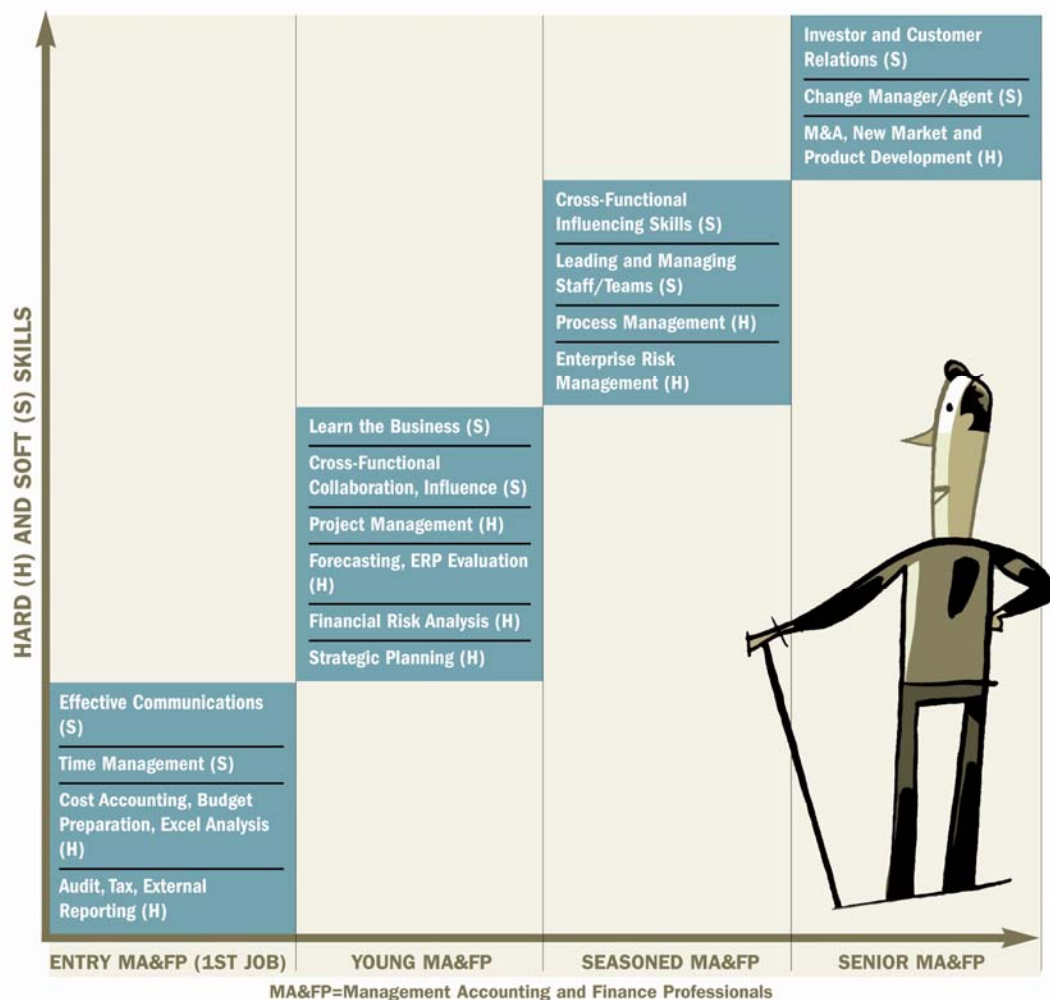
IMA has several resources available to members in the area of financial

leadership/business partner, including articles, Annual Conference topics, webcasts, and research. For research, visit the IMA website at www.imanet.org. In the upper left corner, click on “Research Center of Excellence,” and then find the “Leadership Strategies and Ethics” research practice for relevant articles and research.

Since 1994, IMA has launched a steady stream of research in the area of

understanding and addressing the gap between what corporate America wants from management accountants and the education and training supplied by the education system. This research was conducted by the late Gary Siegel, CPA, professor from DePaul University; James Sorensen, CPA, professor from the University of Denver; and Sandra Richtermeyer, CMA, CPA, professor from Xavier University. It includes What

Figure 2: Financial Leadership—An Illustrative Continuum



**Table 3: IMA Primary Research:
How to Become a Business Partner**

How management accountants can prepare for the change to business partner: ◆ Build the foundation ◆ Develop excellent interpersonal skills ◆ Develop informal communications with people across the organization ◆ Understand the business ◆ Educate the organization	Transitioning strategies for the business partner: ◆ Show value-added analysis ◆ Gain trust ◆ Give high-quality advice that promotes solutions ◆ Help the “financially challenged” understand the information ◆ Understand the needs of decision makers ◆ Promote the value of financial advice
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Corporate America Wants in Entry-Level Accountants (1994); Practice Analysis of Management Accounting (1996); Counting More, Counting Less: Transformations in the Management Accounting Profession (1999); How to Become a Business Partner (2002); and, more recently, Impact of SOX on Business Partners (final stages). Table 3 contains some helpful hints, based on the 2002 business partner research, on how management accountants can prepare themselves to be successful business partners. (You can read the related Strategic Finance articles, “Are You a Business Partner?” (September 2003) and “Becoming a Business Partner” (October 2003), in the Leadership Strategies and Ethics research practice noted above.)

Another way to learn about financial leadership is from the leaders themselves, whether it’s informally or in a more formal relationship such as mentoring. Patrick Stroh, CMA, president of Consumer Health Products at UnitedHealth Group, is a Strategic Finance author and Annual Conference speaker, primarily in the area of enterprise risk management. He says, “I like to say that I ‘cut my teeth’ in the finance organization. But it was the development of an ERM skill set which was the

springboard to getting into critical leadership roles in the ERM area and the organization’s multiple business units. Do not be passive in seeking out these critical new skill sets. Also, actively seeking out mentors and coaches and establishing a professional network are keys to leadership and career success.”

Paula Riemer, CMA, CPA, senior financial analyst at the Martin-Brower Company, LLC, is on IMA’s new Young Professionals Committee. In advancing her career, she has been focused on evolving both hard skills (such as strategic planning, forecasting, project and process management) and soft skills (such as conflict resolution, time management, and cross-functional collaborative skills). Riemer explains: “Staying on top of the skills and experiences required to be a successful financial leader is our professional responsibility as management accountants. We must seek out professional development opportunities to expand and enhance our existing skill sets as we progress through the various stages of our careers. In addition to evolving hard and soft skills, we must learn the operations of the business in order to effectively communicate and understand key issues facing our companies, industries, and business partners.” Riemer recently

attended a seminar for young professionals in her local area on “Preparing to Lead,” which focused on leadership, intergenerational communication, building and maintaining professional networks, meeting savvy, etc.

In his article, “Redefining Management Accounting,” which appeared in the March 2008 issue of Strategic Finance, Peter Brewer presents a new framework for management accounting that includes leadership as one of the four core pillars of the profession. As I noted earlier, Brewer maintains that, while financial leadership has become a “prerequisite” critical core competency for the management accounting and finance

professional, relatively little is being done in the undergraduate accounting curriculum to satisfy this organizational demand.

IT'S UP TO YOU

The answer to the question “What’s financial leadership all about?” is really up to you. With leadership being defined as the ability to influence people, decisions, and outcomes, you have the ability to step out and be a financial leader in your own right even if you aren’t the financial leader at this stage of your career. Your organization’s stakeholders expect nothing less of you and the CFO team in driving business performance.

Jeffrey C. Thomson was Vice President of research at the Institute of Management Accountants (IMA®) in Montvale, N.J. Jeff has considerable experience leading strategic planning processes at the largest global telecom, in academia, and at IMA. He is now President and CEO of the IMA and can be reached at: jthomson@imanet.org.

PRICING POWER: USING PRICE STRATEGY ROADMAPS AND TOOLS TO MAXIMIZE BOTTOM-LINE RESULTS

CMAAs are trained to achieve best-in-class practices that strive for continuous improvements in profitability, cost management, and efficiency. And yet, when it comes to pricing, many organizations fail to use the tools and processes that enable a best-in-class approach

By Scott Miller, CMA

More often than not, anecdotes and “gut feel” remain the key drivers for pricing decisions. Consequently, these organizations fall short of their potential for revenue and profit maximization (RPMs). In addition, lack of a pricing focus can translate into millions of dollars in hidden margin leakage, as well as an inability to support an effective growth strategy. As described in a previous article, “Is the Price Right?” (*CMA Management*, May 2007), neglecting pricing practices can leave an organization’s RPMs stuck in first gear. But all is not lost. Pricing, too, can become an effective process when it is based on developing a pricing roadmap using sound data and pricing tools to optimize RPMs. In Sodhi and Sodhi’s *Harvard Business Review* article “Six Sigma Pricing,” they note: “Many organizations use disciplines to decrease the cost of manufacturing and service processes. They can use the same tools to increase revenues” (May 2005). CMAAs, therefore, can lead the way as change agents, by leveraging the power of pricing and implementing best-in-class practices, an opportunity that translates into both short- and long-term financial gains.

Power of pricing

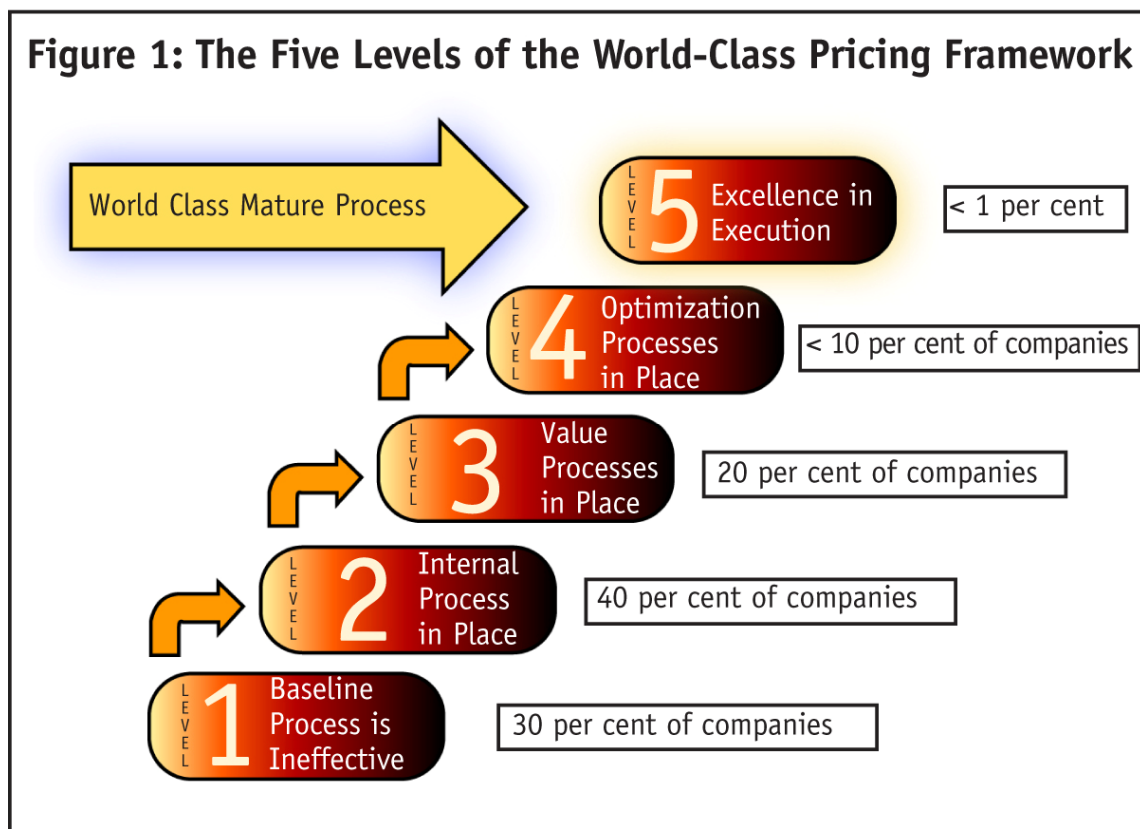
According to an often-referenced study by Marn and Rosiello (1992), pricing is the most effective lever for increasing profitability – more so than managing cost and volume. In fact, for the average organization, a 1 per cent increase in price can result in an 11 per cent increase in profitability. If pricing has such a major impact on net income, why do so many organizations fail to use an effective pricing strategy? “It’s like throwing a dart at a dartboard,” as one manager said. “How can anyone know what price will work? Just provide a target for the sales teams and leave it to them to hit that target. That’s our pricing strategy.” But as time passed and margins shrank, organizations needed to dig deeper into their world of pricing. In this particular case, the management team chose to conduct a pricing diagnostic. This assessment revealed a strong need to gain control of the pricing process, to re-evaluate the organization’s value offering, and ultimately to strive towards optimizing profitability by focusing on pricing disciplines.

Pricing audits

As an increasing number of boards of directors are realizing that a sound pricing process drives improved bottom-line results, there has been a corresponding increase in deployment of price audits to assess areas of improvement and opportunity. As outlined in “*Is the Price Right?*” an internal pricing process assessment helps determine which level within the five levels of world-class pricing (also called the world-class

pricing framework) best describes an organization’s current situation. This audit can help answer questions such as: how effective are the current pricing processes? and what pricing areas need improvement? The framework (*Figure 1*) establishes a snapshot of where an organization is today, and helps chart a vision of where it needs to navigate.

Figure 1: The Five Levels of the World-Class Pricing Framework



Each level within the Framework provides an opportunity to add new tools and processes to the CMA toolbox that sets the stage for improving an organization’s bottom line. This article highlights many of these pricing tools (with a strong focus on the Level 2 toolbox) that have proven to be highly effective as organizations progress along the path to pricing improvement.

Improving pricing competency

Level 1: Baseline process is ineffective

Management meetings at Level 1 companies are usually fraught with stress and tension. One manager described this level as “table-banging arguments whenever the topic of pricing comes up.” At this stage, there is no defined pricing strategy; pricing processes and reports are

non-existent; high margin leakage occurs at every turn; and there is a lack of understanding about the price–value relationship. Revenue changes are often explained using anecdotes rather than sound data and analytical details. As well, pricing managers find they spend a large portion of their time extinguishing internal political fires with little or no time spent investigating margin opportunities. If an organization resides within Level 1, it is important to perform a full pricing diagnostic across all departments to identify areas of pricing weaknesses that require process and tool enhancements. It is also important to meet with different levels of employees and map all potential areas for margin leakage. Once these weaknesses have been defined, it is necessary to audit and track improvements using various pricing management tools as described in Level 2.

Note that moving towards Level 2 will require a change agent, as there are internal cultural implications with pricing policy changes, as well as a need to constantly sell the advantages of using world-class pricing management practices—a perfect leadership opportunity for a CMA.

Level 2: Internal processes in place

This level is primarily defined as the “gaining control” stage for pricing. It involves tracking key pricing pitfalls, areas of margin leakage, and poor pricing practices that the company has identified as weaknesses in Level 1. It is important throughout this stage to employ pricing tools that continuously audit pricing activities, track progress, and ultimately strive for improvements. It is also necessary to train and gain buy-ins from important stakeholders to ensure they use the pricing tools. A prime reason why many organizations remain locked within

Level 2 is the lack of engagement and communication with such stakeholders. A majority of the price audit tools are focused within Level 2, since their key objectives are to take a snapshot of the current state and provide a target that overcomes a pricing weakness and gains control. Gaining control of pricing practices is a critical stage within any organization, and requires the support and engagement of stakeholders in order to progress towards a higher level within the five-level framework.

Case Study: Using a competitive pricing report (Level 2) to grow margin

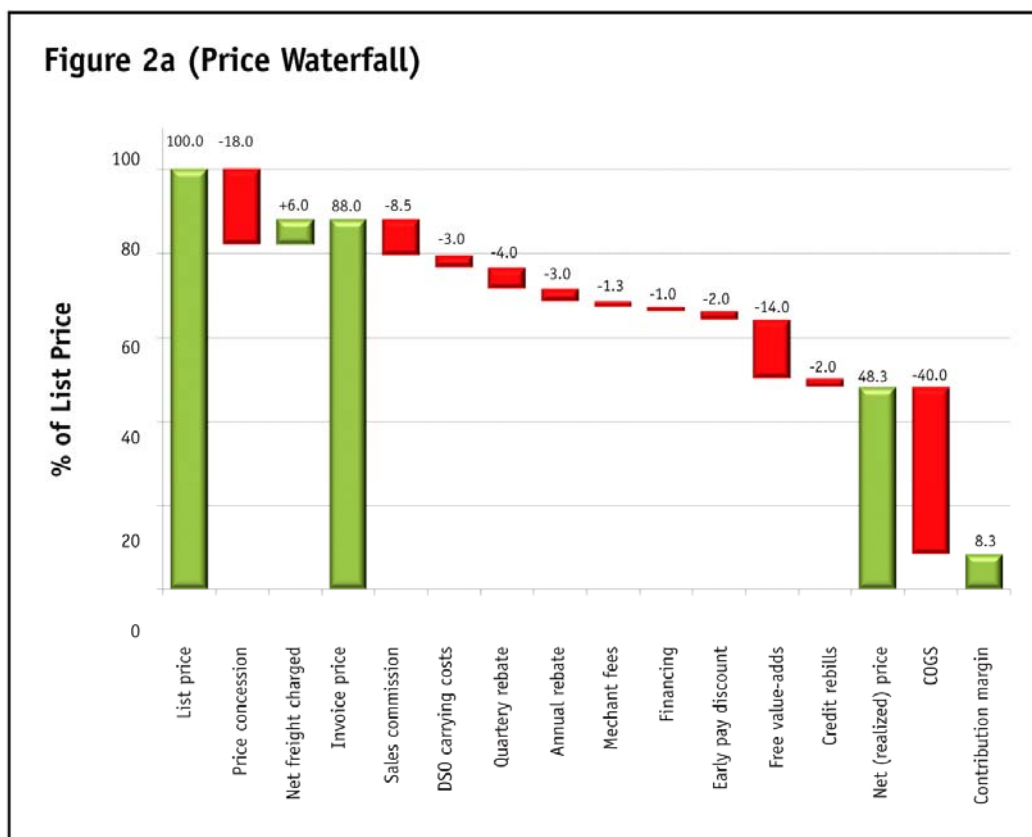
A large technology value-added reseller wanted to increase margins within its hardware category (e.g., printers, cables, notebooks, etc.). However, it was having trouble convincing its sales force. Negotiations were excessive, and pricing, to say the least, was out of control (Level 1). A newly formed pricing committee created a competitive price audit report (Level 2 price tool) that was routinely reviewed to assess competitors’ online and print catalog pricing against the company’s own. To its amazement, the company discovered it had been “giving away” seemingly irrelevant add-on accessories, items that ultimately translated into a bottom-line gain of over \$1.5 million after the organization had trained sales reps to take advantage of this margin opportunity. The report ultimately helped the company gain control of pricing, and set the stage for moving to the Level 2 roadmap.

Two of the most commonly used Level 2 tools include the price waterfall and price dispersion charts. A successful Price Waterfall chart (*Figure 2a*) must integrate the CMA’s talent for costing analysis, as well as the ability to work closely with all departments to identify areas contributing

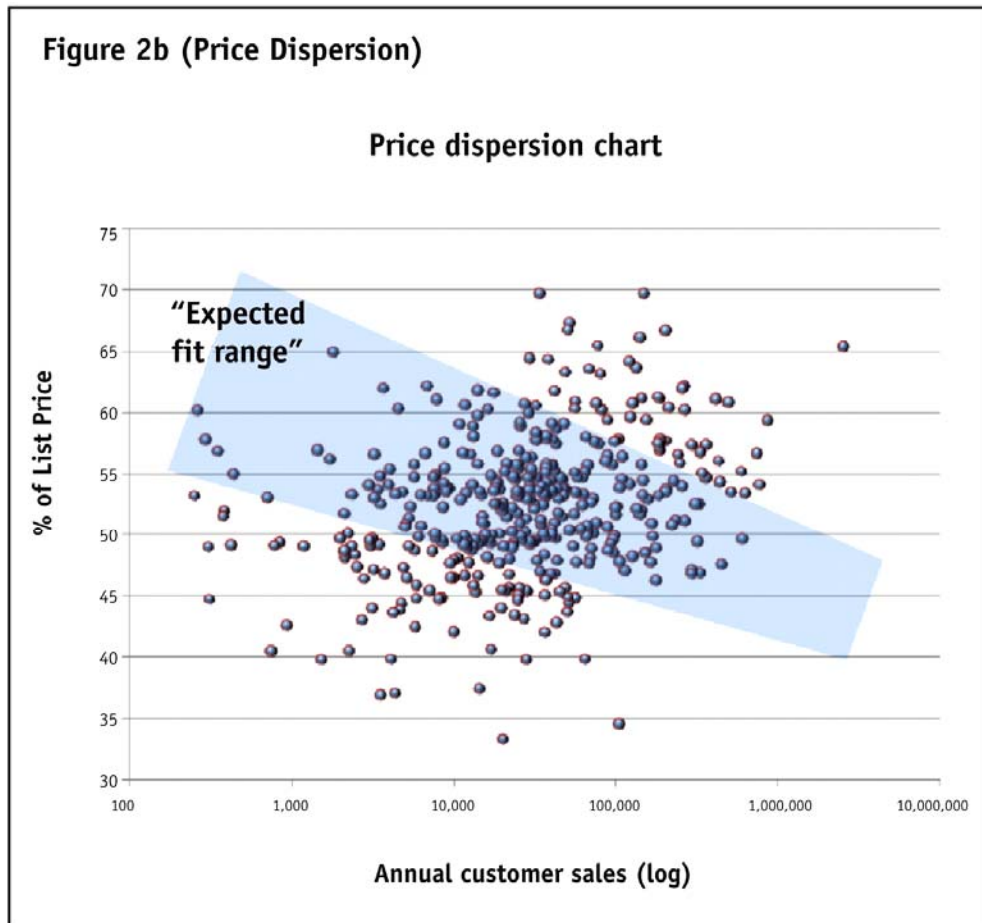
PRICING POWER

to margin leakage. Not all revenue is good revenue, and the Price Waterfall helps companies truly understand the net realized price being charged to customers after factoring in these hidden costs. A price dispersion chart is another useful pricing management tool that focuses on gaining control of pricing practices. It provides a snapshot of customer discounts based on their account size (often measured as revenue per year). One CEO experienced a highly uncomfortable situation when the company's largest multi-million-dollar account discovered that a smaller account was receiving better pricing (buyers often move around companies that are within the same industry). This created a crisis internally,

but it also caused the company to try to understand the current state of discounts and use the Price Dispersion tool (*Figure2b*) to establish future discount boundaries. The choice of which pricing tools to use will depend on an organization's pricing-strategy roadmaps, defined within its original pricing diagnostic. Some tools will be more relevant than others, depending on your pricing needs, and it is important to use those that drive the greatest improvements in RPMs. Other Level 2 tools include: competitive analysis reports, outlier analysis/reports, deal/bid sheets, pricing process documentation – accountability & guidelines, customer profitability reports, and cost-to-serve analysis.



This price-audit tool defines direct customer costs that translate into a net realized price. The identification, tracking, and management of potential regions of margin leakage can help manage the net realized price, and is critical to improving overall profitability.

Figure 2b (Price Dispersion)

This additional price-auditing tool can help determine if there is a logical relationship between price discounts and account size. Organizations that lack a pricing policy will often see an irrational pattern, referred to as a “shotgun blast.”

Level 3: Value Processes in Place

Value is a frequently used term within the B2B and B2C environments, but it’s also one that is least understood. What does value have to do with price, one might ask? Everything. In fact, pricing and value go hand in hand, and drive the top-of-mind mentality at the higher levels of the world-class pricing framework. Level 3 is often considered a paradigm shift for many CMAs, especially for those who rely heavily on cost-plus pricing practices. Cost, of course, is always an important consideration for ensuring a price point drives profit. But a cost-plus pricing approach is far from an optimization

practice. Value-based pricing, on the other hand, seeks to truly optimize revenue and profitability by understanding what customers are willing to pay based on the value of your offering. Historically, value has been more subjective than quantitative. But there are ways to measure how customers perceive value, their willingness to pay, and methods to relate value with pricing.

Value also plays a critical role in market segmentation and growth strategies. Many growth strategies fail, unfortunately, because they focus too much on acquiring market share with price, a tactic that often leads to lower profitability and back-and-

forth market-share gains and losses. A best-practice growth strategy, by contrast, takes a more hands-on approach to help companies understand the value perceptions of different market segments. An understanding of how these market segments perceive product attributes, and their willingness to pay, is critical for value-engineering effective products and offerings. The price-value map (PVM) is an excellent Level 3 pricing tool that can help assess how customer segments perceive a company's offering and prices relative to the competition. Other Level 3 tools include: In-market research tests, pricing tests (conjoint analysis), transactional analysis, cost by SKU, cost by customer segment, and price-volume-profit modeling.

Level 4: Optimization processes in place

Level 4 is the stage in which an organization fully integrates what it has learned in Level 3 about its customer segments, as well as the purchasing behaviour driven by these segments, based on pricing and the value of an organization's offering. Level 4 pricing experts will integrate all of this knowledge within an optimization model to drive a product offering that results in the optimal RPM. Such models estimate the impact of short-term promotional prices as well as longer-term price scenarios.

Historical transactional analysis can also play a critical role in optimization, by helping companies understand the past purchasing behaviours of their account base. This stage will require CMAs to wear their statistical and analytical hats, since they will need to build optimization and forecast models. The key to building such models is to understand the price actions and reactions as determined from

both Level 3 research as well as historical transactional datasets. For a bank, this might include a model that determines which combinations of account savings rate offerings produce the most profitable outcome. Models would need to address key questions, such as how savings rates affect new-customer acquisition, as well as their impact on the current customer base. For a newspaper firm, a model could address how historical classified-advertisement purchasing data can be used to determine optimal bundles that encourage these customers to upgrade to larger and more profitable classified ads.

Another key consideration for optimization modeling is the long-term optimization benefits (i.e., customer lifetime value, or CLV). In the case of a bank optimization model, a low savings rate might show a dramatic short-term increase in profitability (e.g., paying out less interest to customers). But as time passes, the bank could lose current customers and find it difficult to acquire new ones, thus lowering optimization profitability in the long run. An optimization model would factor in a balance that strives for both short- and long-term profitability.

Various optimization tools available in the marketplace include the Microsoft Excel add-in *Solver* and SAS. It would be worthwhile as a CMA to learn *Solver* and begin to understand the inputs and constraints that go into optimization modeling (see *Solver training link* provided in the endnotes).

Level 5: Excellence in execution

As the pinnacle of the pricing framework is reached, there will be an increasingly strong sense of pricing synergy across all departments and channels. At this level, the benefits of pricing are a top-of-mind

mentality for all managers and executives. Pricing is no longer considered a “battle,” but rather, pricing excellence is integrated into the culture throughout the organization. marketing, sales, operations, and accounting all have a stake in the world of pricing, and regularly ensure they: (a) review and improve upon key price audit tools within Level 2; (b) continuously strive to understand customer segments and value perceptions from Level 3; and (c) optimize the organization’s offerings based on understanding customer behaviour in Level 4. As well, Level 5 CEOs recognize pricing is a core capability, and ensure the pricing mindset is a priority across the entire organization.

A great example of Level 5 world-class pricing involves a well-known Fortune 100 hotel chain. This chain has over 150 revenue management analysts who are able to optimize room rates based on region, segments, room types, bookings, and forecasted vacancies. These analysts seek to optimize revenue and profitability, as well as key pricing indicators (i.e., Revenue per Available Room, or RevPAR), by measuring, analyzing, and improving both prices and the pricing process itself. In addition, the company is constantly evaluating its value offerings and making changes in product offerings that strive to fully understand its customer segments and their purchasing behaviour. For example, various hotel regions tap into luxury segments, while others focus on conference and “guest experience” opportunities. Ultimately, the chain’s pricing mindset and commitment to delivering value (price and value go hand in hand) has generated year-over-year growth in both earnings per share and return on invested capital). In its most

recent financial statement, the chain said these results were “largely driven by pricing.”

Building a pricing strategy roadmap, as well as expanding the CMA toolbox, is critical for pricing success and improving bottom-line results. The roadmap provides a plan of action and sets a vision for revenue and profitability improvement. However, it is important to understand that this is a step-based process that takes time. Some organizations try to rush from one level to another at the expense of not gaining internal buy-in, or not effectively integrating and implementing a new pricing process. It can take 12 to 18 months to achieve and consolidate a position at a new level before progressing to the next. Even exposure to new pricing tools requires sound training and buy-in from key stakeholders. One colleague uses what is termed “the seven times rule” – it can take seven times for stakeholders to be exposed to a new tool before they stop fighting the data and start using it to their advantage.

The benefits of using the five levels of world-class pricing are too great for any organization to ignore. Many companies are already reaping the rewards, while others remain stuck in first gear for their RPMs. CMAs have an excellent opportunity to improve their organization’s pricing power and take it to the next level. As one Fortune 100 CEO mentioned: “Nothing gets me more excited than someone providing me a detailed plan to generate an extra \$2 million in profitability.” If an organization is stuck in first gear, now is a better time than any to rev up its RPMs by navigating the roadmap to pricing excellence.

Endnotes and Additional Valuable Pricing Resources

1. Introduction to Optimization with the Excel Solver Tool: <http://office.microsoft.com/en-us/help/HA011245951033.aspx>
2. Marn, M., Roegner, E. and C. Zawada. *The Price Advantage*. John Wiley & Sons Inc., 2004.
3. Professional Pricing Society (PPS). www.pricingsociety.com
4. Sodhi and Sodhi. *Six Sigma Pricing*. FT Press, 2007.
5. www.pricingsolutions.com

Scott Miller, CMA, is a senior consultant with Toronto-based Pricing Solutions Ltd. He provides pricing-related management, research, strategic and training services for North American and European clients and can be contacted at smiller@pricingsolutions.com.

ANATOMY OF A PLAN

Better practices for management accountants

By Jeffrey C. Thomson

Planning, budgeting, and forecasting. On various occasions, I have called these topics the “heart and soul” of management accounting and, on others, its “lifeblood.” Therefore, I thought it appropriate to use the term “anatomy” to describe the key internal elements of the multiyear strategic planning process (which includes budgeting, long-run forecasting, and other types of decision analytics), current practitioner issues, lessons learned, and keys to success. The most important thing I’ll discuss in this article is the roles that management accountants do or can play as critical influencers in the strategic planning process. I’ll also cover some better practices for planning and budgeting. (Since few companies have reached a state of perfection in the planning and budgeting process, I prefer the term “better” rather than “best” practices.)

Why Is Planning the Heart, Soul, and Lifeblood of Management Accounting?

Planning is the ultimate forward-looking, influential activity that impacts key stakeholders over a long period of time. Management accountants and finance function professionals have been on a decade-plus quest to shift their roles from shareholder value stewards to shareholder value creators, from bad cop to respected and credible influencers at the decision table, from transaction processors to strategic business partners. This isn’t a

complete shift away from their “home base” of finance and accounting because management accountants must demonstrate technical accounting depth in order to have the “right” to influence a breadth of business operations. What better opportunity to influence operations, value creation, and business performance than involvement in an organization’s multiyear strategic plan, budgets, and forecasts — those forward-looking activities that chart the path ahead for an enterprise’s critical stakeholders, such as customers/members, investors, and employees, to name a few!

To do this, what knowledge and skills must management accountants and finance professionals have? They regularly list planning, budgeting, and forecasting as areas in which they are seeking to build additional competency, and Table 1 seems to agree. It lists strategic planning as number 1 and budget preparation as number 5 under “most important knowledge and skills,” according to a job analysis conducted by the Institute of Certified Management Accountants (ICMA) in March 2006. The job analysis was conducted to test/validate whether the Certified Management Accountant (CMA®) exam content is consistent with the tasks and functions performed by management accountants in practice today and to suggest future content changes to ensure ongoing exam relevance as environmental conditions change.

**Table 1: Knowledge and Skills
Management Accountants
Need to Possess**

Strategic Planning	87%
Organization Management	83%
Decision Analysis	78%
Statement Analysis	75%
Budget Preparation	75%
Information Management	74%
Performance Measurement	71%
Cost Management	71%
Internal Controls	70%
Business Process	66%
Investment Decisions	64%
Business Economics	63%
External Reporting	63%
Strategic Marketing	58%
Global Business	57%
Quantitative Methods	56%
Corporate Finance	53%
Operational Paradigms	51%

Source: ICMA Job Analysis (March 2006–1,899 respondents)

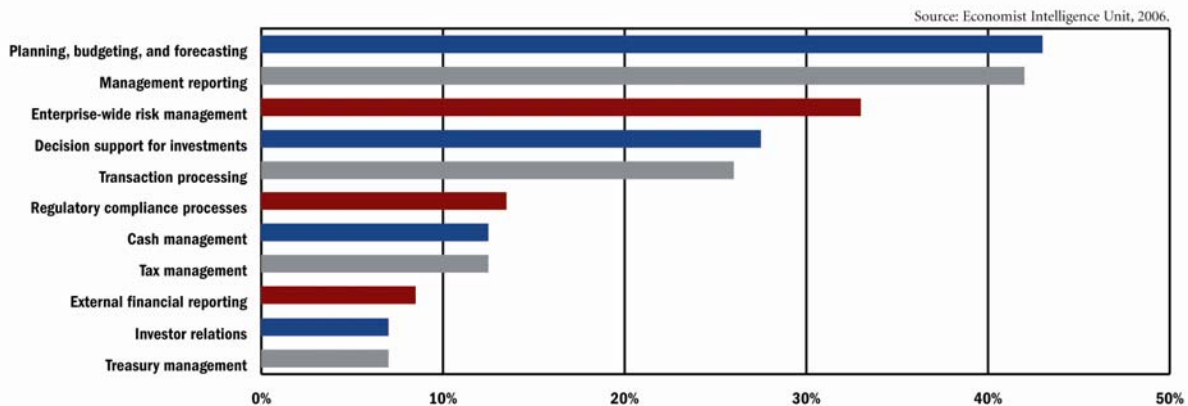
Once management accountants gain these and other skills, a highly desirable set of jobs awaits them! An “FP&A” (financial planning and analysis) job is often a “required” stop on the career path for the aspiring management accountant, regardless of an organization’s size or structure. The position could be inside the central group that manages the planning process (the central FP&A organization), which could be the chief strategy organization (CSO), the controller’s department, or even you (in a small enterprise), among other organizational options. Roles could include developing a master planning calendar; developing guidelines, standards, and templates for business units to apply in their planning; developing forecasts based on external expectations; and “rolling up” business unit forecasts to determine gaps relative to market expectations for key performance metrics such as revenue growth.

Influential positions abound outside the central planning organization as well, namely in the business units, product groups, and/or departments that are the operational “piece parts” or components that make up the total organization. These roles are closer to the market action and could involve preparing departmental budgets, forecasting products or customer segment financials, and “negotiating” with the centralized planning group to create an optimal financial and operational planning view that achieves organizational objectives.

But Why Is Planning Still a Major Pain Point for Most Organizations?

Figure 1 portrays the current level of dissatisfaction with the planning, budgeting, and forecasting processes among leading CFOs. In 2006, KPMG and the Economist Intelligence Unit surveyed more than 200 CFOs about various dimensions of finance leadership, such as people, processes, and technology. Figure 1 indicates that planning heads the list of areas with which the CFO is most dissatisfied. Not surprisingly, other results from the survey reveal that the planning process is the CFO’s highest priority for performance improvement, ahead of management reporting, transaction processing, enterprise risk management, and regulatory compliance.

In addition, many leading benchmarking organizations, such as The Hackett Group and APQC, have conducted research in the area of planning process cycle time and best practices. And an August 2007 Strategic Finance article by Theresa Libby and R. Murray Lindsay, “Beyond Budgeting or Better Budgeting?” based on a survey of more than 200 IMA

Figure 1: Where Is Finance Most Dissatisfied with Its Current Capabilities?

members, also revealed a certain level of dissatisfaction with the annual budgeting process. Here are some additional “fun” (or maybe frightening) facts that reveal current practitioner pain points with the planning and budgeting processes:

1. Cycle times are too long and don’t add value.

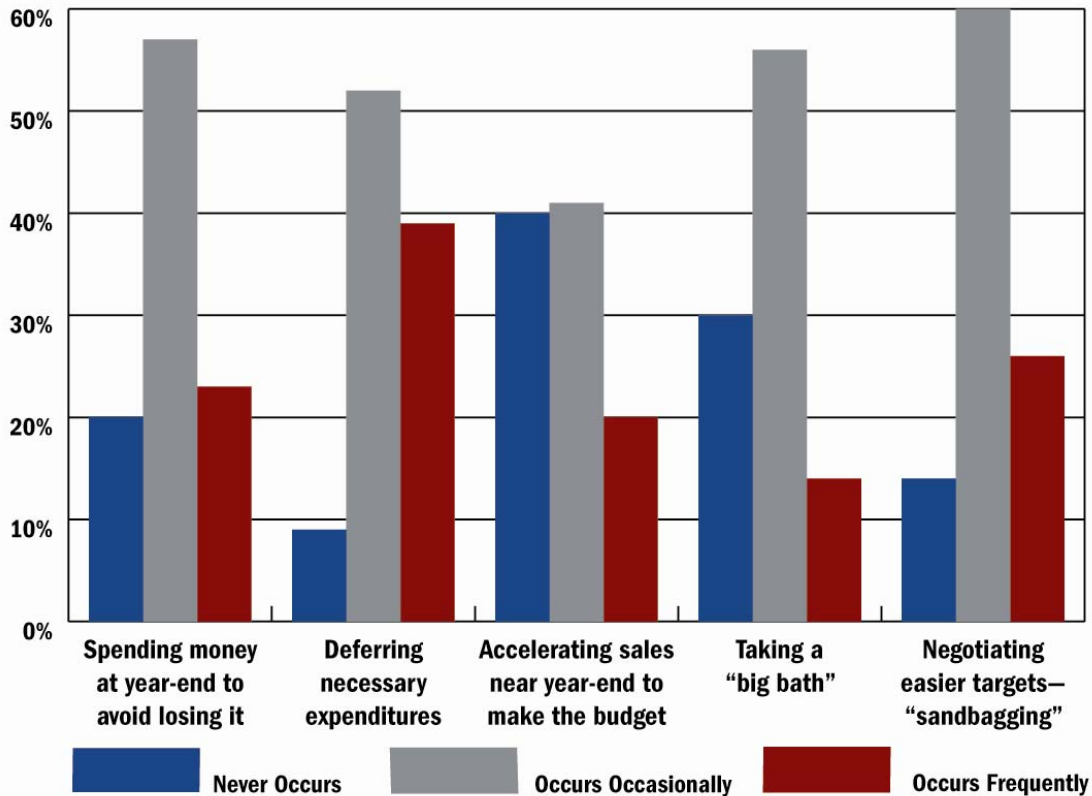
- A. The average cycle time for completing the annual budget process is nearly four months (Hackett, APQC). While there isn’t necessarily an official “best practice” benchmark, ideally this average cycle time would be closer to one month, depending on an organization’s scale and scope.
- B. It takes about 25,000 person days per \$1 billion of revenue to complete the annual budgeting and planning cycle (Hackett).
- C. A majority of IMA member respondents say the traditional budgeting process is too time-consuming, is slow to detect problems, and isn’t reliable for measuring performance (Libby and Lindsay).

2. The traditional budgeting process doesn’t incent “stretch behavior” in

individuals or organizations but does incent gaming.

- A. Bernie Ebbers, former WorldCom CEO now serving jail time, mandated expense performance at least 2% below budgeted amounts.
- B. Jack Welch, the legendary CEO from GE, declared: “The budget is the bane of corporate America. It never should have existed. A budget is this: If you make it, you generally get a pat on the back and a few bucks. If you miss it, you get a stick in the eye—or worse.”
- C. Libby and Lindsay’s research explicitly addressed the issue of budget gaming. A majority of IMA respondents indicated that three “gaming” phenomena occur at least occasionally: spending money at year end to avoid losing it (the age-old “use it or lose it” syndrome), deferring necessary expenditures, and negotiating easier targets (the “sandbagging” syndrome). See Figure 2 for further details.

3. Practitioners are generally using “low grade” technology or aren’t pleased

Figure 2: Budget Gaming

with their existing technology solutions to planning, budgeting, and forecasting.

- A. More than 50% of respondents use Excel as their budgeting software, including Fortune 500 companies (Forrester Research Advisory Services, 2005). Although Excel is very functional and user-friendly when budgeting for a particular product or department, quality control issues arise when trying to achieve integration across multiple work units and rolling up totals to the organizational level.
- B. More than 60% of users weren't satisfied that their BES (Business Enterprise Systems) software lived

up to expectations (Cost Management, May/June 2006). Unless we understand the factors that drove this expectations gap, more recent BPM (Business Performance Management) software suites aren't likely to achieve the desired gains in integration and productivity.

Key Planning Activities and the Role of the Management Accountant

Before discussing better practices for the multiyear strategic planning process, I'll define the key steps and activities that generally make up the strategic planning process, including the annual budget and forecasting processes. See Table 2 for current or potential roles for the

Table 2: Key Planning Activities and Management Accountants

KEY PLANNING ACTIVITY	ROLE OF THE MANAGEMENT ACCOUNTANT	SUGGESTED FREQUENCY
Setting/Validating the Vision	Contributing to feedback sessions to set or validate the Vision.	Every three years
Setting/Validating the Mission	Contributing to feedback sessions to set or validate the Mission.	Every three years
Environmental Scan/ Business Landscape	Research and synthesize intelligence on key environmental factors, including regulatory environment and competitors.	Every three to six months
Product and Market Priorities	Identify key market segments, inventory current product and service set, and determine the priority products and markets for resource allocation, market launches, etc.	Every six to 12 months
Strategic Change Portfolio	Work with cross-functional teams to create and update “strategic initiatives” that overlay the multiyear baseline view to achieve strategic goals.	Every six to 12 months
Determine Measures of Success ◆ Strategic goal setting ◆ Forecasting at micro and macro levels (Baseline + Initiatives) ◆ Budget detail ◆ Financial and nonfinancial measures	Key role for the management accountant in terms of determining goals, key financial and nonfinancial measures (e.g., use of balanced scorecard and strategy maps), long-run forecasting of key measures, budget expense detail for first year of plan, etc.	12 months (budget/plan cycle) supplemented by periodic in-year outlook updates (e.g., quarterly)
Develop, Deploy, and Sustain a Continuous Improvement Process (“the plan for the plan”)	Work closely with cross-functional teams to support or lead continuous process improvement efforts for one of the organization’s most critical business processes: strategic planning, budgeting, and forecasting.	Ongoing

management accountant and a list of the corresponding key planning activities.

The Vision and Mission are the cornerstones, the “rocks” of any organization that has been successful over a long period of time. The Vision is an emotion-inducing statement that tells where an organization is or aspires to be and that provides long-term direction. It should be inspirational, passionate, and evoke the organization’s brand in one short, sweet statement. A Vision statement can evolve just as an organization evolves. For example, in its early days, Microsoft’s Vision was “A PC on every desk and in every home.” Today, its Vision is “Your Potential, Our Passion.” The Mission is meant to describe, at a high level, the value the organization delivers to its various stakeholders and how to achieve the organization’s strategic goals.

What role does the management accountant play regarding an organization’s Vision and Mission? The management accountant may have an opportunity to be part of a team to create, validate, or change the Vision and Mission. There’s no magic as to how often the Vision and Mission should be validated by all stakeholders. If an organization is humming along, the Vision and Mission will stand the test of time unless market changes or evolving technology suggest a change. If the organization is puttering along and not satisfying its stakeholders, the strategy—starting with the Vision and Mission—probably needs to be revamped.

The **Environmental Scan** ensures that you are vigilant about looking “outside your own walls” and not becoming too isolated in setting strategic goals. Michael Porter from Harvard University developed a “Five Forces” framework that models an

industry as being influenced by Supplier Power, Buyer Power, Barriers to Entry, Threat of Substitutes, and Degree of Rivalry. Strategic business partners seeking to gain a competitive edge for their organization can use this framework to better understand the industry context. If your organization is planning to introduce a new product, service, or technology, understanding these influencers before proceeding with internal prioritization, resource allocation, and business cases is critical to building market acceptance and financial viability.

As part of the Environmental Scan, management accountants could assess all environmental factors that impact business success within their company, business unit, product line, or department (e.g., a detailed competitive analysis of your new product line vs. a competitor's). Or their role could be more quantitative in nature, such as forecasting their competitors' or industry peer groups' key performance metrics over the multiyear strategic plan (e.g., revenues, expense-to-revenue ratios) to ensure that stretch organizational targets are set relative to their key competitors vs. internal run rates and "what we did last year + x% better." Or they could compare the demographics of their customer or member base against the broader industry to determine gaps and product marketing implications for key market segments (e.g., U.S. vs. international, gender, organization size, etc.). Management accountants should perform the Environmental Scan every three to six months to ensure that external dynamics are reflected in their latest forecasts.

Product/Market Priorities actually involve several steps. First, baseline your current products and services relative to your key targeted market segments. Are

you delivering products, services, and solutions that satisfy the needs and wants of these segments? Is there a gap that could result in a reassessment of your **Strategic Change Portfolio**—the portfolio of strategic initiatives that will require incremental funding over and above the baseline, multiyear financial view? The final step involves rating and ranking the products and services relative to your key market segments to help in allocating resources. As an influential member of cross-functional teams in larger organizations, the management accountant can play a key role in the project prioritization and resource allocation processes. Market research—the voice of the customer—is also critical for effective prioritization.

The Strategic Change Portfolio will drive sustainable growth value for stakeholders. This portfolio generally falls into two categories: (1) "Market Facing," such as new products and services, and (2) "Infrastructure," such as human resources, IS/IT systems, etc. The management accountant can play many important roles here. One is working with his/her team to conceive, develop (via a business case), and deploy (via a project plan) strategic initiatives. Another is providing financial support for the change initiative, including estimating business case revenue and expenses that are incremental or add to the baseline financial trajectory had the action (the change initiative) not taken place. While being strategic and forward looking, first and foremost the management accountant is the financial steward of the Strategic Change Portfolio, the market basket of change initiatives, over and above an organization's baseline or "momentum" trajectory, that will allow the enterprise to achieve its long- and short-run strategic goals. Finally, rigorous

project planning that includes milestone tracking and release of funds relative to the achievement of milestones (“the banker”) is another key role for the management accountant. The Strategic Change Portfolio should be assessed annually when the plan cycle begins and then ideally every six months.

Determining Measures of Success is where the quantitatively minded management accountant (aren’t we all?) can make a real difference in the strategic planning process. This includes setting the broad multiyear strategic goals for the organization. These goals should contain a balanced set of measures, including financial viability, as measured by revenue, expenses, and margin; customer growth, as measured by new customers and customer retention statistics; customer satisfaction, as measured by surveys and market share; and employee development, as measured by staff retention and career development. A traditional role for the management accountant in the annual planning process involves developing a budget that covers the first year of the multiyear strategic plan—but at a lower level of detail (e.g., expense line items by department).

Management accountants also need to help forecast at macro and micro levels via financial modeling. Financial modeling is a critical element of determining key measures of success over the multiyear planning horizon. A macro financial model is often the first step. Here the modeler collects all available internal data (e.g., department spend history) and external benchmarks (e.g., competitor growth rates) and creates a macro financial projection over the planning period. This view may be limited to the key financial and performance indicators consistent with the

strategic goals, such as revenue, operating expense, margin, and customers. It also is used to test the reasonableness of individual product or departmental views relative to expectations of the market and organizational stakeholders (the infamous “rollup”). A micro financial view also may be developed in conjunction with the macro view. This micro financial view would decompose revenue into a price and a quantity/volume component ($P \times Q = R$), for example. The advantage of having a complementary micro model is that, once the piece parts are calibrated to the reported or planned total at the macro level, the model can be used for “what if” and scenario planning purposes during the periodic outlook update process (e.g., quarterly). For example, what’s the financial impact if we raise prices? What’s the financial impact if we improve our customer retention rates based on a new strategic initiative?

Finally, **Developing, Deploying, and Sustaining a Continuous Improvement Process**, or planning for the plan, is truly the “lifeblood” of a strategic plan because it ensures focus on execution, continuity, and intervention if necessary. Developing the multiyear strategic plan and putting it on the bookshelf to collect dust while focusing on the in-year budget only (the one that affects our pay in the short-term mentality that guides American business) could spell doomsday for the long-run viability of your plan. There are improvement opportunities galore in the central planning group or in the individual work units: Setting the master planning calendar of accountabilities and deliverables, developing external competitive benchmarks, developing and communicating robust business cases, and forecasting key performance indicators are just a few examples. The continuous

improvement process is indeed continuous, much like the blood flow in the human body that sustains us all.

Better Practices

Now let's concentrate on some "better" practices.

1. **Treat Planning as a Key Business Process.** Nothing is more important to an organization's long-run viability, sustainability, and value creation for stakeholders than its strategic plan. But a plan without an enabling process is like human blood flow without the arteries and ventricles—the connective tissue, if you will. First, establish the end-to-end process including accountabilities, time frames, and measures of success. Engage everyone at some level in the plan, not just the central planners or the designated planner or planning coordinator in your group. Good governance principles apply to strategic planning just as they do to any other key business process, and establishing the master planning calendar with deliverables and milestones is vital to downstream success of the process—and ultimately the plan. A critical core competency for the management accountant involved in a leadership role in an organization's planning process is project management skills, which are vital if planning is to be implemented effectively as an end-to-end process or system with key milestones, deliverables, and resources to be managed.
2. **Execution with Enablers Means Excellence ("E cubed").** While excellence as defined by achieving strategic goals is never guaranteed, a passion for execution and a set of

enabling tools and processes are critical success factors. Several enablers come to mind:

- (a) a regular process, perhaps as part of operations reviews or results meetings, to review the status of strategic initiatives and goals and to discuss "interventions" as necessary (e.g., reallocate resources, consider new pricing plans, etc.);
- (b) a milestone-tracking process (integrated with most project management software packages) to manage the progress of strategic initiatives, to release business case funds when key milestones are achieved, and to send out "alerts" if milestones are missed or are in danger of being missed (alerts are usually standard fare in business intelligence or business process management software); and
- (c) integration of a true risk-based approach into the strategic planning process.

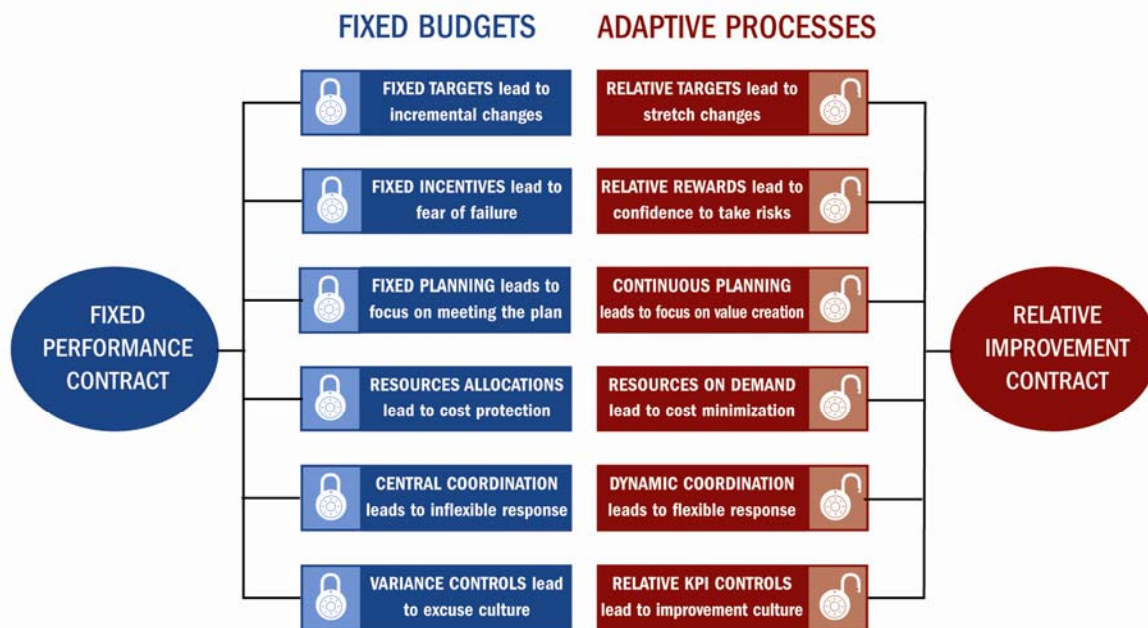
A risk-based approach ensures that the key risks to achieving strategic goals/plan objectives are identified and that interventions are implemented to manage the risk to a level acceptable to all stakeholders. For example, when the Institute of Management Accountants (IMA®) initiated its annual planning cycle, staff responsible for planning participated in a one-day workshop on risk management. My main point is that risk management is a global body of knowledge that contains resources to guide practitioners. (For example, IMA offers two Statements on Management Accounting (SMAs) on Enterprise Risk Management for free on its website at www.imanet.org/publications_statements.)

asp#E.) Risks should be identified holistically and addressed across the enterprise—not just traditional financial risks, but risks such as security, environmental, operational systems, etc.

3. Beyond Budgeting... or just Better Budgeting? Recall the pain points associated with traditional budgeting that I discussed earlier—cycle times that are too long, the process incents gaming vs. stretching for the best possible performance, too much emphasis is placed on internal performance (run rates) vs. external competitive benchmarks, and the (heart) beat goes on! To stretch your thinking, read the book *Beyond Budgeting* by Jeremy Hope and Robin Fraser, or

watch the archived free IMA three-part webinar series focused on planning and budgeting (July-September 2007), which you can find at www.imanet.org/development_webinar_library.asp. The BBRT (Beyond Budgeting Round Table at www.bbrt.org) basically suggests that the budget as we know it should be eliminated because it constitutes a fixed performance contract that doesn't "flex" relative to market conditions, the need for dynamic resources, competitors, etc. See Figure 3 for more detail or the BBRT website as to what BBRT advocates as a replacement for the "fixed performance contract."

Figure 3: Principles of the New Performance Contract



The question is: Do we need to replace budgets as we know them (beyond budgeting) or radically transform the way we have been taught to create them? In any event, there are several better

practices for management accountants involved in budgeting:

- Create the budget only after the broader strategic direction and goals have been set. This generates a context and high-level

“screen” for what can or can’t be included in the more detailed budget.

- Develop rolling outlooks at a reasonable level of detail combined with an aligned incentive scheme. This can “force” thinking beyond the in-year budget whose time horizon naturally shrinks as the fiscal year approaches its year end (a six-quarter rolling outlook, for example, continually forecasts another six quarters ahead for key performance measures such as revenue, margin, etc.).
- Rely at least as much on external benchmarks (metrics like expense to revenue, productivity ratios, etc.) from benchmarking organizations such as The Hackett Group and APQC and vertical industry associations as you do on internal run rates and “what I did last year” plus or minus x%.

4. Predictive and Decision Analytics...

There Is Life Beyond Basic Excel. No, you don’t need to become a Ph.D. statistician, but knowledge of basic statistical tools and techniques for data analysis and forecasting should be part of the management accountant’s toolkit. In Excel, as an add-in option, go to Tools, then Add-Ins, and add in the “Analysis ToolPak.” This gives you access to intermediate statistical functions such as correlation analysis (e.g., the “strength” of the relationship between two variables such as customer growth and advertising over a historical time frame) and regression analysis (life is more sophisticated than the straight-line ruler to forecast historical data such as expenses or

revenues—multiple regression allows you to forecast an “independent” variable such as revenues based on historical relationships with a set of “dependent” or driver variables such as advertising, customers, pricing, volumes, etc.).

Here are three brief examples in which management accountants use predictive technologies and decision analytics (the preferred Google terms) to drive business performance: (a) In an ERM presentation at IMA’s 2nd Annual Global Conference in May 2007 in Dubai, Ananth Rao (professor at the University of Dubai) used intermediate Excel capabilities to have workshop participants create risk-adjusted decision scenarios; (b) in his keynote presentation at IMA’s 88th Annual Conference & Exposition in June 2007 in Phoenix, Ron Riebe (vice president of KeyBank and most recent winner of the IMA/Robert Half Financial Executive of the Year Award) focused on several practical decision analytic capabilities for management accountants who take on positions in pricing, economic analysis, and business forecasting; (c) the article “Sustainable Performance Improvement through Predictive Technologies” in the June 2007 issue of Strategic Finance magazine discusses the emerging body of knowledge called “predictive technologies.” (Contact me for ways to view or read the first two presentations.)

Finally, I suggest you read the 2007 book *Competing on Analytics* by Thomas H. Davenport and Jeanne G. Harris. In short, the book’s premise (based on 30 case studies) is that analytics—forecasting, data mining, statistical analysis of trends, etc.—is truly becoming the “nextgen” competitive differentiator, requiring that organizations create and imbed an entirely

new skill set in their day-to-day activities and planning—yet another opportunity for the management accountant as strategic business partner and influencer in the organization!

5. Communications: Continuous and Comprehensive for all Stakeholders (“C cubed”). Communicating the strategic plan and progress on strategic goal achievement is critical to ensure that all stakeholders are appropriately engaged in executing the plan successfully. Continuous communication ensures that the strategic plan doesn’t collect dust on the bookshelf. Comprehensive communication to all stakeholders—shareholders, investors, customers/members, audit committee, the board of directors, and, of course, ALL employees who have a stake in the success of THEIR strategic plan—is critical.

Two suggestions: Make the communications a bit fun and creative—hold employee meetings and celebrations to kick off the new planning cycle—and be honest and totally transparent with your employees. Don’t supply only “smiley-face” happy news. Show the progress on key goals, highlight successes, but also highlight challenges that require all employees to be engaged. Your employees expect nothing less!

Pumping New Blood

As I hope you’ve been able to see, there are exciting possibilities for management accountants in the areas of strategic planning, budgeting, and forecasting that should pump new blood and life into these processes. These are areas that are forward looking, rely on sound analytics and business judgment, require good communications and business influence skills, and relate directly to creating and sustaining stakeholder value. This is a great opportunity for you as management accountants to advance the profession and drive business performance in your organizations!

Jeffrey C. Thomson was Vice President of research at the Institute of Management Accountants (IMA®) in Montvale, N.J. Jeff has considerable experience leading strategic planning processes at the largest global telecom, in academia, and at IMA. He is now President and CEO of the IMA and can be reached at: jthomson@imanet.org.

REDEFINING MANAGEMENT ACCOUNTING

Promoting the four pillars of our profession

By Peter C. Brewer, CPA

Figure 1: A Management Accounting Framework



Last year I attended a conference where one of the speakers discussed some of his concerns about the management accounting profession. To highlight one of his apprehensions, he shared with the audience a quote from a high-ranking officer in a management accounting professional organization (not IMA) who claimed that the foundation of management accounting was Generally Accepted Accounting Principles (GAAP). As I read this quote on the speaker's PowerPoint slide, I shared his frustration that a highly visible person within our profession had such a misguided view of what management accountants do. The speaker then asked the audience if they agreed with the quote, and, to my

surprise, at least one attendee nodded "yes." When the speaker asked why this member of the audience agreed with the quote, the attendee replied that, after all is said and done, "A debit is still a debit." While I can't refute the truism that a debit is still a debit, I believe that the financial accounting-oriented mentality underlying the audience member's quote needs to be refuted. It shows that many people still don't understand the value-added role that management accountants play (or should play) within organizations.

Financial reporting standards, auditing standards, tax laws, and Sarbanes-Oxley (SOX) legislation play a vital role in ensuring that organizations remain

accountable to their stakeholders. Indeed, many management accountants who are members of the Institute of Management Accountants (IMA®) have expertise in these facets of the accounting profession that has enabled them to advance their careers and add value to their organizations. Yet we need to overtly recognize that rules-based, compliance-oriented activities aren't the focal point of the management accounting profession. Management accounting is first and foremost about managing internal operations to optimize organizational performance.

In doing my part to help advance our profession, I'm introducing a new management accounting framework that describes the full spectrum of skills that should be espoused by management accounting leaders in organizations and management accounting professors in the classroom. The framework moves beyond the rules-based languages of accounting to properly emphasize the management orientation of management accounting. It also expands traditional definitions of management accounting by introducing more inclusive terminology than the widely accepted adjectives of planning, control, and decision making. While these concepts are vitally important to management accounting, they don't adequately capture the breadth of skills needed to build a successful career within our profession. For example, traditional definitions of management accounting largely overlook leadership skills and business partnering skills—two critically important aspects of building a successful management accounting career. We need a new definition of management accounting that better captures the richness of what management accountants stand for and what they do.

A NEW FRAMEWORK

Figure 1 summarizes this new management accounting framework that suggests the ultimate responsibility of management accountants is adding stakeholder value. This definition moves us away from narrow terms like planning and control and toward a more encompassing vision of management accountants as key influencers in an organization's efforts to satisfy stakeholder expectations. The framework also depicts how management accountants add stakeholder value—by providing leadership, by supporting a company's strategic management efforts, by creating operational alignment throughout an organization, and by facilitating continuous learning and improvement.

The remainder of the article serves two purposes. First, it elaborates on the meaning of the four management accounting pillars depicted in Figure 1. Second, it encourages you to consider the 25 questions in Tables 1-4. These four sets of questions (each based on a pillar of the management accounting framework) enable management accounting practitioners and professors to help assess the extent to which they are embracing the full spectrum of management accounting competencies. If you find yourself repeatedly providing unsatisfactory answers to these questions, it suggests two possible concerns. First, perhaps you're spending too much time performing or teaching financial accounting. Second, perhaps you need to expand your definition of management accounting beyond traditional planning, control, and decision making to include leadership, business partnering skills, and other competencies.

LEADERSHIP

While effective leadership undoubtedly emanates from the C-suite, large and small

**Table 1: Leadership Questionnaire****MANAGEMENT ACCOUNTING PRACTITIONERS**

- 1.** How much thought do you invest in defining all of your key stakeholders and identifying ways to improve communications with them to better serve their needs?
- 2.** How much time do you invest in building your communication skills so that you can function effectively when working with diverse business partners? Do you model effective communication for your employees?
- 3.** How much thought have you given to honing your leadership style to ensure that you are providing optimal motivation for your employees to achieve their full potential?
- 4.** How much time do you invest in shaping your company's organizational integrity? Do you train your employees to handle the pressurized situations that can motivate ethical people to make unethical decisions?
- 5.** How much thought do you invest in succession planning? How would you replace key people within your department if they left the company?
- 6.** Do you struggle to communicate with coworkers who reside in a foreign country? Have you assumed a leadership role by taking steps to better understand how to eliminate the root causes of cross-cultural miscommunication?

MANAGEMENT ACCOUNTING PROFESSORS

- 1.** Do you teach stakeholder theory? What are you doing to help students contemplate the purpose of a corporation? (A person's viewpoint on these concepts can dramatically impact the decision-making process.)
- 2.** Do you teach your students how to work and communicate productively with others in the workplace to make effective decisions, to implement those decisions, and to manage resistance to those decisions?
- 3.** How often do you use the word "leadership" in your classes? What are you doing to help students understand that accounting is a leadership-oriented career path?
- 4.** Do you teach the impact of situational pressures on making ethical decisions? Are you helping your students understand why ethical people often make unethical decisions?
- 5.** Do you teach your students about organizational boundary systems such as codes of conduct and whistle-blowing policies?
- 6.** How much time do you spend improving your students' ability to productively communicate with geographically dispersed and culturally diverse coworkers?

decentralized organizations need additional leadership voices to reinforce key messages. As shown in Figure 1, management accountants provide leadership voices that help create shared beliefs, shared boundaries, effective decision-making processes, and effective change management processes. (The concept of belief systems and boundary systems was created by Robert Simons in his 1994 book *Levers of Control: How Managers Use Innovative Control Systems to Drive Strategic Renewal*.) Infusing an organization with shared beliefs includes reinforcing the company's mission, ethical tone, and attitude toward its employees. Is

the company's mission solely to maximize shareholder wealth, or are there other stakeholders who need to be taken into consideration? What are the ethical values espoused by the organization? Is the commitment to these values made with sincere words backed by deeds, or does it consist only of superficial sound bites? Are employees viewed as intellectual assets to be cultivated or as expenses to be minimized? Management accounting leaders need to help shape and communicate answers to these types of questions. They also need to communicate and rigorously abide by shared boundary systems such as corporate codes of

conduct and whistle-blowing policies that clearly define unacceptable behavior.

Two other key elements of the leadership pillar are understanding how to establish effective decision-making processes and how to enable organizational change and innovation. Rather than focusing exclusively on crunching numbers, management accounting leaders need to effectively manage the behavioral interactions of culturally diverse human beings who ultimately shape decision outcomes. Similarly, they need to be able to effectively manage the organizational resistance that often emerges in response to organization-wide change initiatives such as enterprise system implementations, activity-based costing (ABC) systems, balanced scorecards, or Lean accounting systems. In short, quantitative analysis is less than half the battle when it comes to influencing coworkers' attitudes toward change and effectively implementing new initiatives that serve the greater good of the company. Table 1 summarizes six questions that will help practitioners and professors assess the extent to which they are embracing the leadership aspects of management accounting careers. Management accounting is a leadership-oriented career path, and we need to start recognizing this fact when defining and promoting our profession.

STRATEGIC MANAGEMENT

The second pillar of the framework relates to how management accountants aid an organization's strategic management efforts. As shown in Figure 1, there are four aspects to this portion of the framework: formulating and communicating strategy, identifying and managing enterprise risks, developing measurement systems that assess organizational performance, and analyzing decision alternatives.

To effectively support a company's strategic management efforts, management accountants need to be able to create strategies that provide sustainable sources of competitive advantage and to manage the enterprise risks that threaten the attainment of strategic objectives. Too often we incorrectly assume that enterprise risk management and financial reporting risk management are synonymous. This assumption is one of many examples of how we artificially bind ourselves with the ties of financial accounting. We management accountants need to understand the dynamics of our industry and our company's operations so that we can intelligently assess the strategic, operational, internal reporting, and compliance risks associated with particular courses of action.

Management accountants also need to use strategic measurement systems to aid organizations in assessing performance on three levels: enterprise performance, interorganizational performance, and benchmark performance. Our profession has relied too heavily on short-run financial metrics to assess performance. We need to complement these types of admittedly important measures with nonfinancial, process-oriented performance measures as well as stakeholder-based measures of environmental and social performance, interorganizational performance measures that motivate supply chain partners to work in harmony with one another, and benchmark measures that evaluate performance relative to key competitors or world-class standards.

Finally, as Figure 1 shows, management accountants use strategic measurement systems to analyze decision alternatives. These alternatives come in three forms: customer-related decisions, product-/service-related decisions, and process-related decisions. Decision analysis is

**Table 2: Strategic Management Questionnaire****MANAGEMENT ACCOUNTING PRACTITIONERS**

- 1.** Do you discourage using the output from your company's traditional standard costing system to quantify product costs for internal decision-making purposes? How often do you preach "different costs for different purposes" to your employees?
- 2.** How often do you evaluate decisions from a revenue growth perspective rather than from a cost reduction perspective?
- 3.** How skilled are you at incorporating uncertainties and probabilities into your quantitative analyses?
- 4.** How much time do you invest in building your employees' strategy and enterprise risk management skills? Do you emphasize that risk management entails more than controlling financial reporting risk?
- 5.** Do you have a performance measurement dashboard that emphasizes nonfinancial business process performance, or are your key performance measures primarily financial and departmental in nature?
- 6.** To what extent do you evaluate performance from an interorganizational value chain perspective?
- 7.** Do you formally compare your company's performance against external world-class benchmarks? Do you invest time in gathering competitor intelligence?
- 8.** How much time are you investing in building your employees' business analytics skills so that they can derive useful insights from diverse data sources?

MANAGEMENT ACCOUNTING PROFESSORS

- 1.** When you teach job-order costing, do you highlight the fact that the product costing vs. period costing distinction that's required for financial reporting purposes is meaningless for internal decision making?
- 2.** How much time do you spend discussing the concept of revenue drivers as opposed to cost drivers? When teaching pricing, do you only cover cost-plus approaches while overlooking value-based pricing strategies such as "economic value to the customer"?
- 3.** How much time do you spend teaching students to create quantitative analyses that incorporate the uncertainties surrounding cost and revenue projections?
- 4.** How much time do you spend helping students understand the importance of developing strategy-driven, risk-based performance measures and of assessing the risks and responses associated with various decision scenarios?
- 5.** How much time do you spend teaching qualitative topics such as the balanced scorecard as opposed to quantitative topics such as ROI and residual income?
- 6.** How much time do you commit to teaching interorganizational performance measurement and optimization?
- 7.** How much time do you spend teaching performance benchmarking and competitor intelligence?
- 8.** How much time do you spend teaching corporate social responsibility performance measurement?

another area where management accountants too often rely on data produced by the financial reporting system. For example, it's indefensible to measure product profitability using job costs produced by a standard cost system. Not only is the volume-based overhead allocation likely to be distorted, but the product vs. period cost distinction embedded in the job cost computation to

facilitate external reporting is meaningless for internal decision-making purposes. Too often we lose sight of the fundamental management accounting concept of "different costs for different purposes." Furthermore, we spend too much time focusing on cost reduction and not enough time on revenue growth. If management accountants want to be the voice of clarity that transforms data into the valuable insights that drive decision

making, then we need to recognize that strategic decision analysis is broader in scope than cost analysis.

Table 2 summarizes eight questions that help practitioners and professors assess the extent to which they are fully embracing the strategic management aspects of management accounting careers. These questions highlight the fact that there are numerous ways that we can expand our efforts to add value as strategic managers.

OPERATIONAL ALIGNMENT

The third pillar of the framework is operational alignment systems, which decentralized organizations use to create and execute short-run (e.g., annual, quarterly, monthly, weekly, or daily) plans that support strategic objectives. As Figure 1 shows, management accountants use operational alignment systems for four main purposes: planning for the future, communicating vertically, coordinating horizontally, and evaluating and rewarding employees.

With respect to planning, management accountants tend to focus too much attention on “rolling up the budget numbers” rather than on using knowledge of business strategy coupled with rigorous data analysis to accurately forecast future sales and expenses and to allocate resources across business units in a manner that drives optimal performance. We also pay minimal attention to management tactics, such as finished goods postponement, that organizations use to respond to the inevitability of forecasting errors. We need to understand these types of concepts so that we can work with nonaccountants to minimize the financial impact of stockouts, markdowns, inventory carrying costs, and inventory obsolescence/spoilage costs. We also need to cast a critical eye on the

budgeting process in general rather than accepting the inevitable “budgeting time sink” as a given. For example, some companies have replaced budgets with rolling forecasts of financial and nonfinancial data.

Operational alignment systems also are used to formalize vertical communication channels from business units to headquarters and to coordinate operations horizontally across an organization. Management accountants tend to overrely on functionally organized responsibility accounting systems that report financial measures (such as return on investment (ROI) and manufacturing cost variances) as by-products of the monthly closing process. This financial accounting orientation causes us to lose sight of two ways we management accountants can help enable organizational alignment. First, we need to focus on cascading a balanced set of financial and nonfinancial process-oriented measures down through an organization. It’s important for these measures to span functional boundaries. Second, we need to redefine our role as enabling rather than monitoring. Our goal should be to empower teams of employees throughout an organization to assume ownership of their results by providing them with transparent (e.g., understandable, timely, concise, and easily analyzed) feedback.

Finally, operational alignment systems are used to evaluate and reward employees. Our natural inclination in this area is to view individual employees as requiring a “kick in the pants” to do the right thing for the greater good. Given this mind-set, we preoccupy ourselves with attempting to extrinsically motivate employees using financial rewards and with attempting to win the ubiquitous “budgeting gamesmanship” battles. But we need to counterbalance these inclinations with an

**Table 3: Operational Alignment Questionnaire****MANAGEMENT ACCOUNTING PRACTITIONERS**

- 1.** How much time do your people commit to the annual budgeting process? What percentage of this time is value added vs. nonvalue added? How can you improve the budgeting process to make it more efficient and effective?
- 2.** Do you calculate variances periodically? Do your business partners outside the finance function find this information timely and useful or burdensome?
- 3.** Is your mind-set one of monitoring performance or empowering performance?
- 4.** To what extent are the reports generated by your department aligned with the processes that deliver products and services to customers? How much effort do you expend creating measures that show all employees how their efforts drive the attainment of strategic objectives?
- 5.** To what extent do you work with nonaccounting coworkers to reduce forecasting errors and their adverse consequences? In other words, are you moving beyond the goal of simply tabulating numbers toward the goal of participating in managing the business?
- 6.** Do you contemplate and manage the risks associated with the employee performance evaluation and reward system used at your company? In other words, do you proactively manage the dysfunctional behaviors that may arise due to the reward system?

MANAGEMENT ACCOUNTING PROFESSORS

- 1.** Is your coverage of operational budgeting focused on scheduling out cash collections and cash disbursements while overlooking the backbone of budgeting, which is projecting sales and costs using tools such as regression analysis?
- 2.** How much time do you spend covering variance analysis? Conversely, how much time do you invest covering Lean thinking and Lean accounting concepts such as empowering coworkers by providing them with access to data that is understandable, timely, and useful?
- 3.** How much time do you spend on an agency-theory-based view of employees and extrinsic motivators? Conversely, how much time do you spend discussing the role management accountants can play in building intrinsic commitment with coworkers outside the finance function?
- 4.** How much coverage do you provide related to discussing how to improve vertical communication and strategic alignment by cascading a balanced scorecard throughout an organization?
- 5.** How much time do you invest in discussing methods, such as finished goods postponement, that companies use to minimize the risks associated with forecasting errors?
- 6.** How much time do you invest in covering the inevitable gamesmanship that ensues from using budgets for multiple purposes? How much time do you commit to covering emerging alternatives to traditional budgeting?

appreciation for intrinsic motivation, nonfinancial rewards, team-based reward systems, and the concept of decoupling budgets from employee reward systems.

Table 3 summarizes six questions that help practitioners and professors assess the extent to which they are truly embracing the role management accountants can play in creating customer-focused operational alignment.

These questions highlight the limitations of attempting to use a financial reporting system and a functional organizational chart to align organizational resources around the business processes that deliver customer value.

CONTINUOUS LEARNING AND IMPROVEMENT

The final pillar of the management accounting framework suggests that



Table 4: Continuous Learning and Improvement Questionnaire

MANAGEMENT ACCOUNTING PRACTITIONERS

1. Does your department have a training program in place that ensures employees continuously learn key management accounting competencies? Do you understand how to be an effective learner in a business context?
2. How many employees in your department are Six Sigma certified?
3. How much time have you invested in using value stream mapping to streamline compliance-oriented accounting processes?
4. How much time do your employees spend outside the physical confines of the accounting department learning about business operations? How many cross-functional process improvement teams have you participated on lately?
5. What percentage of your time is spent engaged in financial reporting activities vs. time engaged in supporting internal business management?

MANAGEMENT ACCOUNTING PROFESSORS

1. How much time do you spend discussing effective individual and organizational learning strategies as well as the individual and organizational impediments to the learning process?
2. How much time do you spend teaching process improvement methodologies, such as Six Sigma? Do you discuss the application of these methodologies to the finance function?
3. How much time do you spend teaching students how to analyze a business process so that they can identify bottlenecks, suggest ways to elevate constraints, and quantify lead times and cycle times?
4. How often do you use the term “business partnering” in your classes to emphasize the importance of accountants collaborating with nonaccountants to improve the business?
5. How much time do you spend demonstrating how process analysis tools are applicable to nonmanufacturing contexts?

management accountants should facilitate continuous learning and improvement via a four-step process. First, we need to pursue and advocate continuous individual and organizational learning. Second, we need to acquire process improvement skills such as those espoused by the Six Sigma methodology. Third, we need to cast a critical eye on the finance function in search of opportunities to reduce waste and to better serve internal customer needs. The goal should be to automate or (if possible) eliminate transactions and to streamline compliance duties, such as SOX Section 404 compliance. Eliminating waste in the finance function creates more free time for management accountants to help grow the business and add stakeholder value.

The fourth step in this process is partnering to improve operations. Management accountants need to appreciate the value of leaving the safe physical confines of the finance department and the safe linguistic confines of debits, credits, variances, and the like to understand the operational process flows and terminology that drive the business. Obtaining process knowledge enables us to collaborate with our nonaccounting business partners in a continuous effort to improve operations. Embracing this four-step continuous learning and improvement process helps management accountants view an organization from a dynamic, process-oriented standpoint rather than from a stagnant, functionally oriented point of view.

Table 4 summarizes five questions that help practitioners and professors assess the extent to which they recognize the role of management accountants in aiding an organization's continuous learning and improvement efforts. These questions highlight the fact that management accountants need to be problem solvers who understand business operations and who can dialogue and work productively with nonaccountants.

CHAMPION THE CAUSE

I hope I've motivated you to become a champion for management accounting. To become a champion, you need to buy in to two principles. First, management accounting isn't primarily a compliance-oriented profession. It's a profession that focuses first and foremost on internal management and enterprise optimization. Second, traditional definitions of management accounting are too narrow. The management accounting "brand" needs to explicitly include the concepts of leadership, business partnering, and continuous learning and improvement.

I ask my colleagues in academia to consider this: Medical research has shown that the first three years of a human

being's life dramatically influence his or her future. Indeed, we have all probably seen or heard about how young children can learn a second language so easily, yet most adults struggle with acquiring a second language. Similarly, the first three years of an accountant's life take place on a college campus. The way we educate our undergraduate students and the languages that we teach them dramatically influence how they will see the accounting profession as their careers evolve. If we confine our curriculum to the rules-based language of compliance while largely overlooking the language of management accounting, the challenges inherent in second-language acquisition suggest that, as our students leave campus and begin to mature professionally, most of them won't become management accounting champions. Therefore, let's make sure our accounting graduates begin their careers conversant not only in the undeniably important compliance-oriented languages, but also in the languages of leadership, strategic management, operational alignment, and continuous learning and improvement that will also be essential to their long-term career success.

Peter C. Brewer, Ph.D., CPA, is a professor in the Department of Accountancy at Miami University in Oxford, Ohio. You can reach him at brewerpc@muohio.edu.

IGNORE STRATEGIC RISK AT YOUR PERIL

Companies that disregard strategic risk are gambling with their long-term survival, says Gillian Lees, Governance Specialist at CIMA. She explains how the CIMA Strategic Scorecard™ can help boards efficiently manage strategic risk

By Gillian Lees

If organisations wish to ensure their long-term survival, not to mention success, they need to understand and manage strategic risk. And although many organisations have made considerable progress in addressing operational and financial risks in recent years, few have tackled strategic risks.

Evidence suggests that strategic risks have a much greater impact on shareholder value than operational or financial risks – sometimes resulting in the complete destruction of the organisation.

Not only this, but the increasing pace of change, coupled with globalisation, means that strategic risks are becoming a serious challenge for all organisations. In ‘Countering the biggest risk of all’, published in the Harvard Business Review in April 2005, Adrian Slywotzky and John Drzik point out that over the last 20 years the number of stocks receiving a high-quality rating by Standard & Poor’s has fallen dramatically. They also show that between 1993 and 2003 more than one third of Fortune 1,000 companies lost at least 60% of their value in a single year.

However, organisations, and in particular, their boards, can now address strategic risks by using the CIMA Strategic

Scorecard. This is a tool that CIMA has developed to help boards from organisations of all sizes and across all sectors to engage in strategy effectively rather than getting bogged down in detail and/or compliance issues.

Tackling complex risk

In general, a strategic risk can be defined as any occurrence that would prevent the organisation from achieving its goals. It can be difficult to identify such risks, as they can come from any direction at any time (see Table 1). It can be difficult to categorise these risks because they tend to be multifaceted, resulting from a combination of circumstances and events.

Difficult as it can be to identify strategic risks, this is actually the easiest part of the process. It is tempting to believe that once such risks have been identified, assessed and listed on the risk register, the job is done. But in fact, it is only the start.

The real challenge is for boards to discuss strategic risk as an integral part of their overall discussions on strategy on an ongoing basis. So, for example, no major initiative, such as a merger or acquisition, could be pursued without proper consideration of the strategic risks arising from such a proposal.

IGNORE STRATEGIC RISK AT YOUR PERIL

Strategic risk categories	Examples
Industry shifts	The deregulation of airlines, combined with the availability of the internet, has affected the viability of tour operators and travel agents.
Technological changes	The shift towards digital photography and music downloading has impacted the business models of music and camera companies.
Customer changes	The polarisation of the clothing market between designer clothing (driven by celebrity culture) and discount brands has left the middle market exposed.
Project failures	• M&A • Failed product or service launches; for example, the Marks & Spencer home furnishings store in Gateshead
Competitors	Witness Tesco's relentless march into non-food lines, such as mobile phones, books and CDs.
Loss of reputation	The recent controversy over premium-rate phone competitions harmed one of the BBC's most cherished brands – the children's programme Blue Peter.

Table 1. Risk can come from unexpected developments, negatively affecting strategy.

Strategic position	Strategic options
List all the key issues, such as: • competitor activity • legislative developments • core competencies.	List all the options, including: • divestment of major business • outsourcing major processes • development of major new service offering • development of alternative delivery channel.
Strategic implementation	Strategic risks
List all key actions: • introduction of new product • integration of recent acquisition • major reorganisation of business units.	List all major process issues and strategic risks: • risk appetite • risk management capabilities • risk management policies • strategic risks.

Strategic boards lead the way

A strategically minded board that engages effectively with management can make a significant contribution to long-term success. The challenge for management is to leverage the combined skills and experience of the board in an effective and efficient way.

However, this is easier said than done. Boards can struggle to make effective contributions to strategic development due to:

Lack of time and crowded agendas. In recent years, boards have been obliged to devote considerable time and effort to compliance issues. Not surprisingly, some commentators have argued that the pendulum has swung too far and the importance of strategy and entrepreneurial leadership needs to be reasserted. Moreover, boards typically include a significant proportion of non-executive directors whose involvement is part time, making it difficult for them to obtain a deep enough understanding of the business to make a meaningful contribution.

Greater complexity of business combined with information overload. This makes the job of the director even more challenging. Information that is poorly presented or presented in different formats at each meeting is difficult for board members to digest properly.

Lack of robust processes at board level for dealing with strategy. This is in contrast to other issues for which the board is responsible, such as audit and remuneration where there are dedicated committees established to handle those particular issues.

If boards are to deal with strategic risks as an integral part of strategy, then a useful

first step is to ensure that there is a robust board process in place. One possible tool is the CIMA Strategic Scorecard.

A structured approach

The CIMA Strategic Scorecard is designed to help boards contribute to and oversee strategy effectively. Flexibility is provided by the fact that the scorecard is an overarching strategic framework within which a wide range of strategic tools and techniques can be used. The framework can also be adapted to meet an organisation's particular needs.

The scorecard pinpoints the key aspects of strategy so that the board can focus on what really matters and ask constructive and challenging questions. It is unique in bringing all this information together into an integrated whole. This means:

- summarising key aspects of the strategic position to ensure that the board is aware of changing economic and other factors
- identifying the major strategic options that could have a material impact on the strategic direction of the organisation and helping the board to determine which should be implemented
- charting the significant steps or milestones in relation to the chosen strategic plans to be implemented in the coming period and then tracking performance against these
- highlighting the strategic risks facing the board and moving these into manageable opportunities or mitigation plans.

The scorecard ensures that strategy is discussed at board level on a regular basis and provides assurance of the organisation's strategic position and

progress. It also helps the board deal with strategic choice, transformational change and their associated risks. In short, the board is able to engage in the strategic process in a meaningful way. As one board member who has been involved in a

it to the board. In other words, it acts as a useful prompt to iron out all the glitches.

Because the quality of the information presented to the board is improved, the level and quality of the discussion on strategy is enhanced. The scorecard

The four dimensions of the scorecard

1. Strategic position

This dimension focuses on the information required to assess the organisation's current and future position. It covers externally focused information, such as economic, political and regulatory developments, market share and internal issues, such as competencies and resources. The board would review the information and consider its implications.

2. Strategic options

The focus now shifts towards decision-making. Strategic options can be defined as those with the greatest potential for creating or destroying stakeholder value. Typically, there would be no more than four or five under consideration at any one time. The board would discuss a range of options and decide which should be developed into formal business plans.

3. Strategic implementation

At this point, the emphasis is on identifying milestones and monitoring strategy implementation. Decisions may be required if things are not proceeding as planned. It is important that the board does not get too immersed in the details. The board can really add value by generating strategic options and understanding strategic risks. It is important that all the work undertaken here supports the successful delivery of the strategy, as the best analysis and ideas will count for nothing if the strategy is not well executed.

4. Strategic risks

This dimension underpins the others by focusing specifically on the strategic risks that pose the greatest threat to the organisation's strategy. Other issues that need to be tackled here include determining the organisation's risk appetite and implementing effective risk management policies and processes.

Table 2. The CIMA Strategic Scorecard™ highlights the key strategic issues.

trial of the scorecard told us: 'We have discussed more strategy than we ever have before at a board meetings and we have made more decisions.'

While the scorecard was designed as a tool for board-level use, management can also benefit from using it. In particular, the discipline of preparing and updating the scorecard helps management focus on the key strategic issues. In addition, it helps the management team discuss and refine its proposals on strategy before presenting

improves relations between the board and management, which can lead to better governance and performance. For example, one executive director says: 'We have had a great discussion with the board and I feel that they are totally supportive of our strategy. This process has brought us closer together.' Put simply, engaging the board at a number of levels leads to better discussion and makes risks easier to handle. (See Table 2 for an overview of the scorecard's four dimensions.)

The scorecard in practice

When presented to the board, the scorecard is set out in the form of four tables, with relevant headings for each dimension. These can be modified to suit the individual organisation and prompt management to describe the activity in question, including when the last information was put to the board and when new information will be presented in future.

The board then determines which issues and activities are to be included. This enables it to ask challenging questions and decide whether action needs to be taken and/or whether it needs to explore a specific issue in more depth – perhaps by referring to the supporting analysis that management will have used to undertake the detailed strategic planning and management. So in effect, each dimension is supported by a variety of tools and techniques, and organisations can pick and choose what works best for them.

An additional item is a simple summary of all the issues covered in each dimension. This may sound basic, but it provides a snapshot of all the major issues and challenges facing the organisation, which is very useful to incoming non-executive directors who need to understand the business very quickly (see Table 2).

The full scorecard would be presented to the board on a quarterly or biannual basis, although specific components may be reviewed more frequently. For example, a particular strategic option may be considered at a number of meetings until specific actions are agreed. The guiding principle is that strategy needs to be included on the board agenda at a frequency and level that will keep pace with change and support delivery.

The strategic risk dimension in detail

The CIMA Strategic Scorecard provides a useful framework for integrating strategic risk into the overall context of strategy, ensuring that strategy is dealt with effectively.

There are three key components to strategic risk management.

Risk appetite. This covers an organisation's propensity to take risk. Every organisation has a risk appetite, regardless of whether it is aware of it or not. Determining the risk appetite is a key strategic task, as it provides an overall context for the strategy.

Strategic risks and opportunities. This includes the nature of the risks and opportunities facing the organisation, the likelihood of their occurrence and potential for exploitation, and the organisation's ability to manage risks. To a large extent, these need to be considered in respect of each of the other three dimensions, but the strategic risk dimension provides a useful check and balance to ensure that this is actually happening.

Process issues. This includes risk monitoring processes, risk identification and prioritisation, how risks are actually managed within the organisation, training issues, stress testing and whether any risks are currently materialising.

The strategic risk dimension could be regarded as encompassing or driving the other three dimensions, for example:

- a major motor company has considered repositioning the strategic risk dimension so that it is the first to be considered in the sequence
- an alternative approach, suggested by a major media company, is to view the strategic risks dimension as the

‘strategy for risk’ and add what it has termed the ‘risk wrapper’ to the entire scorecard with suggested interventions for each of the dimensions. This makes for a powerful and integrated strategic risk management tool.

What really matters is that the board spends adequate time on all three components of strategic risk and that risk management is fully embedded in the overall strategy. Best practice is intelligent risk taking combined with formalised risk management.

In terms of preparing the strategic risks table of the CIMA Strategic Scorecard, management has to decide which process issues need to be included. Risk appetite should certainly be included, but it may also be useful to include management capabilities, policies and methodologies. The strategic risks themselves also need to be covered; although many will have been identified in each of the other three dimensions, the board will need assurance that this has indeed been done and that these risks are being managed effectively.

There may be other general risks that do not relate to specific strategies, but would still affect the organisation’s ability to achieve its strategy. These can be picked up here as well and perhaps delegated to operational management, reserving the strategic considerations for the board as part of the scorecard process.

At this point, the board has the opportunity to review the structure and content of this part of the scorecard. As part of its discussion, it could consider the following.

- Have we determined the risk appetite?
- Are there any gaps in risk management capabilities and how do we close them?
- Have all the risks been identified in relation to the actual (strategic implementation) and potential strategy (strategic position/options)? Are the proposed risk responses appropriate?
- Have any of the identified risks materialised? What is actually being done and is this response effective?
- What is the organisation’s risk

CIMA Strategic Scorecard: just another initiative?

CIMA’s experience shows that the process of pulling together and using a scorecard is not unduly onerous when it ties in with an organisation’s existing planning schedules. More often than not, the process consists of gathering information that already exists. This helps identify gaps in knowledge and analysis, as it shows all the key strategic information. Once the scorecard is up and running, boards quickly start to see benefits in terms of better use of their time, and it is easy to keep the scorecard updated.



management framework? Is it fit for purpose?

Basically, the scorecard facilitates board discussion by providing a simple framework. In this way, strategic risk can be embedded in the overall discussion on strategy and becomes a regular feature of the board agenda.

Current developments

Since boards need to take sufficient time to deal with strategic risk and best practice is intelligent risk taking with formalised risk management, a vital question is how the scorecard can support the integration of strategic risk into overall strategic development.

CIMA is undertaking trials with a number of organisations and gathering insights from others that have adopted scorecard principles. The results will be published at a later date.

It is essential for boards to take an active role in strategy development and strategic risk mitigation to safeguard the survival and success of their companies. Focusing on such issues in a structured manner is also an efficient way for boards and management to gain an overview of their total strategic plans and work together towards implementation. No company can afford to ignore the risks that could obstruct its long-term goals.

This article is based on CIMA's recent executive report, The CIMA Strategic Scorecard™ – boards engaging in strategy, which can be downloaded from www.cimaglobal.com/strategicscorecard. A separate executive summary is also available.

Gillian Lees, MA is a Governance Specialist within the Technical Department of CIMA. She has been working on corporate governance issues for nearly ten years and has been a key player in the CIMA/IFAC Enterprise Governance project. See www.ifac.org/paib.

She co-wrote Corporate Governance – History, Practice and Future, which was published by CIMA in 2000, and has contributed to various publications, including Financial Management, Corporate Governance International and the Financial Times. She has a background in the City, having worked for NatWest Bank and the Bank of England.

THE PITFALLS OF PAY-FOR-PERFORMANCE

Pay-for-performance (PFP) is often seen as a virtually guaranteed means of achieving employee alignment and motivation and hence superior business performance. But, as Wim Van der Stede points out, PFP has its own potential pitfalls unless handled with care.

by Wim Van Der Stede

PFP is an incentive scheme in which employees receive extra, performance-dependent compensation for their work if they reach certain performance targets. The most common form of PFP incentive awards are cash bonuses. Nearly all firms above minimal size provide some form of PFP to some employees, at least to management level and above. But PFP schemes are also provided at non-management levels and are becoming increasingly popular in the non-profit sector, such as healthcare, where personnel are being rewarded for meeting healthcare service delivery targets.

There are, of course, many benefits from PFP for both the business and the employee. The former gains, presumably, from improved employee alignment and motivation (more of this, later). But PFP also makes compensation more variable with business performance, allowing the business to pay higher compensation only when it can best afford it while reducing compensation expenses when performance is poor. The incentive payments are not entitlements and they are not annuities: they are one-time payments based on performance. Employees appreciate the extra cash, when they meet their performance goals. What's more, employees often feel that their efforts are rewarded more fairly as they are paid for performance rather than

for 'pulse' (ie for just being there) or for seniority. Indeed, the primary rationale for pay-for-performance is to differentiate pay: to provide higher rewards for employees who make the largest contributions. By better recognising employee contributions, firms can more effectively encourage outstanding performance.

PFP - what is there not to like?

So what is there not to like about driving employees to work harder by offering them money for achieving certain performance targets? To answer this question, let us examine the key thrust of PFP: stimulus. Stimulus has two elements, namely:

1. *informational* - the PFP rewards attract employees' attention and inform or remind them of the importance of the rewarded performance. Merely telling employees that customer service, for example, is important might have some effect on their behaviours. But including customer service measures in annual bonus plans is more likely to convince them to emphasise customer service. The rewards signal the performance areas that are important and help employees decide how to direct their efforts. Because money is almost universally valued, monetary

awards are highly effective in directing employees' attention; and

2. *motivational* - some employees need incentives to exert the extra effort required to perform tasks well: ie to work hard, do a good job, and succeed. Sometimes even hardworking employees need incentives to overcome their natural aversion to some difficult or tedious actions that are in their organisation's best interest, such as working cooperatively with other divisions to resolve customer complaints, making cold sales calls to get more business, preparing paperwork, or training employees.

For the above two reasons, one of the most widely-held beliefs about human behaviour in organisations is that monetary incentives are the most powerful drivers of performance.

Distorted performance in multifaceted jobs

However, providing informational and motivational stimuli by connecting pay to performance may be trickier than it appears. This is so primarily because most jobs that employees perform in today's economy are multi-faceted, consisting of many desired activities which compete for the job holder's time and attention. A good example of such multitasking, as this is often called, is delivering current performance at the same time as developing new business. In addition to the challenge of that dual goal there is a further complicating factor: delivering current performance is relatively easily measured in, say, accounting terms, whereas developing new business is much harder to define, less certain, slower to emerge and harder to measure by any

readily-available performance measures, accounting or other.

Given that this measurement complication is likely to lead firms to emphasise the more-easily measurable task by including it in the incentive system, the result is that the PFP system is likely to induce the employees to focus a disproportionate amount of their attention to delivering current performance at the expense of, in this example, developing new business. This is, ironically, testimony that PFP works - employees respond to what is signalled by the incentive system as being important (the informational stimulus) and what they are rewarded for (the motivational stimulus). But it comes at the expense of devoting less attention to important-yet-under/unrewarded activities that are just as critical, sometimes even more critical, for success.

Weak incentives may be best

Therefore, when multitasking is desired – which arguably is the case for most jobs in today's developed economies – it may be best to provide relatively weak incentives for any of the desired dimensions of performance. Although this advice perhaps seems paradoxical, this is so because PFP systems that are not well-calibrated across all the important dimensions of a job will distort the effort allocation of employees because improving incentives for one task may worsen those for other tasks leading employees to overemphasise the better compensated activity and undersupply the other.

There is an abundance of examples illustrating this point, but consider the following one*. City officials wanted to tackle overtime in a garbage collection service. To motivate the garbage collectors to finish early, they were offered an incentive scheme where they

would be paid full time even if they reported back early. And it worked! Garbage collectors came back consistently early and received full pay for the shift, which was apparently an attractive deal for them. But despite this good effect, there was also an increase in preventable traffic accidents, missed pickups of garbage, and trucks filled over the legal weight limit. By emphasising time in the incentive scheme, time is what they got or, rather, rushed time - at the expense of safety, service, and obeying work rules.

I particularly like the above example because garbage collection is not exactly what comes to mind when thinking of multitasking, yet even this job is apparently complex enough to be subject to the effects of distorted incentives. Consider, then, the complexity involved in determining appropriate weights on the multiple dimensions of, say, managerial jobs, and one can see how easy it is for incentives to have potentially damaging effects. The punch line is that there are very few jobs, even apparently simple ones, where what is counted is all that counts.

Attracting the ‘wrong sort’

Organisations not only turn to PFP systems to motivate employees who are already there, but also to attract talented employees of a desired profile. This is particularly so when businesses overtly offer compensation packages with below-average base salaries but with PFP compensation elements that provide the opportunity to earn above-average total compensation if excellent performance is forthcoming. These packages tend to appeal to employees who are entrepreneurial, rather than risk averse, and those who are confident about their abilities to produce superior results.

Initiatives to use compensation packages to attract and retain such employees often are seen as a key feature of a firm’s recruitment strategy aimed at building a performance-driven culture.

While this is quite a reasonable strategy to pursue, it is not without its downsides. First, when incentives become increasingly leveraged - ie, when incentive pay becomes an increasingly important and larger part of employees’ total compensation packages - the incentives are also more likely to have the distorting effects discussed above, especially when they are not carefully calibrated. Second, and related, when highly leveraged, it is not a stretch to see how quickly such compensation packages can turn a performance-driven culture into a money-driven one. This has two undesirable implications, of which businesses should be aware, namely:

- that those who come for the money are also likely to leave for the money (despite this being counter to the intended effect of PFP on employee retention); and
- that evidence suggests that PFP systems almost always lead to higher compensation.

Regarding the latter, to improve recruitment, businesses will have to offer compensation packages that are comparable, or even superior, to those offered by their competitors if they want to attract employees from the same labour pool. Thus, once introduced, PFP systems are likely to create a labour market that forces companies to follow suit in order to attract talent without necessarily the benefit of greater motivation and/or retention. It is easy to see, then, how PFP quickly becomes an institutionalised practice or business necessity rather than

a motivational tool aimed at promoting a performance-driven business culture.

THREE POINTS TO CONSIDER IN YOUR REWARD STRATEGY

- Incentive structure – badly structured incentives are more likely to have unintended consequences relative to weaker but possibly more complete incentives across all the important dimensions of an employee's job.
- Incentive intensity – some of the downsides of PFP systems are proportional to their intensity. More is not always better and good incentive effects can sometimes already be achieved at relatively low levels beyond which the (un)desired incentive effects may decrease (intensify) quickly.
- Money, money, money? Complement monetary incentives with various non-monetary rewards, which can have good effects and are often less costly to the firm, yet valued by employees.

'More' PFP is not always 'better'

How then to break free from these unintended consequences? After all, hardcore advocates of incentives could still claim that this shows that incentives work! I, too, believe that they work, but I do not believe that more is always better. As a matter of fact, some of the downsides of PFP systems seem to be proportional to their intensity. Whereas it is impossible to perfectly calibrate incentives in multitask settings, even presumably relatively simple ones, the negative side effects of ill-calibration are exacerbated when incentive pay constitutes a larger part of total compensation. Interestingly, research** suggests that the positive effects of PFP might already be achieved with a relatively low incentive intensity, and that the motivational effects of PFP taper off quite quickly beyond a meaningful amount.

Moreover, although money clearly is a motivator for the vast majority of employees, it is by no means the only thing that people value. Other research*** has shown that firms tend to over-estimate their employees' concerns for financial rewards and under-estimate intrinsic job features, such as their desire to build a reputation; enjoy decision authority, perform meaningful work, and be appreciated. Not only can non-monetary rewards fulfil a potentially effective role as part of an incentive package, they also place a smaller financial burden on the firm.

Conclusion

When Warren Buffett recently started looking for a 'new Buffett' to help him run his investment empire, he reportedly said "job hoppers and money-grubbers need not apply". In so doing, Buffett highlighted the key point about PFP: that while money is an important motivator with potentially good effects on performance, when it becomes the sole or even just the predominant stimulus it is likely to backfire on businesses' ability to attract, motivate, and retain the talented employees for which PFP was designed.

Footnotes

* Jeffrey Pfeffer and Robert I Sutton, 'Hard facts, dangerous half-truths, and total nonsense' (HBS Press 2006, page 120).

** B R Bucklin and A M Dickinson, 'Individual monetary incentives: a review of different types of arrangements between performance and pay', Journal of Organisational Behaviour Management, 21, no.3 (2001), pp 45-137.

*** Watson Wyatt Worldwide, 'Strategic rewards: maximising the return on your reward investment' (Company Survey Report, 2004)

Wim A Van der Stede is professor of management accountancy at the London School of Economics and Political Science. Email: w.van-der-stede@lse.ac.uk

MEASURING THE SUCCESS OF THE BOARD

How do you measure your board's performance? Sir Andrew Likierman describes the 10 key qualities every board needs for success, and explains how to measure them

By Sir Andrew Likierman

How would you rate your own board of executive and non-executive directors? High, because the organisation is doing well? Low, because you can't fathom how such a bunch (other than you) could have been appointed? At 6 out of 10, because it's a complicated judgement? None of the above bears close examination.

So, in common with many bodies who find it difficult to measure performance, boards may be tempted to fall back on the measurable. But numbers – whether showing activity (number of meetings) or even outcomes (company profitability) – can't possibly capture the essence of how a board functions. This is why it's false, indeed dangerous, for board members to assume that the organisation's success reflects the success of the board.

Today's success may well originate from decisions taken years ago by a previous board, or from other factors that have little to do with the current board's efforts. For the same reason, currently unsuccessful companies can have successful boards – in that they are keeping those companies going while competitors are going bust, and laying down the basis for future success.

Nor is the performance of individual members the same as performance of the board as a whole. There may be excellent individuals in a dysfunctional team. Conversely, a great team could be far

more than the sum of its parts, with the chairman playing a key role in making it happen.

10 KEY MEASURES FOR BOARD

The starting point

1. Ability to choose the right members.
2. Agreement about priorities in its role.
3. Agreement about how to achieve company strategy.

Process and relationships

4. Effective in dispatching business in and between meetings.
5. Good internal board dynamics.
6. Good key relationships.

Coverage

7. Focuses on key issues and risks.
8. Initiative-taking, dealing with crises and identifying emerging issues.

Impact

9. Contributes to the company's performance.*

Sustainability

10. Aware of, and interested in, good practice.

** the crucial factor*

This article sets out how to measure board success. Really discussing how fully your board demonstrates the 10 abilities set out in the box (see Box 1) will provide the basis for an assessment, rather than just adding up numbers or ticking boxes. The list of abilities relates to UK listed companies, but the principles are just as applicable to unlisted companies seeking long-term shareholder value. Most also

apply (though in different institutional contexts) to non-UK companies and to public sector organisations.

The formal requirements

The combined code, which gives corporate governance requirements for listed companies, is clear: “Every company should be headed by an effective board, which is collectively responsible for the success of the company.” And paragraph A6 of the code specifies that “the board should undertake a formal and rigorous annual evaluation of its own performance and that of its committees and individual directors.”

There is certainly evidence that such evaluation is happening. But the main focus of paragraph A6 is on individuals, not the board as a whole. Also, ‘performance’ is a less ambitious goal than ‘success’ – a board could be effective if it simply kept to the rules.

Doing the right thing in corporate governance terms is an important, but not a sufficient, condition of success. And doing the wrong thing (eg an ineffective audit committee, or lack of independence among the non-executives) will make it more difficult to succeed but is not a measure of success (or lack of it).

Anyway, being successful means being more than just effective. It means making a significant contribution to the long term interests of the shareholders by adding value in excess of competitors.

The starting point

The starting point for measuring board effectiveness is to consider how it rates on the first three measures, ie:

1. Does the board have the ability to choose members with the right balance of qualities and skills,

particularly the right chief executive officer (CEO)?

2. Is it agreed about priorities in its role?
3. Is it agreed about how to achieve the company’s strategy?

Board membership needs will evolve constantly with the needs of the business, for example when moving from national to international operations, or from family control to wider ownership. To meet constantly evolving challenges, the board needs the right combination of qualities and knowledge, with an ability to renew and refresh its own membership and their skills. So ‘right’, here, means appropriate for this stage of the company’s development.

It’s difficult for any group to recognise the need to change its own composition and provide for succession, but this is essential for a board. And among these appointments, that of the CEO is critical. Indeed, it’s arguable that this is the single most important decision a board can make.

Success also means the board having a common understanding about the priorities in its role. All boards fulfil the same formal purposes, but these don’t capture the real agenda. For example, does the board need to encourage the executive directors to take initiatives? Or does it need to restrain them from taking too many? Is it about adding skills (say communication) or experience (say doing business in China) to complement those of the executive directors? With a common understanding of these priorities, the board will get the best out of its members and board discussions. Without it, opportunities will be lost.

THE DISCUSSION FOLLOWING BOARD APPRAISAL

Board appraisal usually involves a set of questions to each board member (face-to-face or through a questionnaire), discussion of the completed form with each member individually (if a questionnaire), collation of the findings and discussion of them by the board as a whole. The chairman may then take up points with members individually, perhaps as part of their individual annual appraisal

If possible, feedback should be from face-to-face interviews to supplement questionnaires, with the emphasis on nuanced responses. It may only be possible to tackle sensitive issues when outsiders are used: relying on anonymous responses given to other employees isn't realistic, and internal reviews will probably need to be less ambitious.

Adequate time must be allowed to discuss the results from questionnaires in depth. The discussion needs to be about significant issues arising from comments about outlying scores and views on board priorities, processes and relationships. It should not be a cosy chat or have a focus on small movements in numbers.

The discussion should take into account developments from previous years, to clarify whether lessons can be learned about the choice of key issues and decisions and how they were handled. Nevertheless the discussion will add value by focusing on specific examples and suggestions to shape the agenda for next year rather than being a post-mortem.

The form of the review needs to reflect the internal dynamics of the board. If there can't be candour in open session, the chairman should orchestrate a combination of private and open meetings. If issues to be discussed include the role of the chair, the senior independent director should take the lead.

A separate issue is basic agreement about how the company's strategy is to be achieved. This does not mean agreeing on all aspects of what to do and how to do it (there is a danger of 'groupthink'). But if the board is hopelessly divided on basic assumptions about whether to grow organically or inorganically, and about the appetite for risk, the chances of being successful are slim.

Appropriate measurement: board appraisal (see Box 2) and annual personal feedback procedures need to pick up what board members think about their colleagues, about the role of the board and about delivering the company's strategy. The chairman is key to turning the potential for disagreement into creative discussion and to defusing any potentially harmful personal differences.

Process and relationships

The subsequent three qualities required for board success concern process and relationships, the key questions being:

4. How effective is the board in dispatching business (including through effective board committees in and between meetings) and following up on decisions?
5. How good are internal board dynamics and culture (handling dissent, the relationship between executives and non-executives etc)?
6. How good are the board's key relationships with major stakeholders, and is there respect for what it does?

Effective processes, including persistence and resilience in making sure things happen, not just talking about them, are a prerequisite for board success. An open culture, with the board involved early and fully in key decisions and board members

comfortable about challenging in meetings, is crucial. So, too, is the ability to communicate effectively inside the company and with other stakeholders. And respect (not popularity) is an important signal, both inside and outside the company.

Appropriate measurement: since the code became a requirement for listed companies, increasingly sophisticated questionnaires for board members have been developed. Discussing the answers is the golden opportunity to improve board performance. There will be feedback on respect for the board – and therefore its communication skills – from employee surveys and the opinions of major shareholders.

Coverage

The questions relating to coverage are:

7. Does the board identify and focus on key (not just a long list of) issues and risks facing the organisation?
8. Is the board able to take initiatives, deal with crises and identify emerging issues?

These may look like factual questions, but both are matters of judgement. They apply as much to interpreting the past as hypothesising about the future, since usually only after an extended period is it possible to know whether the board has dealt with the right issues, how well it has done so, and which issues have not been addressed. Thus failing to ensure succession or invest in new technology is just as much about performance as successful talent management or systems investment. And boards can be really helpful in identifying risks that executive directors alone, sometimes preoccupied with current challenges, may not have spotted.

There are two questions rather than one here because a history of dealing with key issues as they arise is not enough. The ability to take initiatives, deal with crises and identify issues that are not part of ‘normal business’ is a crucial differentiator between a good and an adequate board. For the same reason ‘meeting board objectives’ isn’t included as a success measure, since it runs the risk of being too inward-looking and passively taking things too much as they are.

Appropriate measurement: the board needs to take stock of the answers to these questions as part of its annual appraisal process.

Impact

If there had to be a single question about the success of the board, it would be:

9. What is the board’s contribution to the company’s performance?

Boards will understandably want to take credit for things that go well. This inclination applies not only to the success of visible initiatives (new ventures, new people etc) but also to actions resulting in the absence of problems normally indicating board failure (eg deciding against an unfortunate acquisition, recording fewer bad debts than competitors).

But making either connection isn’t easy, particularly for contributions such as establishing ethical standards. So while it may be possible for major individual events, such as acquisitions, to be linked to board decisions, the larger the organisation and the longer the lead time between decision and result, the less plausible the connection. Even for events with a short lead time, quality of execution and overall stock market trends often mask the board’s particular role.

Appropriate measurement: the answer will be qualitative and will come from a combination of questions in the annual board appraisal and feedback from key interlocutors inside and outside the organisation. Again the chairman has a key role in using the results of the feedback to discuss members' understanding of how exactly the board currently adds value and what it can do to improve.

Sustainability

Finally, comes the over-arching question:

10. Is the board aware of, and interested in, good practice?

Left to themselves, boards tend to become insular. Working methods become “the way we do things round here”. So even if the board comes out well from questions 1-9, there's still the issue of whether it is committed to sustaining good practice. Non-executive directors can be very helpful here in giving context and helping with best practice.

Appropriate measurement: executive directors may not have a basis for comparison and even non-executives may have limited experience of other boards. But there is a huge amount of information around about good practice, including increasing amounts of detailed information in annual reports. This is not

about grasping every passing fad, but about always being willing to learn.

Conclusion

A successful board cannot guarantee that a company will be successful, but can make a huge contribution to it being so. An unsuccessful board will mean that at best the company does not reach its potential, and at worst it is destroyed. So there's plenty at stake here, and not only for the investors and other stakeholders who want reassurance about investments or relationships.

Board members as individuals have a great deal to gain from an answer to the question, “is the board successful?” All will want to know about the results of their efforts and, on the downside, about any danger of personal liability or to their reputations. Executive directors (and indeed all other employees) will want to know that their company is getting the best direction possible and that their futures are secure.

Answers to the above questions will mean that the successful board does not have to guess whether it is successful, and the unsuccessful one will possess information providing the basis for improvement. Continuing success will mean continuing to ask for answers to the questions. F&M

*Sir Andrew Likierman is professor of management practice at the London Business School and a past president of the Chartered Institute of Management Accountants.
alikierman@london.edu*

WHEELS OF CHANGE

Finance and accounting outsourcing has already had a major impact on finance business partnering and analytics, but as we broaden our understanding of the issues, FAO itself is growing more complex. CIMA's Martin Fahy and Chris Fuller look at how market leaders are ushering in a second wave of FAO, and gradually moving towards a new paradigm: knowledge process outsourcing

By Chris Fuller and Martin Fahy

It is now 15 years since BP in Aberdeen signed the first finance and accounting outsourcing (FAO) deal with what was then Andersen Consulting (now Accenture). Since then, FAO has grown to become an established part of the finance transformation landscape and an increasingly widely adopted component of finance restructuring in large multinational organisations. In the last 12 months, Unilever, Cadbury Schweppes, Lindt, Diageo, GSK and other large multinational firms have all embarked on FAO projects.

To date, FAO has been viewed as a mechanism to reduce finance transaction processing costs by moving structured operational tasks, such as accounts payable and other lower-skill activities, to lower-cost offshore locations.

While the move towards FAO has been driven by labour arbitrage around low-skilled processes such as purchase to pay, order to cash and fixed assets, our research suggests that FAO is rapidly moving up the finance value chain, and leading firms are now moving beyond traditional FAO towards knowledge process outsourcing (KPO).

Under this approach firms are leveraging the substantial pools of highly educated business graduates in countries such as

India, Malaysia, Central Eastern Europe and China to move value-added finance business partnering type activities to lower-cost and, crucially, more effective locations.

This is a significant departure from the buy-side market perception that only structured operational transaction processing can be moved to FAO delivery centres. The growing confidence in vendor domain expertise goes some way to exhausting the arguments of those who believe that FAO is a passing fad. The experience of a small group of leading firms suggests that firms will outsource higher-level analytical and finance business partnering roles to FAO delivery centres in near- and offshore locations.

During 2006 we conducted structured interviews with FAO analysts, business process outsourcing (BPO) vendors and 25 senior finance professionals from large organisations that have entered FAO agreements or were in the process of moving to FAO. This research, along with previous work, provides the basis for examining the role FAO has played in facilitating finance transformation and its emerging position in support of effective business partnering.

From captive shared service centres to transactional FAO

	Captive	Non-captive
Onshore	Most shared service centres e.g. 3M, Eaton, RBS, Nestle, Michelin (UK)	Accenture for Thomas Cook and Microsoft IBM for Roadchef Capgemini for Blue Scope Steel
Nearshore	Diageo, Allied Signal, Phillips Typically CEE	Accenture for Rodia (Prague) Genpact for GSK (Bratislava) Capgemini for Dairyfarm HP for P&G (Barcelona)
Offshore	Reuters (India) and Caltex (Manila)	Accenture for Unilever (India) WNS for Aviva/CGNUA (Sri Lanka) Genpact for CS (Chennai)
	Shared services space	BPO space

Figure 1. The finance transaction processing landscape.

Finance functions are faced with the dual challenge of meeting an increasing compliance burden and reducing finance costs to the world-class benchmark of less than 0.75% of revenues. While single-instance enterprise resource planning, single global processes and captive shared service centres have played an important role in achieving these conflicting objectives, CFOs are increasingly looking to a small number of global finance and accounting outsourcing vendors to provide a quicker route to the necessary efficiencies and associated cost savings.

The earliest attempts at reducing finance costs consisted of captive finance and accounting (F&A) delivery centres, where firms established regional and or global service delivery centres, which they operated themselves (see Figure 1).

Typically, these centres focused on purchase to pay, finance and accounting, travel and expenses, and general ledger processing.

Within a relatively short period of time, large multinationals began to look to (non-captive) vendors such as Accenture, IBM, Genpact, Capgemini and WNS to take responsibility for the core F&A transaction activities. These vendors quickly established a global network of multi-shore delivery centres in cities from Chennai to Krakow to Dalian.

The adoption of FAO was motivated by wider finance transformation objectives, which, according to outsourcing advisory company Equaterra, included:

- guaranteed operational cost savings through economies of scale and scope and access to low-cost global labour, with savings typically stated at 20–40% on a seven to ten-year basis
- improved quality of service delivery
- improved cash flow/working capital savings
- avoidance of the capital expenditure required to make individual, company

process-based improvements and technology upgrades

- accelerated transformation to best in class service delivery through access to service providers' intellectual capital, best practices and competencies
- accelerated ongoing improvement
- improved performance management and measurement of services with increased visibility and clarity across companies
- increased controls and accountability, and process and cost structure adaptability to changing business conditions
- enhanced ability to focus on core businesses and processes.

Accepted wisdom suggested that firms should move sequentially from a geographically distributed finance operation into shared services and selective FAO. By 2005, a number of firms were willing to trade the savings captured from the intermediate step into shared services for the quick wins provided by FAO providers. The move directly to FAO was driven by a number of considerations, including:

- the lack of resources and focus for taking internal improvement to the next level of performance
- competitive pressures driving overall margins down, particularly when faced with the threat of private equity investors
- a lack of capital to renew or extend enterprise resource planning (ERP) and other technology investments
- wider organisational changes in the form of mergers and acquisitions, divestitures, contraction and growth

- the need to focus on value-added business partner activities in the face of increasing regulatory pressures.

In assessing their suitability for outsourcing, firms divided F&A processes and activities into the following categories (see Figure 2):

- pure transactional, first-level customer service and issue-resolution processes that can be leveraged across the company, offering the best opportunity for outsourcing
- processes that involve higher-level issue resolution and escalation are fringe candidates for outsourcing and often depend on the degree of standardisation and systemisation
- governance, policy-setting and high-end strategy and planning processes (rarely outsourced).

From transactional FAO to value-added analytics

With the march towards FAO gaining momentum, it is important to address the question of how much of the finance function we can conceivably outsource. While the vast majority of FAO deals to date have focused on low-skilled processes, more innovative firms are embracing outsourcing across a much wider range of finance activities and processes. Our research indicates that a small number of leading firms have already moved beyond the transactional focus to higher-level analytics and activities traditionally viewed as too strategic or complex to outsource.

Our investigations show that successful experience of FAO has encouraged firms to extend the scope of FAO contracts into the KPO space and include F&A processes or activities which have traditionally fallen under the business

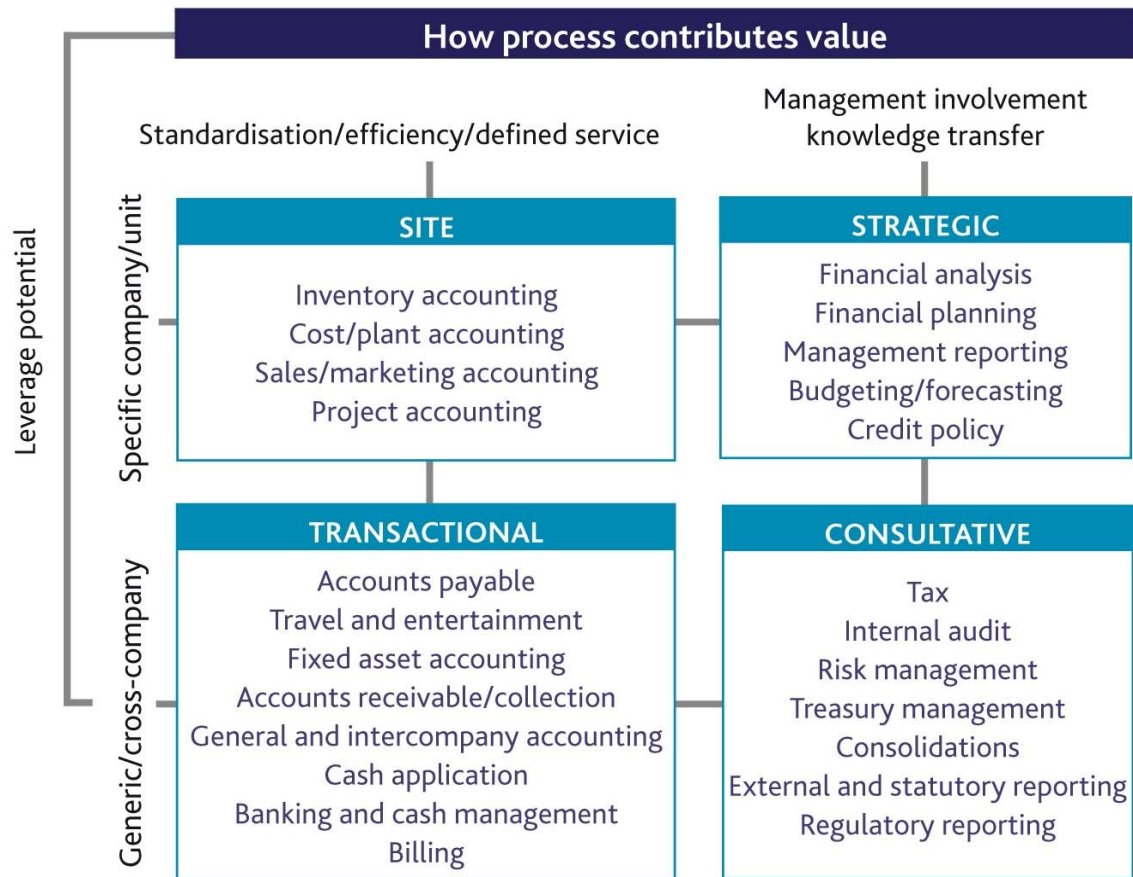


Figure 2. F&A processes and their suitability for outsourcing under first-wave FAO.

partnering heading. We are now seeing the transfer of management accounting activities such as variance analysis, costing and other reporting to non-captive FAO delivery centres. The WNS/Aviva case study on pg 10 is a good example of how this is happening.

While KPO remains the exception rather than the rule, the experience with FAO in the past suggests that the trend towards outsourcing more value-added finance and accounting activities is likely to become mainstream within five years.

The key features of this second wave of FAO are as follows:

- 1. Data cleansing/data scrubbing in support of analytics is often the starting point for KPO.**

Many organisations find themselves data-rich but information-poor. Our study supports the notion that the single biggest constraint on improved financial analysis is the lack of clean reliable data. Multiple enterprise resource planning instances and poor data capture have led to a situation where much of the effort in business partnering by finance staff is directed not at analysis but in manually extracting and scrubbing data from underlying operational systems. Discussions with finance professionals indicate that in future they will look to outsource this cleansing to BPO providers who have already taken over the transactional activities associated with the data. Using this model, self-service access to clean data for financial analysts and others in

the business units will be met by teams from BPO providers who will prepare data cubes and decks which the business units can then analyse. With this approach, shortcomings in data and systems delivery can be overcome using labour cost arbitrage.

2. KPO is initially targeting structured institutionalised analytics and reporting.

In cases where the analysis to be carried out is highly specifiable, firms are willing to transfer the production of this analysis and reporting to BPO/KPO providers. Examples of this type of work include costing, inventory accounting, pro forma scorecard production, cost budgets and other forms of traditional management accounting. The burden of extracting information from ERP applications, using data marts and business warehouses, is transferred to BPO teams who have in-depth knowledge of the technology and data architectures. The data to desktop reporting process is then enabled using web-based portal reporting.

3. KPO is driving harmonisation of management accounting and business analytics.

As firms seek to exploit the service of BPO/KPO providers, there is a strong economic argument for the global harmonisation of management accounting and reporting/analysis processes. Fixed-price, volume-based charging for these services encourages firms to stop, simplify and standardise much of their reporting and management accounting activities.

4. KPO providers bring the discipline of process improvement to the business partnering space.

Just as they have used Six Sigma and process redesign to achieve breakthroughs in process improvement, BPO/KPO providers are now applying these techniques to the analytics space. This is leading to an industrialisation of many extraction, classification, filtering and reporting activities that make up business partnering. In time, we are likely to see world-class business partnering processes being embedded in the emerging corporate performance management and business intelligence technologies.

5. KPO is unlikely to deliver context-specific analytics close to the market.

While BPO/KPO providers will have a cost and size advantage in the areas outlined, it is unlikely that this will extend to context-specific and unstructured ad hoc analytics associated with optimising and configuring the business model. In the case of analytics to support brand and marketing effectiveness, strategy and product introduction, the highly contextualised nature of the knowledge needed to support these decisions will erode any labour arbitrage. As global firms have discovered in the war for talent, world-class business analysts come with a world-class price tag, regardless of where they originated.

Key challenges for CFOs

CFOs will need to take proactive steps to ensure that their organisation can capitalise on the emerging second wave of FAO. They will also need to ensure that they have the capability to put in place agreements that go beyond the traditional transactional scope that has defined FAO to date. The specific challenges which CFOs need to address in building that capability include:

- developing a knowledge and understanding of the role of FAO in the emerging regional and global finance architectures which firms are seeking to put in place
- understanding which finance processes are appropriate for second-wave FAO and which activities will need to remain embedded in the business
- having a comprehensive understanding of the different offerings available from FAO vendors and the value proposition under which these vendors operate
- having the sourcing, contracting and negotiating skills to put in place collaborative agreements that are sustainable and flexible for both the firm and the vendor
- devising effective risk management approaches to ensure that FAO does not undermine the firm's compliance, performance and corporate social responsibility obligations
- developing governance and relationship management frameworks, including service level agreements, key performance indicators and performance management incentives, that drive value for both the firm and the vendor
- focusing on creating viable long-term relationships with the vendor that reduce adversarial behaviour and encourage sharing of information and efficiency gains
- working with specialist outsourcing and legal advisers who understand the intricate details of outsourcing contracts, statements of work, due diligence and the other elements needed to put in place a working agreement.

FAO trend set to continue

It is clear that second-wave FAO will continue the trend towards smaller business unit finance teams as more business partnering activities are outsourced to FAO providers. While the majority of firms will move slowly towards FAO for finance transaction processing, leading firms will leap ahead to exploit the extensive educational talent available from offshore delivery centres.

As labour arbitrage on transaction processing is eliminated, FAO providers will, through the deployment of technology and process improvement, seek to divert the increasingly expensive labour resources to higher valued-added analytical work. In doing so, finance will follow the established KPO model of other professions.

In the long term, culture and the other barriers to effective outsourcing of analytical tasks will be overcome and firms will seek to source finance business partnering from a network of global delivery centres.

The changing face of FAO

- **Cost savings** continue to be the main motive for global sourcing strategies. Quality and flexibility are increasingly important drivers.
- **Simple labour arbitrage** is no longer sufficient to sustain outsourcing. There has been a move towards skills, capabilities and availability of resources.
- **Experience on both the buy and sell side** is now allowing for greater sophistication and clarity of sourcing decisions and contract management.
- **Decision-making** and understanding and managing the operational risk of

outsourcing and offshoring, are beginning to reach maturity, allowing firms to trade off the expense of outsourcing and offshoring against the superior skills and lower costs available offshore and from third parties.

- **Core and non-core processes** are being componentised. Financial services firms are beginning to use componentisation to simplify complex business processes – the act of deconstructing complexity allows activities to be performed by individuals with specialist skills. Componentising a process minimises investment in knowledge transfer and training, and lends itself to multiple sourcing options.
- **Lean manufacturing** concepts are being adopted to identify efficiencies.
- **The process of componentisation** is enabling firms to adopt a global services sourcing model, establishing competency-based centres optimising cost, quality and skills offered by selected geographies.
- **Market commodification** is forcing firms to evaluate their operational models, leading to a shift away from product-focused towards process-focused strategies.
- **Supplier experience** has grown with the marketplace, allowing suppliers to produce better offerings. The result is lowered risk to buyers and suppliers adding more value through new tools and technology.
- It is interesting to note that **Sarbanes-Oxley** concerns are no longer an issue. In 2002 companies were worried about sending work offshore

and meeting the reporting requirements of the Sarbanes-Oxley Act. Company executives, who faced jail-time if they could not certify their financial results, were not eager to outsource these functions.

- Many US companies took a **waiting brief towards FAO**. By the end of 2004 the marketplace had resolved these issues, with outsourcing now viewed as offering the potential to improve control and reporting, making it easier to comply with the requirements of Section 404 and other provisions.
- **The variety of sourcing options** available to companies today is in stark contrast to the scope of contracts negotiated ten years ago; experience gained by both buy and sell sides is now allowing for greater sophistication and clarity of sourcing decisions and contract management (see Figure 3 on page 8).

WNS & AVIVA: second-wave FAO in action

Aviva is the world's fifth largest insurance group and the largest insurance services provider in the UK. It has premium income and investment sales of £36 billion and £332 billion of assets under management, a presence in more than 25 countries and 35 million customers.

Aviva has embraced outsourcing and offshoring as a means of addressing the competitive pressures it faces. By the end of 2007 it will have offshored 7,800 roles across five locations. As part of its global BPO capability, it has established, in

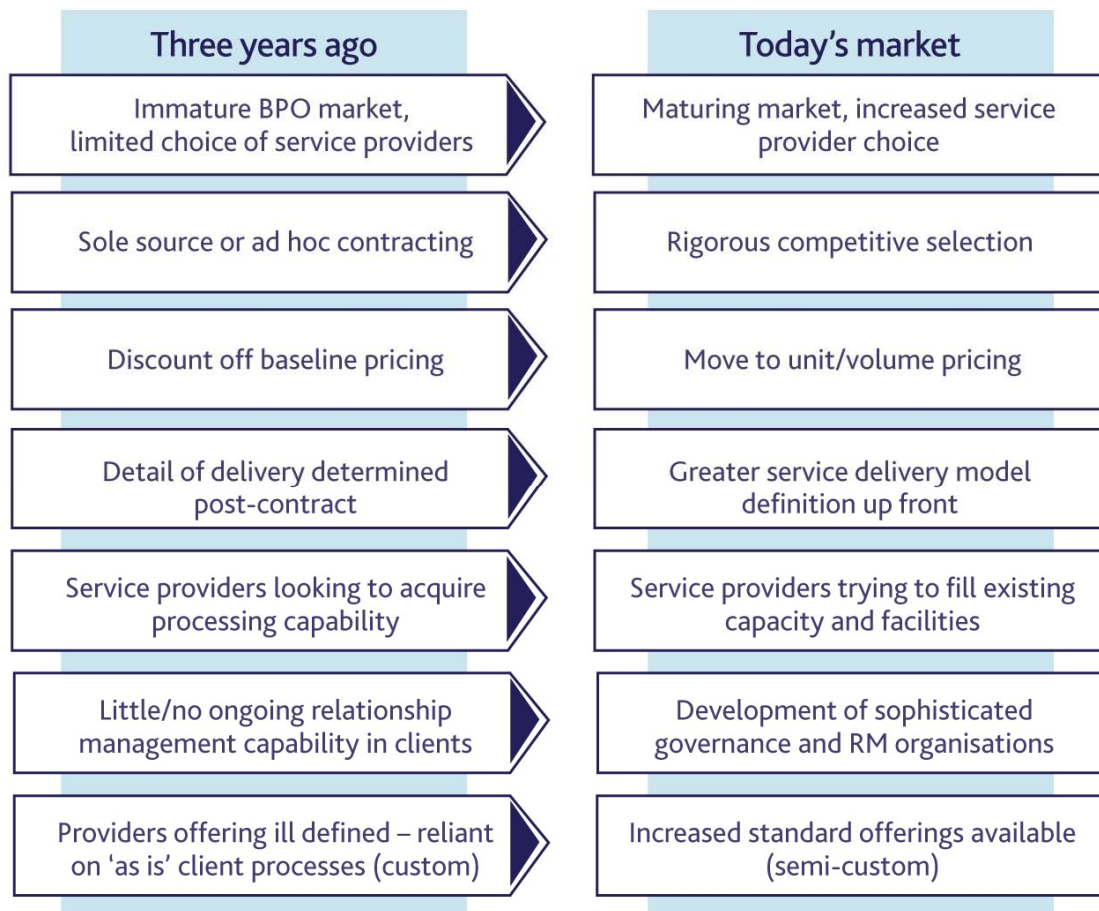


Figure 3. Growing maturity of the FAO market.

partnership with WNS, an offshoring centre in Colombo, Sri Lanka for its F&A activities. This centre was established in 2003 and will be managed by WNS until July 2007 when the staff and operation are due to be transferred back to Aviva.

The operation began as a traditional first-wave FAO centre with a focus on transaction processing. Early on, management acted to bring more value-added, analytical activities into the centre. By 2005 100 staff were supporting management accounting, planning and forecasting, project analysis and related activities; by 2006 this had extended to the preparation of full statutory accounts and business partnering across the group.

Outsourcing: glossary of terms

Business process outsourcing (BPO)

BPO can be seen as a process in which a company delegates some of its in-house operations or processes to a third party.

Business warehouse

A business warehouse is a packaged, comprehensive business intelligence product centred on a data warehouse. Like most data warehouses, a business warehouse is a combination of databases and database management tools that are used to support management decision-making.

Component business modelling (CBM)

CBM simplifies the way firms look at their operations; it allows executives to escape the process rut and helps them get at the real sources of value that drive their firms. Viewing business activities as autonomously managed components helps decision-makers to cut through the historical boundaries that build up along organisational, product, channel, customer, geographical and informational lines.

Data cubes

A data cube is a multidimensional representation of data which provides fast retrieval and drill down facilities.

Data marts

A data mart is a repository of data gathered from operational data and other sources that is designed to serve a particular community of knowledge workers. The emphasis of a data mart is on meeting the specific demands of a particular group of knowledge users in terms of analysis, content, presentation and ease of use.

Domain expertise

Domain expertise is knowledge and experience that has been acquired through a thorough track record that comes to represent the core competencies of the organisation.

Enterprise resource planning (ERP)

ERP attempts to integrate all data and processes of an organisation into a unified system. A typical ERP system will use multiple components of computer software and hardware to achieve the integration. A key ingredient of most ERP systems is the use of a unified database to store data for the various system modules.

Finance and accounting outsourcing (FAO)

Many companies are now choosing to outsource elements of their finance and accounting processes to third-party vendors. The basic premise is that by outsourcing these operations companies will achieve cost savings and be able to focus more on their core competencies.

Knowledge process outsourcing (KPO)

KPO is a form of outsourcing that sits at a higher level on the intellectual value chain than BPO. KPO involves processes that demand advanced information research, analytical, interpretation and technical skills, as well as some judgment and decision-making.

Lean manufacturing

Lean manufacturing is a management philosophy focusing on reduction of wastes with attention focused on transportation, inventory, motion, waiting time, over production, over processing and defective product. By eliminating waste, quality is improved and production time and costs are reduced.

Market commodification

Commodification is a process that transforms the market for a unique, branded product into a market based on undifferentiated price competition.

Sarbanes-Oxley section 404

Section 404 requires that companies subject to the reporting requirements of the Securities Exchange Act of 1934, other than registered investment companies, include in their annual reports a report of management on the company's internal control over financial reporting.

Web-based portal reporting

Web-based reporting tools enable enterprise-wide reporting, information delivery, analysis and decision-making. Some applications support distribution of

reports within departments, across enterprises and may also be integrated within web-based applications to deliver back-end core reporting information and front-end information analysis.

Chris Fuller is a Member of CIMA's International Development team, based in London. This role involves research and analysis of trends in the finance transformation, shared services and BPO/FAO sectors. His most recent work involved a major study of the challenges facing CFOs in the Asia Pacific region.

Martin Fahy was Director of Development for CIMA Asia Pacific. He is a Fellow of the Institute of Chartered Accountants in Ireland and holds a PhD in Business Information Systems from University College Cork, Ireland. He is a recognised thought leader in the areas of shared service/BPO and finance transformation.

He has written extensively on the areas of shared service, ERP systems and emerging issues in finance. His most recent books include Beyond Governance, ERP: Levering the Benefits (a joint venture with CIMA and PWC), Strategic Enterprise Management Systems and Shared Services: an executive briefing (co-authored with Andrew Kris).

IFRS CREATES A TOUGHER WORLD FOR M&A

Accounting changes have dramatically altered the way mergers and acquisitions are analysed. This is the first of two articles based on a report by Dimitris Karydas and Kenneth Lee of Citigroup.

By Dimitris Karydas and Kenneth Lee

The high level of M&A - or 'business combinations' - over the past two years has made analysis of deals vital for investors. However, accounting rules in this area have been subject to huge changes with the transition to IFRS. The first changes, made in 2005 and known as phase 1, were significant but not controversial. Phase II, however, is causing a great deal of concern.

Let's first look at what has already changed as this is what investors will have to cope with when analysing 2006 deals.

Elimination of merger accounting

It was already difficult for a combination to qualify as an accounting merger under IFRS due to the strict criteria. The elimination of this approach to M&A accounting seemed a sensible bit of housekeeping. Having only one business combination accounting approach should also enhance inter-company comparability. This change will apply prospectively: previous poolings will not have to be 'unpooled'. As merger accounting has been eliminated, the attraction of using share consideration has diminished.

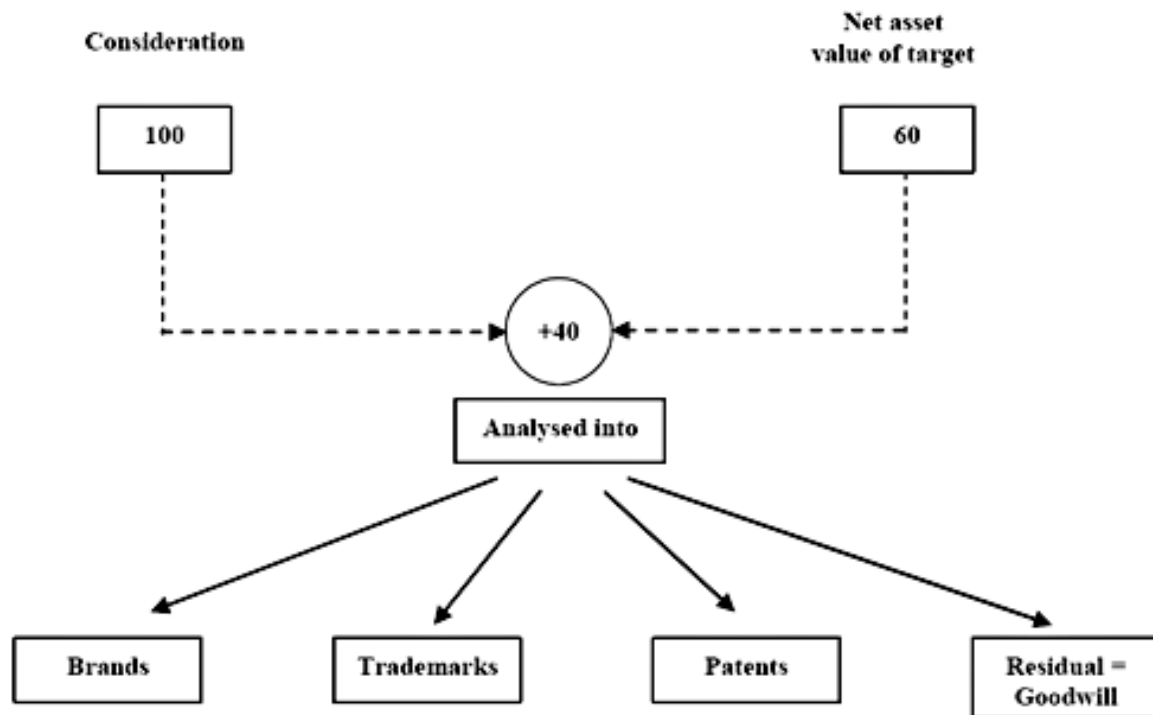
Change in the definition of goodwill

Goodwill is now defined as the 'future economic benefits arising from assets that

are not capable of being individually identified and separately recognised'. This is a distinct change from the previous approach whereby goodwill was merely a residual difference between the purchase consideration and the fair value of the net assets. The onus is on the company to split out any separately identifiable intangible assets on future acquisitions. This should provide a more detailed and useful breakdown of these assets. However, this will reduce the amount allocated to goodwill on future acquisitions. There is some initial evidence that companies are allocating very low levels of the purchase cost to other intangibles and goodwill is still dominant. This is despite the clear expectation in IFRS 3 that this would change.

No more goodwill amortisation

There is no longer any systematic amortisation of goodwill. However, amortisation of other intangibles is required. Goodwill will instead be subject to an annual impairment test. Most companies have applied this change prospectively so that existing goodwill has, in essence, been frozen at its current value (see footnote 1) and then subject to impairment tests.

Figure 1. Changed Definition of Goodwill

Source: Citigroup Investment Research.

Less opportunity to manipulate post-acquisition results

Restructuring provisions on acquisitions has been severely restricted. This should provide fewer opportunities for management to manipulate post-acquisition results.

The verdict on these changes

The headline change was the elimination of goodwill amortisation. We have always seen this as a positive step. Given the 'autopilot' nature of goodwill amortisation it was largely ignored as having no economic relevance. Impairment testing is a more meaningful approach under which management will be forced to think through the value of goodwill using a cash-flow-based methodology. Also, the disaggregation of intangibles should provide more useful information.

From a valuation perspective goodwill impairment should continue to be examined in a similar way to amortisation. This is because, unlike depreciation which relates to tangible fixed assets that must be replaced, impairments relate to goodwill that need not be explicitly replaced. Therefore impairment charges would be expected to have little discernible impact on investor sentiment. Of course an unexpected impairment or an impairment that is larger than expected may indicate a problem. A reaction would then be no surprise (see footnote 2).

The introduction of an impairment regime does have two further possible implications. First, it will make profits less predictable. Second, it may well increase management discretion in relation to earnings. There may be little to stop management overestimating impairments to increase future profits and

returns on book equity at the expense of short-term earnings.

Finally, in the absence of impairments, eliminating annual amortisation has resulted in a step-up in earnings. As this is likely to be relatively higher than the increase in equity due to non-amortisation, returns on book equity should increase.

Let's look now at the proposed Phase II changes and their likely effects.

Full, not partial, recognition of goodwill

Currently goodwill is measured on a partial basis. In essence we only recognise the part of goodwill that has been purchased. So if 60% of the business is acquired then only 60% of goodwill is recognised. This is inconsistent with the treatment of other assets where, once control is achieved, we consolidate 100% and back out the minority interests.

Acquisition costs to be expensed

The theory is that such costs are not assets so they should be expensed within goodwill, rather than subsumed as is currently the case.

Contingent consideration

The new standard will distinguish between contingencies that relate to uncertainties existing at the acquisition date (for example, what is the fair value of receivables?) and those uncertainties that will only be resolved as the target conducts its business (for example, earn out provisions). The standard suggests that the former are dealt with by adjusting the price and the latter are recognised as items unrelated to the original acquisition.

So what are the implications for acquisitions of these proposed accounting changes? Earnings will certainly be more

volatile: the elimination of techniques such as restructure provisioning will make it more difficult to smooth earnings after the acquisition. In most cases redundancy and similar costs will be recognised as period expenses. It will also be harder to show a post-acquisition uplift: this follows on from the restrictions on provisioning.

On a positive note, there should be improved transparency. Extra disclosures are required about the makeup of the purchase price, the adjustments to asset values and the determination of the residual goodwill number. However, in the UK the new disclosures appear more limited than UK GAAP.

Finally, troubled acquisitions will be revealed more quickly.

Investor Q&A on business combinations accounting

Q. The elimination of goodwill amortisation will result in an increase in earnings per share (EPS). Has this caused higher valuations?

It shouldn't have. From an investment perspective goodwill amortisation is not relevant because companies do not have to replace the goodwill.

This contrasts with depreciation which relates to operating assets that must be replaced. Many investors and sell-side analysts have long been using Ebitda (earnings before interest, taxes, depreciation and amortisation) as an operating profit measure or a quasi cash-based EPS number where the major adjustment was to add back goodwill amortisation. However, remember that some investors do look at unadjusted EPS numbers and not all investment houses ignored goodwill amortisation.

Q. Many countries allowed companies to write goodwill off direct to reserves (equity) under local GAAP. Has IFRS required reinstatement of this goodwill?

There is no requirement to reinstate this goodwill and it is unlikely that companies would choose to do so.

This goodwill will not be recognised in the income statement as part of the calculation of any profit/loss on disposal. This may well significantly increase profits on disposals for those companies that have written off goodwill against equity.

Q. The standard includes rules about restructuring provisions. What will be the impact of these rules?

This is an area of major change by IFRS 3. Essentially the opportunity to make provisions on an acquisition is often exploited by acquirers to manage the earnings profile of a combined entity after acquisition. It allows companies to channel operating costs through goodwill, or at least to avoid recognition of certain expenses in the income statement. The rules have been tightened up so that many of the standard approaches to managing earnings in an acquisition have been eliminated.

Q. Can an acquirer recognise a restructuring provision which is dependent on the acquisition taking place?

This is crucial. According to the detail in IFRS 3 the possibility, or even near certainty, of an acquisition is an insufficient recognition event. Therefore an acquiree cannot recognise such a provision in its financial statements.

Q. Has amortisation disappeared as a concept altogether?

We need to be careful here. The prohibition on amortisation in IFRS 3 relates solely to goodwill. Other intangibles such as brands, patents, development costs and so on will continue to be amortised. This ties in with the change in the definition of goodwill which means that other separable intangibles will be recognised and amortised as normal.

Footnotes

¹ For cross-border deals under IFRS, goodwill will have to be restated to take into account shifting exchange rates. This is a departure from many other GAAPs that allowed goodwill to be recorded at the historical rate. This may well cause much larger foreign exchange movements in equity on the re-translation of foreign subsidiaries.

² There is some evidence that impairments do matter and are negatively correlated with the firm's post-acquisition return performance (Li, Shroff and Venkataraman, 2004).

REPORT DEBUNKS MYTHS ABOUT SUCCESSFUL MERGERS

In the second of two articles based on a report by Citigroup, Dimitris Karydas and Kenneth Lee propose a framework for analysing mergers and acquisitions

By Dimitris Karydas and Kenneth Lee

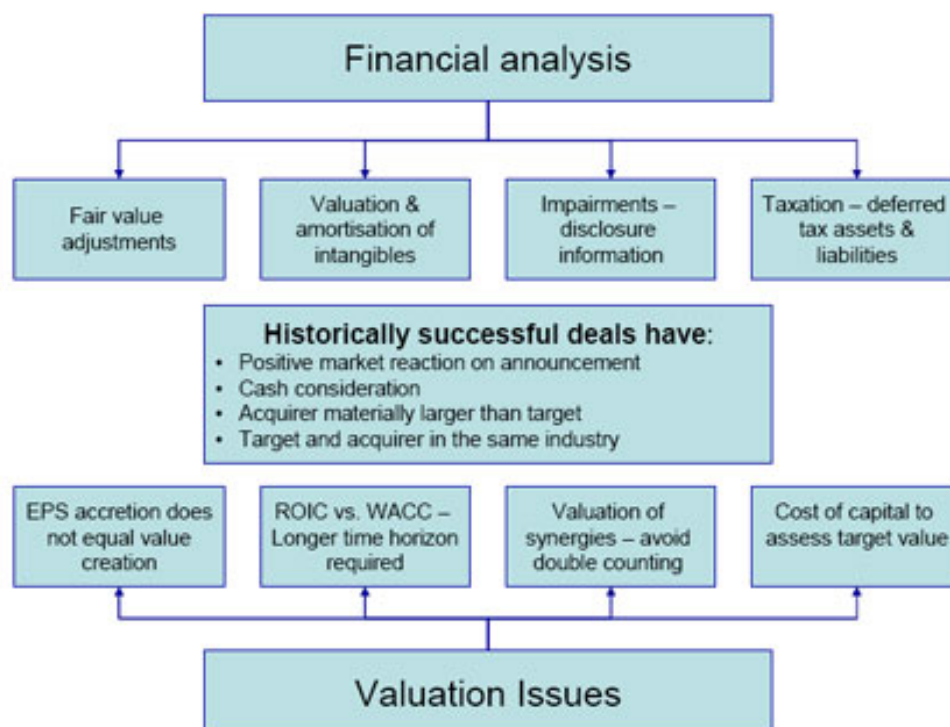
There are three areas of analysis that are particularly important when it comes to understanding merger and acquisition (M&A) deals. They are:

- financial analysis: what accounting issues/disclosures may be particularly interesting to examine?

- valuation issues: the common valuation errors to avoid
- empirical evidence: what factors have historically indicated successful M&As?

Figure 3 below puts these into a framework.

Figure 3. M&A analysis framework



Source: Citigroup Investment.

Four points of analysis

Last month's article in Insight looked at the accounting rules governing M&A accounting. Here we examine four areas that may receive less attention but that are worthy of analysis.

1. Fair value adjustments

The fair value exercise is a major component of any M&A analysis process and it can be revealing. Establishing an estimate for the fair value of an asset and then any subsequent adjustment can have important implications for key performance indicators (KPIs). For example, if an initial fair value estimate for a property was conservatively biased then depreciation would be understated with goodwill overstated (but no amortisation under IFRS). Therefore investors should be sensitive to the fair value exercise and especially to any changes from the initial estimates.

2. Allocation of value to separable intangibles and subsequent amortisation

The crucial questions here relate to:

- What separable intangibles have been recognised? Does this reveal extra value in the target? Are the recognised amounts unexpectedly high or low?
- What amortisation period has been chosen? How does this compare with peer companies?
- Are the separable intangibles maintained? If these assets do not have to be replaced, is amortisation a real economic cost or merely double counting?

3. Impairment disclosures

There is a huge amount of disclosure required in this area that may have significant relevance for value. However,

based on anecdotal evidence, we believe it is rarely addressed in detail. For example, the disclosures for un-amortised goodwill would include:

- key assumptions underpinning any value in calculation of use
- the period over which cash flows have been forecast
- the discount rates used.

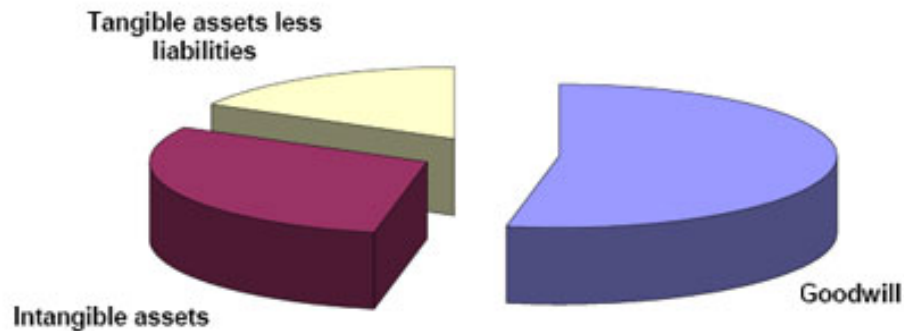
If a change to a particular assumption causes an impairment to be recognised then a form of sensitivity analysis must be disclosed. Many investors and analysts would find these audited disclosures of interest as another way to access management thinking.

4. Taxation

Often the tax aspects of a deal are particularly important motivators. Indeed an acquisition may open opportunities for acquirers to unlock tax value. In addition deferred taxation aspects can be most confusing. The tax disclosures post-acquisition are well worth studying carefully: any recognition of previously unrecognised deferred tax assets indicates the creation of value in the deal. It is likely that new deferred tax liabilities, especially those on goodwill and other intangibles, are actually instruments of 'matching' rather than true economic liabilities. Therefore it may well be that most investors choose to ignore these.

Allocation of purchase price to goodwill versus intangibles - evidence from the UK

A recent report by Intangible Business examined the proportion of the purchase price that had been allocated to goodwill as against intangible assets. The overall split is illustrated in Figure 4 below. Clearly goodwill has maintained its dominance.

Figure 4. FTSE 100 purchase price allocation

Source: Intangible Business.

The question is whether such a heavy allocation to goodwill is actually evidence of companies making biased decisions about the disaggregation. Why might companies be motivated to allocate more to goodwill?

There may be a concern among corporates that the amortisation of non-goodwill intangibles will not be added back to earnings by the market in the same way that goodwill amortisation was. Therefore a large allocation to goodwill preserves earnings.

Also, dividing up assets into smaller units can expose the company to a higher risk of an impairment. For example, when assets are grouped together strong cash flows from one may offset weaker cash flows from another. However, if assets are split out then this compensating offset may not happen and an impairment is more likely.

If the assertion in the Intangible Business report is correct then IFRS 3 would appear to have failed to give investors materially enhanced information on intangibles in the context of acquisitions. However, we feel that more time is required before a final verdict can be delivered. The quality of disclosures for

2006/2007 will be the start of the acid test.

Valuation issues

There are certain valuation issues on M&A deals that cause confusion when assessing what constitutes a successful or unsuccessful acquisition.

The most common include:

1. Earnings accretive deals are a good thing.

It is not uncommon to read in the press that a company could afford to pay up to a particular amount for something ‘without diluting its earnings per share’, as if this represented an economically meaningful statement. The maths may well be right. It is just that the answer does not matter. This is easiest to see if we think of an acquisition financed by borrowing. Suppose that a company can borrow money at a gross interest cost of 6%, and that it has a 33% marginal rate of tax.

Interest will cost it a net four cents in the euro. So if it buys an asset, or a company, on a multiple to earnings of less than 25 times [see footnote 1], the result will be earnings accretive. Suppose it pays a multiple of 20 times, then the earnings yield on the acquisition will be an

immediate 5%, with an uplift of 1% on its return on capital.

Readers should not have difficulty thinking of acquisitions that would be very poor value on a multiple of 20 times current earnings. Now take an acquisition funded with new shares. If the earnings multiple of the acquirer is higher than that of the target then the result will be earnings accretion. If you do deals on this basis regularly enough you will sustain a high rate of growth in earnings per share, apparently justifying the high multiple — until you run out of large enough targets to maintain the pretence.

There is some evidence that in fact it is dilutive deals that do best. Why? Perhaps because they are the ones that get thought about more carefully before management takes them to the market.

2. Return on capital employed must exceed the cost of capital for a deal to be a good thing.

How many times have we read in the financial press that ‘if you take the projected synergies, tax them, and add them to the ongoing earnings of the target company, then the implied return on the transaction value — the price paid for the equity and the debt that is being assumed - is less than the cost of capital, so it is a bad deal’?

Most acquisitions destroy value for the bidder’s shareholders, but this calculation simply does not work. By this logic if you want a return on your equity investment of 8% or more then you would never buy a share on a multiple to earnings of more than 12.5 times. Investors happily pay more than that because they are capitalising upside from future growth

opportunities. Why shouldn’t corporate bidders do the same?

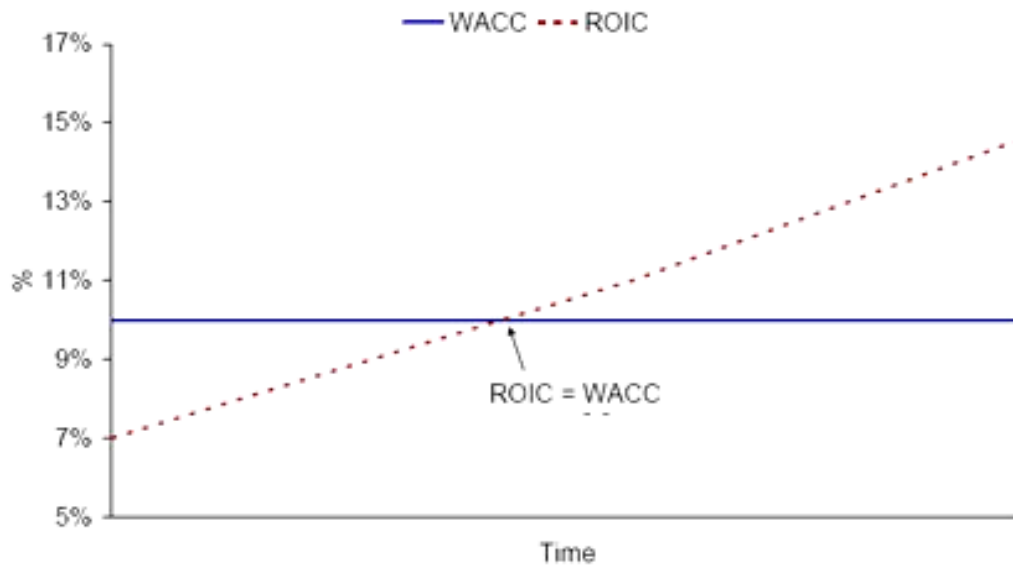
This point is illustrated in Figure 5 below. While the acquirer achieves a Return on Invested Capital (ROIC) lower than the Weighted Average Cost of Capital (WACC) in the early years of the post-merger integration, it generates returns over and above the cost of capital in later years. Any transaction judged on the basis of any single year’s comparison of return and cost of capital would give the wrong conclusion about the value creation potential.

Instead, a holistic approach is required that explores whether the value creation in the later stages of the transaction integration ($ROIC > WACC$) outweighs the initial value loss.

3. Acquirers’ share prices underperform because promised synergies don’t happen.

Not so. It is true that historically the share prices of most bidders underperform the market for a long time after the transaction, and the bigger the transaction, the worse the damage. It is not true that the profitability of merged companies is lower than that of their competitors who have not made acquisitions - rather the reverse.

So how do we square this circle? Because when companies make acquisitions the price that they pay generally includes an element that relates to expected synergies. The problem is not that the synergies don’t happen. It’s just that they are not generally large enough to justify what was paid for them. If a company pays for 150 per cent of the achievable upside from a deal, the target’s shareholders will be very happy. The acquirers will not and may come to regret the deal.

Figure 5. M&A value creation profile

Source: Citigroup Investment Research.

4. Whose cost of capital?

A company that has paid what seems to observers to be a relatively high price for an acquisition often justifies it by saying ‘we have a very low cost of capital so can pay more’, to which the unkind response might be ‘not any more, you don’t!’

The first and most basic rule relating to the application of discount rates to acquisitions is that the discount rate applies to the target, not the acquirer. But there are more subtle issues. What if the target has an inefficient balance sheet and the acquirer argues that by funding the acquisition more effectively, it can cut the cost of capital? And how much of this upside should it be prepared to pay for?

One starting point is to question whether the tax shelter could have been created by the acquirer through the purchase of its own shares, rather than by borrowing money to pay for someone else’s. If the answer to this question is ‘yes’ then that in no way justifies paying up for the target. One could imagine a situation in which the bidder already had an optimally

financed balance sheet, the target did not, and the refinancing element of the bid was part of the addition of value created by the deal - but probably not outside the world of private equity. If a bidder funds an acquisition with cash then it is clearly not justifiable to value the target using a cost of debt.

Why? Because the bidder is only able to fund the acquisition by virtue of having equity in its balance sheet. What is happening is a cross-subsidy of the target by the previously owned assets, which clearly does not in itself add value. So most of the time the prudent course is to allocate no value to the effect of refinancing.

5. Analyst models that have steadily rising returns on capital employed in them are overly optimistic.

Usually, but not when the company being analysed has lots of goodwill in its balance sheet. This is an extension of the point made under item 2. When companies make new investments they do not install a pile of goodwill on top of

them. It is the return that the company makes on its existing capital — excluding goodwill — that presumably provides the best indication of the returns that can be expected on new capital. This explains Figure 5 under item 2 above. As the balance between existing assets and new ones shifts towards the new, so the weighted return on capital shifts upwards towards the underlying level, excluding the goodwill.

6. Control premiums and synergies — avoiding double counting.

Acquirers generally pay a premium over the previously prevailing market price. This is what is generally known as a premium for control. It is justified by synergies of one sort or another, and these should be carefully divided into two categories.

The first relates to the possibility that the market value of the company was depressed — perhaps because of a perception of poor management. In this case, the uplift in value that the acquirer expects derives entirely from its expected

ability to achieve a higher value from the existing assets. This is either by managing them better or by financing them more efficiently, or both. This is what private equity funds are designed to exploit.

The second relates to the possibility that putting two operations together will result in either lower costs or higher revenues. Here the benefit is not stand-alone. It is the direct consequence of economies of scale, cross-marketing, technology transfer, and so on.

Clearly when assessing deals it is essential to differentiate between the expected justifications for the control premium. It is also essential not to pay a control premium over and above the expected synergies.

Footnotes:

¹ A price-to-earnings multiple of 25 implies an earnings yield (the reciprocal) of 4%. Any PE of less than 25 would have a larger earnings yield and so the increase in earnings would be greater than the incremental borrowing cost of 4% in our example. So by default earnings per share would rise.

SOLVING THE SUPPLY CHAIN COST RIDDLE

Textbook variance analysis tools don't cut it in today's complex distribution systems. Finding something that does work is a challenge that Vancouver, B.C.-based Catalyst Paper tackled two years ago — to great effect.

By Kevin Gaffney, CMA, and Valeri Gladkikh

Distribution costs can be more complex than many manufacturing processes, and are often a major piece of a company's overall cost structure. In spite of such significance and complexity, the accounting profession offers no proper model, approach or mathematical construct to analyze and explain the transportation component of a supply chain's cost structure.

At Catalyst Paper, a pulp and paper manufacturer based in Vancouver, B.C., this need was recognized in 2005 and several months were spent in creating an appropriate model for our \$250 million annual distribution spend. The eventual model, based on SAP source data run through Access and Excel, quantified a host of variances to provide a complete explanation of distribution costs company-wide, as well as at the level of individual customer accounts. The Canadian Academic Accounting Association published these results in *Accounting Perspectives* in May 2007. This is a synopsis of those results.

Financial analysis of transportation cost variances versus benchmarks is usually done at a fairly high level with some specifics analyzed in detail on an ad hoc basis. The impacts of rate increases, suboptimal routings, costly carrier choices, fuel cost increases, etc., are often estimated. Though high-level generalizations and ad hoc analyses are often adequate, today's just-in-time and cost-sensitive environment justify having better tools at hand. Also, analysis at

the customer account level requires very specific and precise cost and efficiency identification. The goal should be to have a tool that can handle the macroeconomic and the microeconomic variables quickly and automatically.

At Catalyst Paper, as at many other organizations, the number of customer ship-to locations and combinations of routes, modes and carriers is many times greater than the organization's number of products. And Catalyst's distribution costs are typically between 5-30 per cent of the eventual selling price — not unusual for manufacturers. Catalyst has four source manufacturing plants, four means of transport to about 12 warehouses, varying handling and storage costs at each warehouse, several modes of transport and multiple carrier options for delivery to the customer. For each carrier, freight rates and surcharges vary, some billed in Canadian and some in U.S. dollars and each region and carrier have unique stow limits. Considering the company typically has 500 or more customers to serve in a single month, there are thousands of possible combinations of distribution data.

We needed a tool that could incorporate all of the key drivers of costs and sum them up simply, quantifying how each item contributed to cost overruns or under runs. The tool needed to properly identify which factors were failing to meet expected levels and which could be improved.

SOLVING THE SUPPLY CHAIN COST RIDDLE

Various variance analysis tools could be applied here. But at Catalyst, what looked good in theory left much to be desired when applied to real cost data for complex distribution systems. Textbook examples of widget manufacturing costs didn't have the complexity of interdependent variables that supply chains typically exhibit; and real-life data is fraught with errors and adjustments that must be dealt with to provide a complete explanation of distribution variances.

Issues of data integrity and completeness can be daunting. Seemingly insignificant flaws in source data can destroy the integrity of entire analyses if not treated properly. Filtering, applying certain rules to certain types of errors, dealing with prior period accounting entries and such can wreak havoc with the eventual reports. Don't underestimate the importance of getting the data complete, consistent and correct; it needs to fit neatly into a somewhat unforgiving model.

This article provides an outline of the concepts and output that Catalyst settled on. Each situation won't be the same, but the general concepts are portable.

At the highest level, total distribution costs will be more or less than budgeted. Observe Exhibit 1. The company spent \$36,650 less than budget. Try to identify the reasons for those savings; one can discern soon enough that transportation costs were low due to reduced sales volume. Now try to identify the reasons that costs were \$2.09 per unit less than the budget of \$91.17. The reasons for that difference aren't obvious but the major factors can be identified fairly quickly. Imagine having to do this for hundreds or thousands of customers. The challenge is to break down the total variance into numbers that identify all the reasons that costs aren't as planned — whether at a corporate level or by customer.

Exhibit 1 — Transportation cost variance, July 2007 vs Plan [Favourable/(Unfavourable)]

ACTUAL AND PLAN DATA RECORDS												
						Plants, Units		1st Leg Transp \$/Unit				
Customer	Whse	Mode	Carrier	Loads	Units	1st Plant	2nd Plant	1st Plant	2nd Plant	Whse to Customer, \$/Unit	TOTAL \$/Unit	TOTAL, \$
ACTUAL DATA												
ABCInc	Whse1	TRUCK	ABC Truck	25	500	500	-	15	17	80	95	
ABCInc	Whse2	RAIL	DEF Rail	5	360	360	-	20	25	60	80	
ABCInc	Whse2	TRUCK	Joe's Truck	70	1,400	1,400	-	20	25	70	90	
ABCInc	Whse2	TRUCK	XYZ Trucking	30	600	600	-	20	25	65	85	
ABCInc	Whse2	TRUCK	Bill's Trucking	4	100	100	-	20	25	75	95	
K&V Ltd	Whse3	Rail	GH Rail	5	400	300	100	30	35	60	91	
					3,360	3,260	100	20	25	68	\$89.08 /unit	\$299,300
PLAN DATA												
ABCInc	Whse1	TRUCK	ABC Truck	40	800	800	-	15	17	80	95	
ABCInc	Whse2	RAIL	DEF Rail	1	85	85	-	20	25	50	70	
ABCInc	Whse2	TRUCK	Joe's Truck	100	2,000	2,000	-	20	25	70	90	
K&V Ltd	Whse3	Rail	GH Rail	10	800	400	400	30	35	60	93	
					3,685	3,285	400	21	25	70	\$91.17 /unit	\$335,950
Total Variance, all customers. Note: negative number means more money was spent on freight than planned.											Difference	\$36,650

Customer-destination mix variance

The customer or destination mix variance determines the impact of shipping to different customers. Rarely does a company manage to ship to all of the customers they planned to and in precisely planned proportions. A calculation of the mix impact must be done for each customer. Some will be favourable (i.e. more product shipped to low-cost locations) and some will be unfavourable, and the results are summed up to arrive at the total cost variance attributable to customer mix. The customer mix variance multiplies the planned cost per unit for each destination by the difference between the actual volume shipped and the volume that would have been shipped if this customer received the planned proportion of total sales.

In Exhibit 2, the destination mix calculation shows that the company sold more product to ABC Inc. than planned and less to K&V; and, because K&V was a more expensive ship-to location than ABC, the net result was favourable, a savings of \$561.

While the first two variances are fairly simple to calculate and represent high-level impacts, the remaining variances are more complex and involve calculations at the level of groupings of actual deliveries.

Distribution mix variances

Distribution mix variances deal with the logistical complexities involved in routing product from source to customer. The selection from many options may seem simple enough to deal with in day-to-day operations, but these combinations complicate the mathematical analysis of costs. Supply chains typically involve choices that depend on other choices, which is why the mathematics for supply chain cost variance analysis can be much more complex than manufacturing cost variance analysis. For example, the choice of one

manufacturing plant over another can result in a different set of warehouse options; the warehouse chosen to route the product through may have different outbound mode options than another warehouse, and so on. We won't go into the specific explanations and proofs of the mathematics in this brief article, but suffice to say that the combinations of routes and modes and carriers complicate the variance analysis math at each turn.

Catalyst breaks its distribution mix variances into the following:

- First-leg route (or source plant)
- Last-leg route (or warehouse)
- Mode
- Carrier

The first-leg route variance and the last-leg route variance quantify the impact of the end-to-end routing decision. If product can be sourced from plants at different geographic locations and shipped to one or more warehouses, the choices made can result in significantly different costs. Capacity constraints, production problems, strikes, weather, and a host of other factors can result in sourcing and routing product through suboptimal channels. Isolating the impact of routing decisions can go far to optimizing a supply chain or identifying bottlenecks and shortcomings.

Mathematically, the calculations of the route variances are relatively complex, requiring a specific data record structure and formulae to avoid double-counting and overlap with other variance amounts. Accountants will recognize the general idea of mix variances from their management accountant training, but will find that the routing mix variance calculations here go beyond textbook examples because of the interdependency of the first-leg mix and last-leg mix.

In Exhibit 2, the example points to effective routing saving the company \$0.70 per unit; a loss of \$0.33 on the first leg and a saving of \$1.03 on the final leg to the customer by routing a higher proportion of product through Warehouse 2, which has lower planned last-leg costs to ABC Inc. than Warehouse 1.

The mode mix variance recognizes the impact on costs of selecting various modes of transport between which there can be large differences in cost. Customer preference, late production, late orders or adverse weather conditions are examples of what can create deviations from a planned mode mix and can be the primary determinant of average freight cost.

The mode mix variance reflects whether the actual mode mix (at benchmark costs) was more/less expensive than the benchmark mode mix. The mode mix variance calculates the impact of shipping via a different mix of modes than planned and can point out the impact of bottlenecks or equipment shortages.

In the example, we find that the company managed to save \$1.55 per unit in distribution costs due to an effective mode mix. The company shipped a higher proportion of product by rail than planned. Rail had a planned cost per unit to ABC that was less than the average cost per unit for trucking. The carrier mix can be influenced by carriers' relative rates, equipment shortages, strikes, core carrier programs, contractual agreements on minimum or maximum volumes, etc. There can be a very significant variation in rates from one carrier to the next and some carriers may even have differing vehicle capacities that can influence average yield. The carrier mix variance reflects whether the actual carrier mix for a given mode was more or less expensive than the benchmark or budgeted carrier mix.

In our example, a judicious selection of carriers resulted in a savings on overall freight costs of \$0.74 per unit.

Carrier charge variances

Once the route, mode and carrier have been selected and costed, the analyst needs to determine the impact of the rates charged and the efficiencies achieved. Mathematically and intuitively, these price and efficiency variances are easier to determine than the distribution mix variances, but they still require attention to detail. Catalyst breaks their carrier charge variances into two types: rates and efficiency.

Rate variances include, for instance, the difference between the actual and planned freight rate, fuel surcharges, border charges, brokerage fees, port charges, etc. Essentially, each component of the actual cost (in dollars per load or dollars per unit) is compared to the budget and the difference in cost is applied to the actual volume shipped to arrive at the dollar impact. In Catalyst's case, transportation is transacted in multiple currencies, so the exchange has to be isolated from other factors.

In the example, rates charged by DEF Rail were slightly higher than planned, adding \$0.10 per unit to average freight costs.

Efficiency, in Catalyst's case, is limited to the difference between the actual and planned yields (volume per truckload, rail car or container). The difference determines, for instance, the number of extra truckloads or carloads that were required due to low yields (which may have been the result of poorly planned stows or suboptimal order sizes). The change in the number of trips is applied to the planned cost per trip to determine the dollar impact of the efficiency loss or gain.

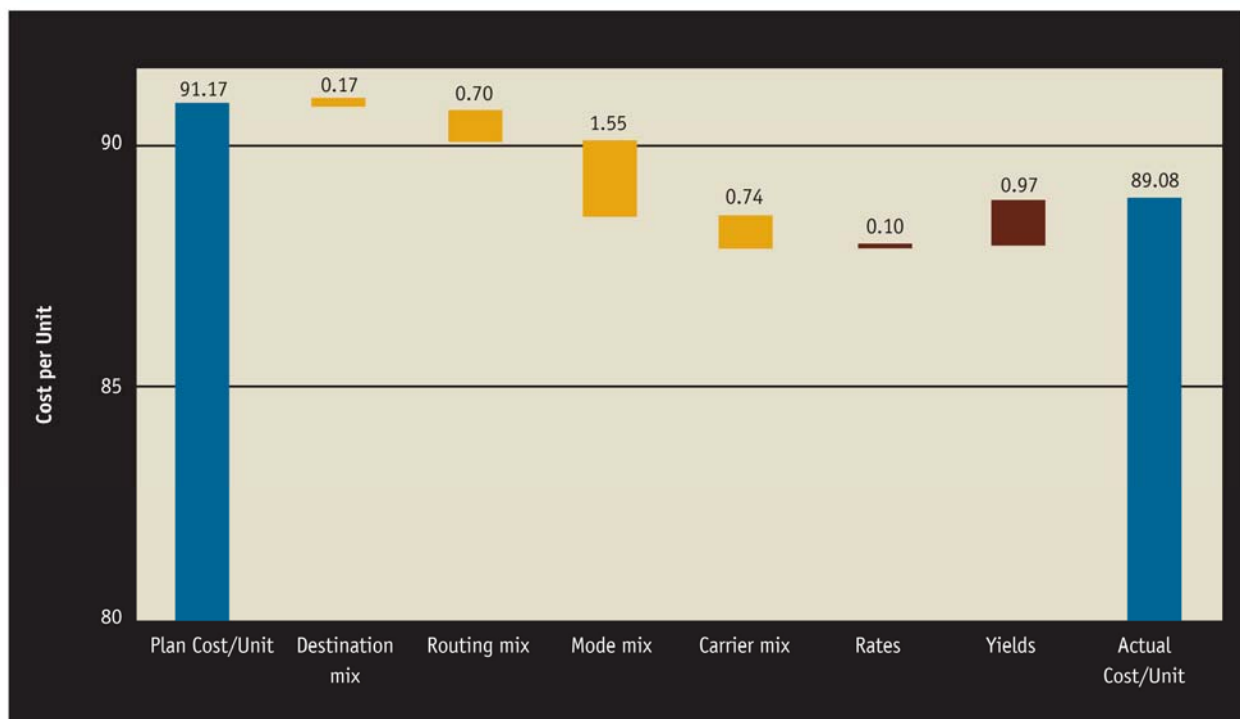
In this example, the plan was to ship 85 units per rail car but only managed 72, adding \$3,250 or \$0.97 per unit to distribution costs.

Reporting the results

The rubber hits the road in any cost analysis when the results are presented. The variances need to be summarized in a clear and productive format. The method of reporting and explaining variances will determine if the results are used for effective change. Consider using one or more of the following presentation methods:

- Summarize the results graphically, as shown in Exhibit 3, for the overall results or for individual customers. This can be particularly powerful for explaining overall freight costs.
- For each customer or for major customers, present a single page of actual and benchmark summary records with a listing of the variances. Sales reps can find this particularly useful for assessing customer profitability;

Exhibit 3 — Transportation Costs per Unit Versus Budget



- Top-ten lists for each type of variance, showing the ship-to destinations with the highest impact. For example:
 - o carriers or warehouses providing the worst/best yields;
 - o warehouses arranging the worst/best carrier mix;
 - o warehouses experiencing the worst/best mode mix; and
 - o customers whose freight costs are most sensitive to exchange fluctuations.

These reports can identify business process and/or logistical issues that create increasing costs or keep your company from achieving planned efficiencies.

As the relevance of distribution to industry grows, it's increasingly important to have

immediate and complete analysis tools for those costs. While all of the attributes of transportation costs and their efficiencies aren't covered, a general approach has been illustrated that can possibly be applied to each specific circumstance.

For a more complete examination of the formulae and suggested record structure, see *A Case Study of a Variance Analysis Framework for Managing Distribution Costs*, Accounting Perspectives, 2007, Volume 6. Number 2, Canadian Academic Accounting Association.

Kevin Gaffney, CMA, (kevin.gaffney@catalystpaper.com) is the senior business analyst at Catalyst Paper and Valeri Gladkikh (valeri.gladkikh@telus.net) is a consultant.



International Federation of Accountants

545 Fifth Avenue, 14th Floor, New York, NY 10017 USA

Tel +1 (212) 286-9344 Fax +1(212) 286-9570 www.ifac.org