Black Hole or Competitive Edge?

March, 2004

Impacts and Opportunities Stemming from Government Regulation

by Anthony E. Ghosn

Introduction

In 1998, the Millstein report[1] to the Organization for Economic Development and Cooperation (OECD) on corporate governance pointed to a competitive market place in capital markets tied directly to governance and board performance. More recently, Ira Millstein, the well-known corporate governance consultant and attorney, reported to Congress in February of 2002[2] and continued to advocate a theme of global competition for capital with corporate governance being a main factor to success.

Alternatively, more recent reports have sited Sarbanes-Oxley (SOX) amendments to the SEC corporate finance rulings as huge expense burdens that public corporations will have to absorb as overhead and operational costs. These reports point to a new a layer of expense with no foreseeable economic return.

So which of these diametrically opposed theories is more true? Are we faced with an opportunity for proactive leaders of public and private corporations to leverage into low-cost capital acquisition and performance effectiveness (what we've called "competitive edge" in this paper) or is it a black hole of ever-increasing expense burden that should be mitigated and streamlined with a "letter-of-the-law" approach. This author believes the former premise has more merit and momentum, and sets out within this article to demonstrate how corporate governance translates into corporate incremental and sustainable performance. We start from a metaphorical perspective:

When the proverbial "pendulum of societal issues" swings too far in any one direction, things usually change quickly, producing a 'societal shift' in legislative or regulatory action. It's a basic axiom for any macro-economic student: The speed at which Sarbanes Oxley legislation passed Congress in 2002 (SEC regulations) is a very good example. The reaction to the wardrobe malfunction between Janet Jackson and Justin Timberlake at the 2004 Super Bowl Halftime broadcast was a cultural example of the same type of societal shift and could serve as another benchmark for how fast changes in government regulation (FCC regs in that case) can occur when perceived limits (social mores) are crossed[1].

The commonality between these two seemingly unrelated events is a "last-straw" type reaction from the public reflected through US Government lawmakers. In other words, an extreme swing of skepticism, mistrust and outrageous events can trigger significant change. Furthering this point, it is important to note that the content of the Sarbanes-Oxley legislation had been lying around the chambers of Congress for a long, long time just as the abuses which they targeted had been going on for a long, long time. Once the pendulum swung to its societal limit, the legislation easily passed into law (i.e. Enron, WorldCom, Tyco, Adelphia et al.)

So, do we have a knee-jerk reaction or measured response? What are the repercussions? Are they all negative? Leaving TV broadcasters and the entertainment industry to fend for themselves, let's turn to the case of US securities markets, corporate boards and regulated financial reporting by public corporations and ask a basic question: What strategies for compliance make the most sense?

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1 The Millstein Report to the OECD. April, 1998
2 Ira Millstein report to US Congress. Feb. 2002
3 WebCPA, Survey: "Section 404 could cost...."

1 The FCC experienced a volume of complaints regarding the Jackson/Timberlake matter, five fold over previous years causing huge changes in public broadcast regulations on decency; http://en.wikipedia.org/wiki/Super_Bowl_XXXVIII_halftime_show_controversy

The Fundamentals

Over the last century, this country's capital markets have fueled the longest economic period of prosperity the United States has ever experienced and therefore leads the world in economic expansion to date. Approximately one- third of this country's wealth is currently invested in our capital markets, which have an aggregate value of approximately 17 trillion dollars, nearly

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twice the Gross National Product. Almost 80 million investors from all walks of life have placed their trust in the U.S. capital markets—unquestionably the most liquid and deepest markets in the world.

Throughout the twentieth century, capital markets and their participants theoretically gained investors' confidence through quality information and vigilant corporate governance. Quality information was and is the life-blood of markets; corporate governance ensures the flow of that information is not severed or obscured.

Yet investors and the business community learned a very valuable lesson 70 years ago during the great depression—that confidence in markets can be shaken and lost. We learned that liquidity can disappear and capital can quickly dry up. Fair and orderly markets can dissolve much more quickly than they were built. A golden economy can turn to dust overnight.

Taking an altruistic view for a moment, consider that the real intent or spirit of Sarbanes-Oxley is to reinforce what our capital markets have created and to avoid a collapse in confidence. The premise of this article is that those public companies that can do a better job of instilling confidence are the winners in the capital valuation markets.

A strategy for competitive advantage begins to take shape. **Figure 1** and **Figure 2** project a simple, but compelling, rationale that good corporate governance results in good corporate performance.

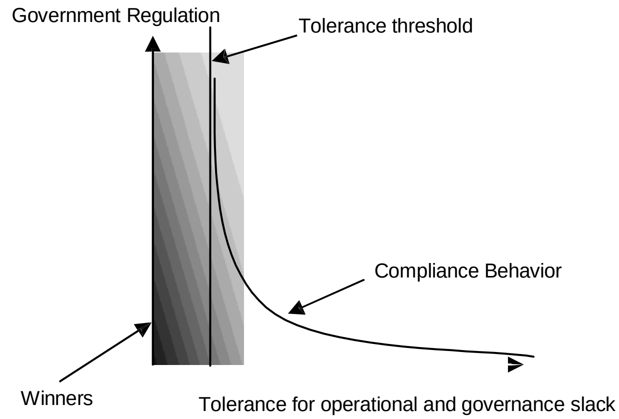

Figure 1

This graphic chart demonstrates that when tolerance for operational and governance slack is reduced (as it has in the last few years), government regulation and the adherence to it increases. So as one moves left on the horizontal axis, the corresponding plot on the vertical axis increases. The long tale of the curve suggests that tolerance is very flexible up to a certain point and then a seismic shift occurs as in the case of Sarbanes-Oxley. The vertical line represents an absolute tolerance threshold (as in zero tolerance.) The shaded area that is marked "winners" represents the organization that can very quickly demonstrate they are moving towards or are well within the boundaries of regulation and even exceed the letter of the law. As the shading gets darker to the lower left of this model, the competitive advantage increases because the organization is behaving on its own without the imposition of government regulation.

As tolerance for performance slack grows smaller the propensity to regulate increases and the compliance by companies tends to follow. The companies that can exceed the tolerance threshold represent quality and may command a premium in the markets for capital.

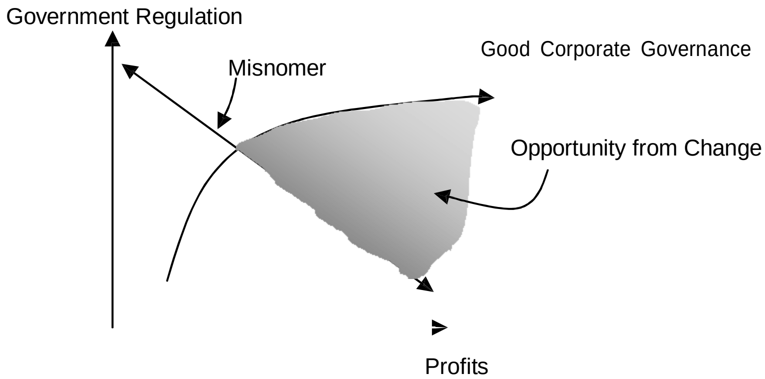

Figure 2

This graph demonstrates the misconception that government regulation automatically equals fewer profits (indicated by the sloped line running downward from left to right marked as a "misnomer.") The corresponding curved line represents how good governance equates to good corporate performance and actually contributes to profits up to the point where its economies begin to flatten. The gray space between these two lines represents the potential opportunity available to an organization that makes a paradigm shift in its understanding of compliance as it relates to performance.

Profits do not necessarily run opposite of government regulation. The gray space above the misnomer line bordered by the "good corporate governance" factor represents a competitive advantage opportunity.

Anecdotal Results of Surveys

This author interviewed several internal auditors and CFOs over the last twelve months, and the majority of their opinions are that Sarbanes-Oxley amendments to SEC regulations are a cost burden requiring a cost analysis approach for solutions.

Granted, the overwhelming requirements of the deadlines for Section 404 alone will keep a financial manager focused only on the absolute requirement to the letter of the law with little time or energy left for consideration of positive organizational impacts or positive economies.

When questioned as to the long-term impact on effective critical processes as by-products of SarBox requirements, respondents to the survey demonstrated little recognition of this potential. Although there was agreement that efficiencies could be realized in report consolidation and internal control processes, the connection to organizational performance and effectiveness was not acknowledged to any sizeable degree. Capital valuation was not a topic that held value within these conversations either. In addition, the opinions on change management requirements held that it would be too difficult to achieve enterprise-wide integration of processes and procedures.

With all due respect to colleagues in the accounting profession of private industry, a sizeable opportunity in client needs and a shift in culture is going somewhat unaddressed. The profession has treated itself as fixed overhead and has molded the rest of us to this established norm. If the hunter/gatherer model were applied to accounting and financial management, M&A pros would be closer to the hunter end of the spectrum and internal audit professionals might be at the opposite end. Nevertheless, the whole spectrum would be considered fixed overhead. Marginal requirements for more work, like Section 404 and other provisions in SOX, are therefore considered pure incremental costs. Competitive and strategic thinking is not figuring into the equation. Although there are certainly many advisors sighting these opportunities and rightly so.

The Black Hole premise has the accounting world adding up the marginal costs[3] necessary to comply. The other school of thought, Competitive Edge Thinking[4], is looking at extensions to traditional GAAP measurements and corporate governance strategies that can create an advantage in the corporate valuation marketplace while adhering to the new regulations standards.

The Sarbanes-Oxley legislation and the resulting changes to SEC regulations are obviously at the core of this debate but the argument goes far

beyond what the SEC or any government regulation can really address. The spirit of well-intentioned government has to be embraced by those that are playing the game in order to go beyond the burden, or tax perceptions, that the new regulations impose. Morality cannot be legislated; although '*leveraging' morality can be a very powerful strategy.*

The graphic in **Figure 3** below shows this plain and simple:

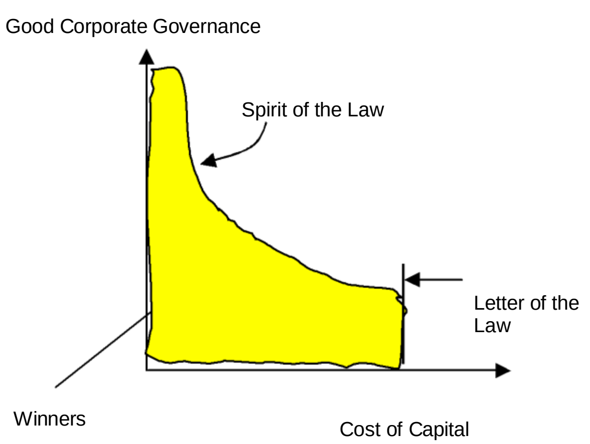

Figure 3

The horizontal axis represents the cost of capital, the vertical axis represents levels of corporate governance that in turn provide credibility and assurance to the investment community. The single point identified as "Letter of the Law" represents an organization taking a minimalist approach, treating government regulation literally with no strategy for leveraging. This creates an inflexible cost of capital factor relative to corporate governance. The "Spirit of the Law" curve represents an organization that creates a dynamic environment with respect to governance and continuously strives to increase its board's performance. The yellow space bordered by the "Spirit of the Law" curve and the fixed point of the "Letter of the Law" on the horizontal axis represents the competitive advantage that is realized when taking a proactive stance towards governance, internal control and enterprise risk management.

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[4] The Gartner report

Business Case Models for Creating Competitive Advantage

Internal Controls and Procedures for Financial Reporting

Letter of the law: Section 404 of Sarbanes-calls for "Management's report (or assessment) of the effectiveness of the internal control structure and procedures of the issuer for financial reporting." Further, the law requires that "each registered public accounting firm that prepares or issues the audit report for the issuer shall attest to, and report on, the assessment (of internal financial controls) made by management."

Simple enough. Document your internal controls and procedures, plug the holes, issue the report for the auditor to review, and include in the annual report. Done. Add up the hours and external costs to perform the tasks and book the expense wherever appropriate. And while there is no denying that this is a very large effort, the specter of the effort is whether or not there is any value to be realized.

In the scenario above, nothing but pure overhead is realized to meet the new requirements. Additionally, the operations' processes don't even come into the picture. Recent legal counsel advises that "operations' internal controls do not need to be reviewed." According to the letter of the law, this is true, although one must question this minimalist approach in terms of the value advice imparted. Isn't faulty operational process by definition, faulty financial reporting process? When did the firebreak between these two extremely important components of business become independent of one another? Where is the risk component in this kind advice?

Spirit of the law: Put your processes to an empirical test. Make sure that controls have substance and are implemented in such a way that you can electronically monitor activity and red-flag issues. Make the mapping process of critical financial processes to critical GL accounts an integrated, on-line effort. This requires that controls exist in the form of business rules and process management systems where the controls for financial reporting are tied directly to the operation's daily activity.

Document management and business process integration tools that have the ability to monitor operational activities in real time can play a very powerful role by taking what used to be a hand book of procedures and controls and creating a secure, live, process-monitoring system. Even the most ERP-proactive organization can realize value from this Section 404 and Section 302 strategy. (ERP systems do not automatically provide process integration, especially when legacy systems and outside partners are concerned. i.e. SAS 70 issues)

Result: Competitive advantage will occur in two forms:

- Imagine the annual attestation that reports on the corporation that has initiated the integrated process management system for more effective financial reporting compared to the one that has not. We contend that confidence in the institutional investor group will increase as a result of corporations that are doing more than just simply streamlining their consolidation processes.

- What overhead expense reductions and productivity can be realized from this initiative? A solid business case can be made for economic return from this strategy. Has risk been addressed? We believe that risk for financial reporting process and operational gaps are addressed, and that the first steps towards the identification of materiality are taken through this proactive strategy.

Figure 4 demonstrates where integrated internal controls lead to the broader framework of the COSO Enterprise Risk Management model.

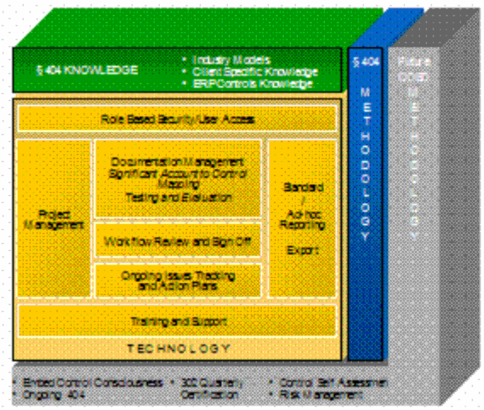

Figure 4

This entire block represents the components necessary for an organization to realize the proactive goals that can generate competitive advantage. The green block represents industry knowledge from internal and external sources to the enterprise. The entire gold block represents the technology and physical components necessary, including appropriate security. The blue and gray blocks represent methodologies and strategies for incorporating the regulations, rules, and concepts directly into the operational processes of the enterprise. (Please see exploded view in addendum.)

Risk Management

Section 409 of Sarbanes-Oxley is focused on the definition of "materiality" and the management of material variance, which is in essence a large part of the premise to enterprise risk management. The challenge, albeit without final ruling from the SEC, is to foresee issues of materiality and be able to report them in a timely manner. This creates a distinct potential advantage to the company that manages risk (materiality) better than its industry competitors, even before the ink dries on final Section 409 rulings. The graphics in **Figure 5** and **Figure 6** show where the well-governed corporation moves into high return/high probabilities of successful risk-taking while leaving the cost-oriented management team behind a wall of uncertainty and low probability/return opportunities. The penalties and stigma attached to materiality in the form of financial restatements, media attention and potential legal action are creating this wall of uncertainty, and the proactive manager can use that to his advantage through the combination of good governance and technology solutions.

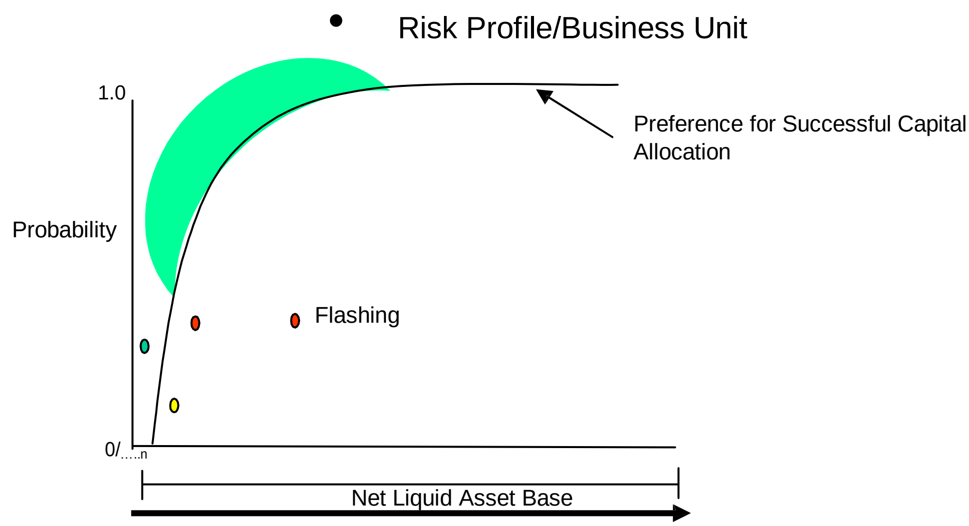

Figure 5

The horizontal axis represents the capital that an organization has to allocate (put at risk.) The vertical axis represents probability from zero to one, or 100%. Through surveys, a specific company's appetite for risk is plotted and represented by the curve in this diagram. This example shows that the example organization does not put capital at risk relative to its asset base until the probabilities for success are well above 70%. Any opportunities on or above the curve, especially in the green highlighted area, are ones to be pursued. Opportunities and events inside the curve are ones to avoid and represent risk that is not tolerable to this organization. It is important to note that events inside the curve would represent material events. The red and yellow dots depict material events that might occur without the ability to report them in the required time (Section 409.) This area becomes exceptionally risky without the ability to meet 409 requirements. Different organizations will have different profiles or appetites for risk, according to culture and other factors. This is a normal risk profile model used to help companies facilitate decisions and decision analysis, commonly called rational economic behavior.

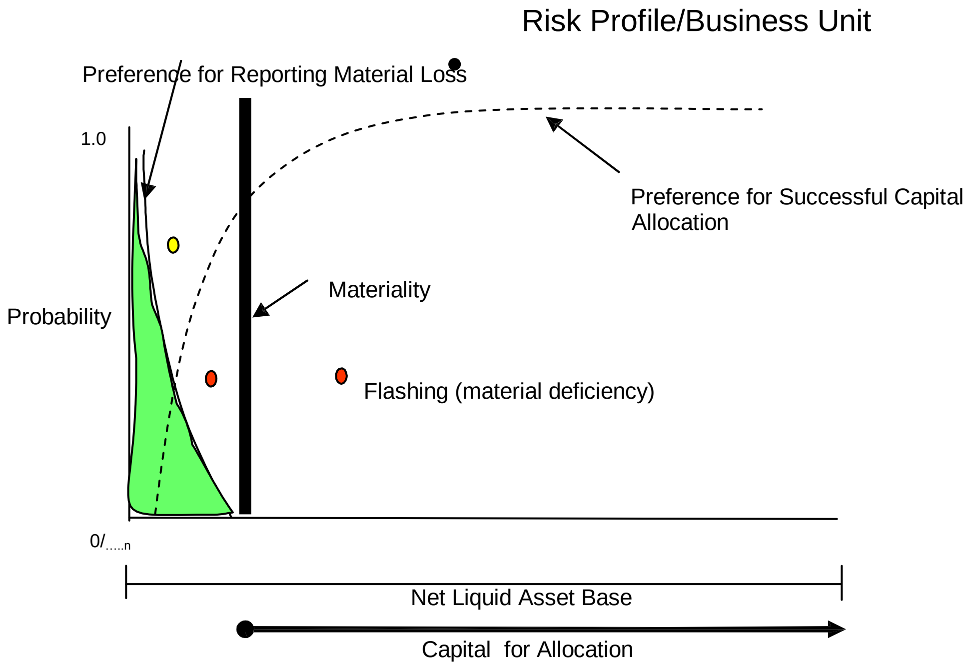

Figure 6

The new curve and vertical bold line in this diagram represent the behavior that takes place when Section 409 is imposed and there is no ability or limited ability to comply. Instead of acting on the normal profile curve, a new curve is created that avoids risk-taking to a very large degree and stifles the company's ability to compete. The bold vertical line represents the definition of materiality for this company. If this company does not know when it is on or beyond this threshold, then a material event (inventory shrinks, fraud, errors, receivables loss etc.) becomes so critical that a hurdle to risk-taking is created.

The probability curve is a profile of any given company's tolerance for risk as probabilities of success are plotted in **Figure 5**. The profile is formed through the relationship between a company's net liquid assets on the X-axis and Zero (0) to One (1.0) probability of success on the Y-axis. This profile is determined through a survey and interviewing process with senior management.

Space below the knee of the curve in this case is a risk/return combination that is beyond the tolerance of the example company's profile. In other words, assets would be placed at risk at a level beyond the acceptable probability for success that this company could justify. Space on or above the knee of the profile, highlighted in green, represents risk/return scenarios that this company would seek for inclusion in their investment portfolio and business models whether they are new products, M&A activity or other business ventures. This behavior occurs naturally and is sometimes considered part of rational economic behavior. It is a common model used in decision analysis and risk management. The new definitions and scrutiny regarding materiality in Section 409 is where economic behavior takes a turn.

Two new dimensions of this model are introduced in **Figure 6**. The bold vertical line represents the financial quantification of materiality for this company. Without the ability to report a material loss (8k filing within 3 to 5 days), a company will not feel comfortable venturing past this point (because of the new scrutiny of a material event within Section 409.) The potential negative impact is too high. Therefore, a new risk profile is created. The steep curve that is exactly opposite in behavior to natural risk-taking is the second element introduced in **Figure 6**. This curve shows that behavior is altered and now risk is measured with respect to the materiality hurdle instead of the open market and this company's capital capabilities. The higher probability for materiality results in lower and lower capital at risk. Simultaneously, the institutional investor has an eye on materiality. Investors are leery of those situations in which risk information does not flow from operations and management to the board for strategic decision.

The letter of the law is simply that a company identifies materiality and makes sure that it is visible any time a venture, investment or operational event occurs where materiality (loss) has occurred—simple enough, although potentially very expensive to monitor without proper IS and IT strategies in place.

The spirit of the law, however, puts CEOs in control when they can demonstrate how a material event is identified through operational data monitoring coupled with real-time, integrated risk profiles long before the 3 to 5 day 8k reporting window arrives. How that event is managed can allay the concerns of institutional investors and management, thus moving the company back into their natural profile for risk-taking.

The management team that uses the spirit of a regulatory issue, conforms operations to meet good corporate governance, and uses the corporate governance performance to lower capital costs creates this competitive advantage in the form of lower costs of capital and lower compliance costs. Why? Because the firm that demonstrates that it has overcome the materiality vertical line in **Figure 6** demonstrates that it manages risk better than its competitors, allocates capital with more accuracy, and puts confidence back into the investor community. The compliance costs automatically are lowered because of the integrated systems.

Imagine how CEO I and CEO II, one of whom can identify his materiality threshold and can demonstrate that ability to the market, might compete in a bid for a new stock issue. Would the market discount the offer price for the CEO that does not have this ability? Would the market pay a premium for the one that can? The answer has been a resounding *yes* from securities analysts and demonstrated in a study conducted by Institutional Shareholder Services and Georgia State University[5].

Non-GAAP Financial Measurements

Section 401 of the Sarbanes-Oxley legislation is the final area in which we will demonstrate the presence of competitive advantage through embracing the spirit of legislation and applying organizational solutions.

Regulation G is the SEC ruling on Section 401 of the Sarbanes-Oxley legislation. In short, the ruling requires that all non-GAAP financial measures be reconciled to the closest, most relevant GAAP-approved measurement. The intention is to put some boundaries around what used to be the "smoke and mirrors" section of MD&A in annual reports. Industry-specific measurements such as same-store metrics or market-share calculations, and even cash-flow projections are very pertinent factors to industry analysts.

Strategic metrics such as these many times do fall into GAAP-approved guidelines without some manipulation or reconciliation. However, by utilizing Management Accounting models such as Balanced Score carding, Target Costing, and Scenario Planning, an integrated corporate dashboard can tie each model back to its financial impacts and in turn to GAAP guidelines. This facilitates powerful industry metrics, and the specifics can again play a crucial role in information that flows to the board and then to the investor community. At the same time, IT and IS security measures can play a crucial role since the operations data that drive the dashboard are now appropriately monitored and can be blanketed with security layers.

[5] Study by ISS and Georgia State University

In Conclusion: The Pendulum Has Moved

"Investment capital will follow the path to those corporations that have adopted efficient governance standards, which include acceptable accounting and disclosure standards, satisfactory investor protections and board practices designed to provide independent, accountable oversight of managers."[6]

The student and practitioner of management accounting, internal audit, governance, risk management and compliance provides an excellent perspective and capability on how to make these strategy models a reality at individual organizations. Management accountants know process, financial modeling, score carding, and reporting protocol. In combination with their CPA colleagues, corporate legal minds, IT professionals and the appropriate technology and layers of security in corporate dashboards and metric algorithms, competitive advantage as described in this article begins to take shape. The accounting and finance professions will have furthered their path into new strategic success while maintaining their objectivity and fiduciary responsibilities. Some might describe this transition as one from the old-school number cruncher to a new, holistic and fully integrated strategic partner to the enterprise.

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[6] Ira Millstein, 1998 report to OECD