

# ARE YOU CONTROLLING THE FUTURE?

The following article was published as part of *Finance & Management* – FM153, in March 2008 by the ICAEW's Finance and Management Faculty.

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# ARE YOU CONTROLLING THE FUTURE?



When redesigning strategy and working processes, companies often neglect their internal controls until later. Yet, say **Jeff Herman** and **Mike Almond**, such periods of change are the ideal time for simultaneously improving the management of future risk.

Managing a response to the forces of change is probably an organisation's greatest challenge. As well as competition, climate change, credit crunches and regulatory compliance, there is the threat of the simply unknown to be taken into account.

Having opted for a fundamental rethink of the organisation's strategic direction and ways of working (as opposed to just tinkering at the edges), a new infrastructure of process designs, change managers and war rooms must be established to design the future operating model in a controlled and considered way.

This redesign is rarely easy. With the constant (if clichéd) encouragement to think outside the box, paint the sky blue and challenge everything, the future suddenly looks a lot less controllable ... especially if the operational and financial processes are to be changed.

Further, in the desire to 'design the future', internal controls may not be at the forefront of minds. Indeed, despite the official requirement for directors to provide assurances regarding the effectiveness of an organisation's internal controls, process designers still seem to give them a low priority, even when there are very substantial inherent financial risks.

To give just one example of this, the unbilled gap between purchases and sales in the utilities industry frequently requires write-offs of hundreds of millions of pounds. This can often be the result of a utility being unable to invoice customers, because they may not have the correct address or even any knowledge of them at all.

So although not all of this type of risk can be avoided, the start of a process redesign would appear to be an ideal opportunity to get the management of such risks right.

#### **Why internal controls are neglected**

The reasons for not embedding internal controls during process design can be a complex mix of:

- poor understanding of internal control issues;
- the nature of projects;
- lack of process design skills; and

## Risk management and internal control are usually deferred to the accountants and auditors following completion of the perceived 'real' work

- lack of an appropriate framework within which to consider internal controls.

Below, we take a look at each of these above factors, and suggest (with a sample framework) how management – particularly finance professionals – can work towards a remedy.

### Poor understanding of internal control issues

A change management group at a utilities company was recently asked about the internal controls over its reengineered processes. Their reply was: "What have internal controls to do with us?" And at corporate governance workshops within the same company even those in the finance function provided a poor response to the question: what is internal control?

To understand what we are talking about here, the Treadway Commission's Committee of Sponsoring Organisations (COSO) ([www.coso.org](http://www.coso.org)) defines internal control as 'a process, effected by an entity's board of directors, management and other personnel, designed to provide reasonable assurance regarding the achievement of objectives in the following categories:

- effectiveness and efficiency of operations;
- reliability of financial reporting; and
- compliance with applicable laws and regulations.'

The implication of this definition (used for both Sarbanes-Oxley and Combined Code compliance) is that an organisation must adopt a recognised internal control framework to provide the oversight and processes to manage and embed risk management techniques and controls within the organisation and its operations.

### The nature of projects

Business managers and professionals, working in hierarchical organisational structures with a clear career path are often reluctant to be assigned to major change projects. Accountants are typically employed to be focused functionally on activities related to financial planning, budgets, forecasts and other activities enabling effective stewardship, resource management and decision making.

In major change initiatives, accountants will undoubtedly get involved in the financial modelling for the business case, but are not the obvious candidates for envisioning what the future business will look like along with the underlying process designs. They will typically be concerned about the career risk of time spent on a project and the difficulty of reintegrating into the organisation once the project ends.

Also, since any form of change can fail if not managed in a disciplined and sensitive way, relatively new disciplines have evolved around project and change management staffed by in-house teams and external consultants. While these change managers have a very broad range of technical and interpersonal skills, their grasp of the subtle arts of organisational psychology may not be enough to engage with and understand the language of a wide range of professional disciplines within an organisation.

Yet at the same time, there are often preconceptions that accountants, and risk management and internal control experts, are the people who like to say no, rather than a source of quality process design input. Risk management with its focus on managing and minimising potential financial loss, can be viewed as negative and constraining.

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## Accountants are often untrained in the techniques of process design and not confident in their own abilities to contribute and to take a leadership role

Hence, consideration of risk management and internal controls is usually deferred to the accountants and auditors following completion of the perceived 'real' work of designing efficient management and operational processes. Such a response misses the opportunity to ensure efficient, effective and regulatory compliant processes that are aligned with the business objectives and resilient to the shock of future changes.

### Lack of process design skills

As technical finance experts, accountants are often untrained in the techniques of process design and not confident in their own abilities to contribute and to take a leadership role (see 'Case study' below).

### Lack of an appropriate framework

Intuitively, we accept that designing processes at the outset with appropriate key internal controls must have a cheaper lifetime cost and be more effective in preventing financial loss, than trying to design them in afterwards. Even if financial loss is not the immediate issue, the corruption of financial management information will undermine any support for decision making in the same way that driving a car when blindfolded is completely disabling and bound to result in something nasty.

However, this intuitive acceptance of building-in rather than bolting-on internal controls can be a costly error if

### CASE STUDY: LACK OF PROCESS DESIGN SKILLS

In a recent experience of ours in the public sector, a procurement process evolved with insufficient input from finance and internal control experts. The resultant process for procurements costing less than £20,000 had a distorted focus on compliance that ignored the wider internal control context.

This distortion was further compounded by an unbalanced focus on only one key performance indicator (KPI) – the prompt payment indicator – rather than a more balanced view that also took account of process costs. Additionally it emerged that:

- more than 30 clerical staff were directly engaged in ensuring that all payments to suppliers were fully compliant;
- virtually all supplier invoices were non-compliant and deemed unworthy for payment, usually through not quoting an order reference or being unsupported by an authorised request for procurement; and
- to prepare the invoice for payment, staff had to re-work the failed procurement process.

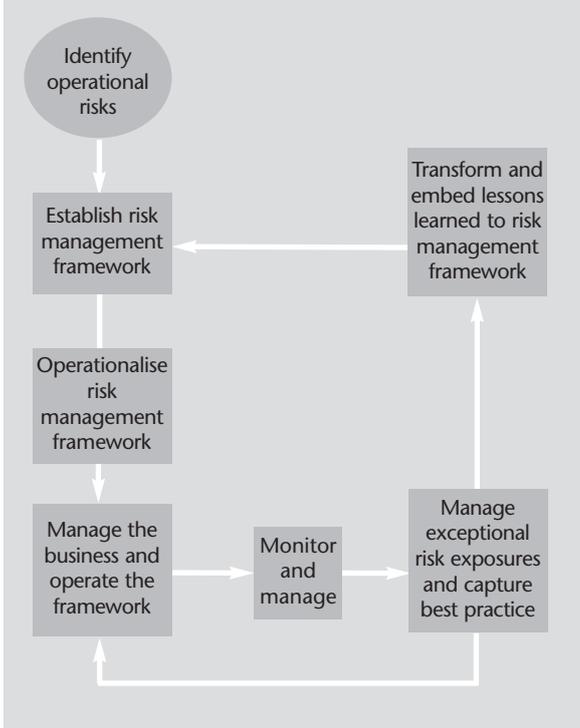
Further investigation found that non-compliance was due to senior management and suppliers not understanding a seemingly bureaucratic and unwieldy process for minor items such as in-house catering or the recruitment of contract staff.

The instinctive response to non-compliance was to apply additional bureaucracy and process performance reporting. By completely ignoring the business context and the fact that 75% of the invoices were for relatively trivial amounts, the only outcome was more compliance staff being engaged to report on non compliance.

Eventually a more considered approach, with input from finance personnel and the internal auditors, resulted in a process that asked the question, 'What is the risk of paying this non-compliant invoice to this particular supplier?'

This enabled the payment process to be transferred completely to the existing finance shared service centre, enabling savings in excess of £1m per annum.

FIGURE 1 RISK MANAGEMENT PROCESS



the internal control perspective is not managed in a risk management context. This requires key internal controls to be related and cascaded down from an organisation's principal business and financial risks. Risk management starts with an understanding of how much risk an organisation is prepared to accept and what the key risks are to the business. Focusing on these key risks, cascading and mitigating them within a risk management framework avoids the haphazard bottom-up approach of incorporating numerous internal controls that are unrelated to meaningful control objectives and material business risks.

Figure 1 (above) illustrates the risk management process needed to build controls into management processes cost effectively.

The bottom-up approach, on the other hand, attracts the involvement of an ever-increasing circle of potentially resistant stakeholders who will not readily appreciate the need for additional controls over their processes and area of operations unless they can be shown to relate to management of a key strategic risk, or to benefit a stakeholder's own area of operations. Business managers are no longer intimidated by finance professionals mumbling the mantra of internal controls without a reasoned and justified argument for them. And there is also the additional risk – one that may eventually overwhelm a change programme – of the expanding amounts of time and emotion required to manage those stakeholders.

## IDEAS FOR ACTION

- Evaluate your company's risk management strategy on a scale of one (does the minimum to tick the box) to 10 (fully embraces internal control to improve the bottom line).
- Since all employees are responsible for internal control, ensure they know what it is so that they fully understand their responsibilities. Are internal controls embedded in standard operating procedures? Is there a control culture?
- Ensure that internal control is covered as part of the induction of new employees. When was the last time there was any internal control training for management and staff? Remember that this has to be a continuous process given staff turnover and rotation.
- Ensure that internal controls are specified within the 'to be' processes. Are these controls over processes and activities clearly identified in process maps not only for the 'to be' processes but also for the 'as is' ones?

Lastly, remember that the risks of doing nothing usually far outweigh those of a well-planned, structured and controlled change programme.

## Conclusion

Clearly, finance and internal control professionals need a range of skills to engage effectively with business and change managers. Understanding the language and process of change may not enable finance professionals to control the future, but they may be better able to influence the outcomes for the business.

The implementation of internal controls is not a one-off project but must be developed as part of the culture of the organisation and a defined management process. So before embarking on any major change programme, assess your organisation's approach to risk management and internal controls by considering the above ideas for action. ■

## FACULTY WEB LINKS

- 'Internal control from a risk-based perspective' – SR20  
[www.icaew.com/index.cfm?route=154250](http://www.icaew.com/index.cfm?route=154250)
- 'Risk management: a guide for finance professionals' – SR10  
[www.icaew.com/index.cfm?route=126431](http://www.icaew.com/index.cfm?route=126431)
- 'Internal controls: a risk management tool' – F&M137  
[www.icaew.com/index.cfm?route=142352](http://www.icaew.com/index.cfm?route=142352)