THE HAWKAMAH JOURNAL

Board Risk
Article by John Plender
Pages 04-07

A JOURNAL ON CORPORATE GOVERNANCE & LEADERSHIP
Most people believe that an internal auditor’s function is the most important tool available to the board of directors in the control environment. In reality, it is often the chief financial officer’s continuous presence and proactive stance that shapes the control environment in a company. The CFO’s important role is sometimes either forgotten or, more commonly, under-utilized. Often, we see the CFO role folded under the management team, particularly, under the chief executive officer. There is indeed a lot of merit in so doing. Most notably, to preserve the CEO’s full responsibility and accountability for the performance of the company.

When reflecting on the control environment in companies, there is one universally accepted conclusion. There is no “one-size-fits-all” approach to the application of controls. Despite the tried and tested best practice procedures, which are often used to draft common policies and processes, every company remains, in varying degrees, unique. The primary reason for this variation, is that the control environment is intimately linked to the culture of the company. The DNA of a company is its culture, it defines its uniqueness and shapes its competitive advantage, hence its success. From this perspective, controls become a strategic tool in the arsenal of a company and an enabler to out-perform its competitors. As
competition is increasingly polarized, supply-chain against supply-chain, the role of processes and controls becomes a key success factor crucial to survival.

**CFO – selection, roles and responsibilities**

“The world of a CFO has changed dramatically. It used to be about technical expertise. Now CFOs need to make strategic financial decisions in a changing dynamic environment.”

Currently, CFOs have to be business savvy, and able to add that strategic business angle to their respective companies. The selection of the CFO has become as delicate and strategic as that of the CEO. A CFO with multi-industry practice could, potentially, bring substantial innovation across several aspects such as: Financing, Controls, Risk Assessment, Business Development, and Strategic Planning. More importantly, a well-versed CFO can properly balance the Culture–Strategy–Control triangle to achieve optimal results, through custom-fitting the control environment. As businesses are changing at an ever faster pace, a thorough challenge of the status-quo is expected from each CFO. That includes bringing his set of cross-industry experience to assess the situation from various perspectives.

Depending on the company’s size and lifecycle phase the function of the CFO and his expected role and responsibility vary substantially. The size criteria for a company could be: Annual Turnover, Assets, Net Profit, Dividends, Market Valuation, Number of Employees, Location/Branches. The lifecycle phase can be a start-up, emerging, stable cash-cow, regressing, restructuring entity. The role of the CFO can be very vertical and narrow. Focusing only on overseeing the finance team’s booking activity, and reporting of financial statements. It could also be very horizontal and broad. Encompassing procurement, administration, HR, and IT. However, we frequently see present-day CFOs covering the following functions: Accounting, Treasury, Performance Reporting, Budgeting and Planning, Financial and Cross Departmental Policies and Processes, Managerial Information Systems, Cost Control, Auditors Relations, Risk Management, Audit Committee Relations, Investors Relations. (Outside the Middle-East, the CFO often has a role of Executive Director, as a member of the Board).

Unfortunately, often, the role of the CFO translates differently when comparing the job description to the de-facto “on the ground” role. This situation occurs more frequently than is documented and is commonly associated with the frequent frustrations experienced by the CFO. As their shelf-lives are increasingly reducing, as witnessed in the past few years, CFOs have a very brief time to make an impact on their companies. The race against the clock to establish the right set of controls, while having to forge and break alliances to accommodate the company’s interests, leaves the CFOs exposed to the many internal attacks. Although often the board of directors are involved in the selection of the CFO, this involvement often vanishes as soon as the CFO is on-boarded. Very little involvement and interest are manifested to accompany the integration, and the up-taking of the function. Whether it is a new function creation or a transition of an existing role, the CFO’s scope can be undermined, and stripped of effective controls and governance tools. As an illustration, a company seeking to cut costs might find itself in a situation where the CFO is trying to influence certain savings in line with the strategy, while other management colleagues are fixated on different objectives. Such a disagreement could lead to conflict, obliging the CEO to step in, and find a middle ground. While compromise may attenuate the conflict, it is not necessarily the optimal decision.

Many times, the assumption is that the CFO is actually in charge of cost controls, good governance, and the establishment of processes.

---

1 Ilya Strebulaev, Faculty Director, Stanford University
while, in fact, his role and authority have been compromised. This often goes undetected until a major event reveals it to the board/shareholders, albeit post-factor. As Benjamin Franklin once said “Laws and sausages should never be watched in the making”, it is because so much compromise and messy proceedings take place when making a law or a process. For this reason, it is a primary duty of the board to ensure that there is a proper procedure for establishing processes in the company, and that the CFO has a sufficient level of independence and clout to deliver it. This fact cannot be over-emphasized, as it sits at the root of major policy miscarriages.

The disappearance of key controls from the CFO’s role, cannot and should not be offset by additional reviews and audits from internal audit. The proactive controls provided by the CFO do not just ensure governance and fraud avoidance, but go beyond to safeguard and achieve competitive behavior.

The CFO plays a crucial role in providing information to the board. Any experienced executive will be well aware that numbers could lead to a different conclusion based on how these numbers are “sliced and diced.” Management is also well aware that the outcome of a presentation can sway the board’s decision in one way or the other. The combination of these two factors makes the role of the CFO crucial to a company’s strategy and governance framework. The board, particularly the audit committee, is expected to fully understand how the numbers are being produced, reviewed, and commented upon.

Among the 4 drivers contributing to fraud - lacking or inadequate board involvement, opaque holding structures, behavioral weaknesses, one-size-fits-all controls - lacking or inadequate board involvement is, by far, the most dangerous, but also the easiest to remedy. The 3 other drivers can be addressed by the board, with the proper involvement of the audit committee or other board body. In fact, it is the inadequate Involvement of the board that will foster behavioral weaknesses or disregards an opaque holding structure. The one-size-fits-all approach can be addressed by ensuring the board’s involvement in setting the policies and processes (P&P), and understanding the underlying risks associated with it. Thus the CFO should play a crucial role in building the company’s P&P, and gain the board’s full support and involvement to achieve this objective.

The CFO’s role needs to be empowered to ensure sufficient independency to accomplish this task, shielding it as much as possible from internal pressure exercised by the management team. Although it is crucial that the CFO is closely allied to the CEO to achieve company objectives, one would wonder to what extend should the board sanction this bond? In other words, the board must ensure that the CFO and CEO remain proximate though at a healthy distance. In reviewing historic fraud cases, it was all too often discovered that the most damaging cases have involved collusion at the top-level.

This potential risk can be avoided by redefining the CFO’s role, applying certain measures to ensure checks and balances. For instance, a simple 30-minute private meeting between the CFO and the audit committee could precede the official committee’s meeting. Such a private session, if it becomes a ritual preceding every meeting, could help the committee and the CFO align and discuss several matters, anticipating issues and enabling the CFO to share concerns.

Another measure would be to establish a “dotted” reporting line for the CFO to the audit committee, pertaining to predefined matters only. The CFO still reports to the CEO, but the “dotted line reporting” allows for an official channel, which loops back into the board enabling proactive decision making, rather than a reactive one, as often seen in internal audit reports.

An additional measure to gain insights into the company’s control environment, is to ensure...
that the chairman of the audit committee builds a solid relationship with the CFO, similar to the relationship established between the CEO and chairman of the board. Furthermore, a simple informal visit from directors to the company's premises, can often shed light on several control issues, and help the board adjust its focus.

It is also important that the audit committee is equipped with the right resources, such as the presence of a CFO (or former CFO) among its members. Currently, almost 100% of the S&P 500 companies have an independent CFO (or former CFO) as chairman of its audit committee. This has been mandated by the SEC to ensure proper understanding and probing into the financial machinery of the company. Being in charge of financial governance, the audit committee is normally the most active body on the board, and represents the last line of defense before a mishap occurs. The directors (or advisors) serving on it, should be a proficient, well experienced in corporate environments, capable of understanding "how the sausage factory works", and able to detect issues and share it with the board.

There are several ways to enhance the audit committee’s involvement without having to do the job on behalf of the management team. While remaining directors’ committee, it needs to be aware of the key performance differentiators that drive the company. Without stifling management, the committee can request special reports pertaining to certain activities, which could be discussed further in the meetings. The fine line between monitoring and executing must be respected, avoiding personal opinions that could distort the reality or sway the outcome into a specific direction.

Recently, Management Information Systems have become inevitable in every company to ensure successful results. The CFO is normally in charge of these tools, and the board should ensure that he or she is able to drive and champion these initiatives. These tools are becoming more elaborate and sophisticated, presenting a golden opportunity for board members to align with the CFO on building the appropriate control environment.

Finally, the collaborative work between the internal audit and the CFO on the enterprise risk management (ERM) task can be a great tool in the hands of the board to oversee the control environment. The role of the CFO here is to ensure that risks have been identified and assessed, while the internal audit can audit against these risks to ensure proper management action. The job nature of the CFO prepares him/her to oversee the ERM function and to use it as an effective governance tool. This tool, if it is closely monitored by the board, can prove very effective in establishing a balanced management team, and detect control and governance problems.

In conclusion, the role of the CFO in corporate governance, particularly in the control environment, is crucial to the success of every company. The board should be well aware of the spectrum of tools and initiatives at its reach, to properly use the CFO as a proactive governance agent in the company.