streetwise

BY STEPHEN BARLAS, JEAN-VICTOR CÔTÉ, KATHY WILLIAMS

[NEWS]

How Is Your Company Managing Risk? | KATHY WILLIAMS

Although enterprise risk management is one of the hot strategic business tools that companies are employing right now, many firms still have a long way to go toward proper execution, two recent surveys found.

In an Oversight Systems Inc. survey, conducted at a Financial Executives International (FEI) conference in May, 68% of the respondents said their CEO is placing a greater emphasis on managing all types of risk holistically, and 60% said their company already has an enterprise risk management approach that considers various interactions among different types of risk. The problem is that the critical elements of risk management aren't in place. For instance, only 35% of the financial executives said their company has formally trained executives and business line managers to assess the probability of risk, 55% said no one in senior management has explicit responsibility to manage risk, and 55% noted that there's no widely communicated definition of risk. And 54% said their company had faced significant operational surprises in the last five years, while 52% faced pressure from key stakeholders.

Yet the majority of the respondents said their company was "more prepared than not" to assess and manage the risk associated with most business functions. Given their Sarbanes-Oxley compliance efforts, most of the financial executives said they were best prepared to assess financial reporting risk and that they were planning to leverage what they found during SOX compliance into an enterprise risk management program. The other areas of risk they felt prepared to assess? Credit/market risk, legal risk, reputation risk, and IT risk.

In their recent survey of risk management executives, The Conference Board and Mercer Oliver Wyman found that more than 90% of the respondents said they are building or want to build enterprise risk management processes into their companies, but only 11% have completed the implementation. Those who are using ERM report that the procedures have added a great deal of value to their operations, particularly better-informed decisions, greater management consensus, and increased management accountability. The study also found that companies that are fully embracing ERM "are better able to improve management practices, such as

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IS YOUR SMALL BUSINESS HEALTHY?

Robert Half Management Resources has come up with 10 key questions for small business owners to answer if they want to maximize productivity and ensure efficiency.

1. Is it time to update your financial systems? If you have postponed updates, the answer is probably "yes." But make sure you have a project manager to help you to oversee the budget and timeline and consider the impact on employees.

2. Does your company have a three-, five-, and 10-year business plan?

3. Is your business secure? Here they are talking about system security to prevent e-mail viruses, worms, unauthorized access, and the like.

4. Are business costs under control? Try to anticipate what costs are going up, such as employee healthcare plans, as you figure out your budget.

5. Are you adhering to cur-

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ILLUSTRATION: STEPHANIE CARTER/ARTVILLE

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rent accounting best practices in areas such as financial reporting, tax planning, systems, cost accounting, inventory management, strategic planning, procurement, payroll?

6. Have you experienced another "taxing" tax season? Do you have the right professionals to help—those who know all the local and state tax laws?

7. How do you rate on the corporate governance scale? Take a look at your internal controls, processes, and procedures, and get all departments to help.

8. Are you holding onto your best people? Offer competitive compensation packages as well as creative benefits, and recognize team and individual accomplishments.

9. Are you losing market share to the competition? In addition to staying up with the news about your industry and local market, ask clients and business associates how they feel your company measures up to the competition and what new ideas they might have.

10. Has your company been a victim of fraud? Many small businesses that don't have an internal audit department bring in these professionals on a full-time or project basis to help improve internal controls and better detect and prevent all types of fraud.

For more information, contact Christine Pardi at christine.pardi@rhmr.com.

Errata There's a typo on p. 45 of the August issue in the "Suzie's Sweater" article. The "$200" of revenue the FASB wants the store to recognize should read $20. We apologize for the error.

[GOVERNMENT]

Corporate Credit Ratings at Issue | STEPHEN BARLAS, EDITOR

The failure of Moody's and Standard & Poor's, the two ratings giants, to predict the corporate financial disasters at Enron and WorldCom is the rationale Rep. Mike Fitzpatrick (R.-Pa.) is citing for his Credit Rating Agencies Relief Act of 2005 (H.R. 2990). The legislation was the subject of hearings in the House Financial Services Committee in late June. "Two firms dominate the ratings market with SEC approval, and this creates an uncompetitive marketplace, stifles competition from other rating agencies, lowers the quality of ratings, and allows conflicts of interest to go unchecked," Fitzpatrick said. "It is bad for the market, and it is hurtful to individual investors."

Committee Chairman Rep. Mike Oxley (R.-Ohio) of Sarbanes-Oxley fame praised Fitzpatrick's bill. He said, "Congressman Fitzpatrick's legislation would inject some long overdue competition into the ratings industry, make the ratings process more transparent, reduce the cost and improve the quality of ratings, and ensure adequate oversight of ratings firms. These reforms would provide enormous benefits to the market participants using these ratings."

Not surprisingly, Rita Bolger, managing director of Standard & Poor's, was less than enthusiastic about the bill. She said S&P has "serious concerns" about the Fitzpatrick bill and "the disruptive effect its sweeping provisions could well have on the efficient operation of the capital markets." One of the main things the bill does is eliminate the Nationally Recognized Statistical Rating Organization ("NRSRO") designation currently bestowed by the SEC. The SEC itself has proposed a change in the way it designates NRSROs as a means of answering criticism that its very tight criteria severely limit NRSRO membership to the disadvantage of investors.

Sean J. Egan, managing director of Egan-Jones Ratings Company, says that although the SEC has recognized two new NRSROs during the past 18 months, "neither firm warned investors about the recent major failures, nor do they provide any significant competition to the two partner-monopoly firms, S&P and Moody's." Moreover, Egan says the SEC reform proposal requires that rating firms provide their ratings free to the public. "That effectively means that the rating firms have to seek compensation from the Enrons and WorldComs of the world, which, in many people's view, is a system rife with conflicts," he states.

House Bill Changes Pension Funding and Rules

The House Education and Workforce Committee passed a pension reform bill that will almost assuredly pass the full House. The Pension Protection Act (H.R. 2830) attempts to finish the job started by previous pension reform bills passed by the House and Senate, which were short-term fixes. For example, the Pension Funding Equity Act of 2004 temporarily replaced the 30-year

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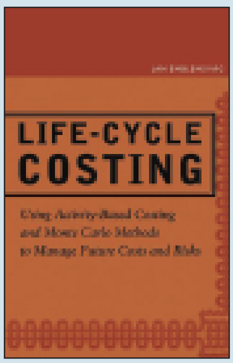
[BOOKS]

Activity-Based Life-Cycle Costing

BY JEAN-VICTOR CÔTÉ

Long associated with manufacturing, engineering, and weapons systems, Life-Cycle Costing (LCC) is now being applied in a broader range of businesses. According to Jan Emblemsvåg, author of *Life-Cycle Costing: Using Activity-Based Costing and Monte Carlo Methods to Manage Future Costs and Risks*, LCC can be a valuable technique to use with any open system that "evolves over time and changes based on its environment." In his book, Emblemsvåg combines Activity-Based Costing (ABC) with LCC to get what he calls Activity-Based Life-Cycle Costing (ABLCC), which helps bring risk and uncertainty to the forefront.



ABLCC helps model overhead costs, which have increased in importance since LCC was first developed by the U.S. Department of Defense in the early 1960s. The addition of ABC to LCC also enables companies to manage costs proactively rather than reactively. It also helps model the product life cycle, a process that goes from cradle to grave. In other words, ABLCC includes the usual manufacturing process and the demanufacturing process, which can have many branching points according to the economics of the alternative remanufacturing processes. In manufacturing, ABC helps specifically with Design for Manufacturing (DFM) and Design for Disassembly (DFD).

ABLCC is completed by employing Monte Carlo methods, which are used to model liability and contingent costs and "costs that arise due to noncompliance and potential future liabilities." In general, Monte Carlo analyses help assess the impact of uncertainty in the model parameters on a project's cost. Using the methods through an Excel add-on like Crystal Ball or @RISK can yield output graphs, such as tornado charts based on the rank correlation coefficients and frequency charts, using the uncertainty distributions of the various model parameters as input.

Keeping a focus on risk management, Emblemsvåg sprinkles the book with many implementation tips or common traps to look out for and avoid. Two chapters also focus mainly on risk management: "Uncertainty Analysis and Risk Management" and "From Hindsight to Foresight."

In his book, Emblemsvåg uses triangular distributions, which are equivalent in practice to triangular fuzzy numbers, since "for Monte Carlo methods, the difference in interpretation makes no difference to the calculations." As a result, we practitioners don't have to become overly worried about not understanding the sophisticated definitions for addition and multiplication of fuzzy numbers the author provides.

The author also argues that statistical methods are less intensive computationally than differential methods to sensitivity and uncertainty analysis. Furthermore, "Open systems can't really be optimized because they interact with the environment and because implementing a solution can take so much time that the solution is no longer the optimum by the time it is implemented." Among statistical methods, "the error in the approximation is smaller for Monte Carlo methods than for other comparable methods....[and] by using Latin Hypercube Sampling (LHS) instead of Simple Random Sampling (SRS), the number of trials can be reduced drastically." This is especially important since "to improve an estimate tenfold, we need to run a hundred times more trials." Emblemsvåg cites the following rule of thumb: "The number of trials should be at least six times the number of variables to achieve satisfactory estimates."

Emblemsvåg describes a notable improvement in cash flow analysis: the declining baseline. "The incremental cash flows that should be built into the capital investment model should be based on an assumption of declining cash flows in the future....A minimum degree of progress is simply needed just to remain competitive in the marketplace....The more comprehensive the innovation, the higher the potential improvement and the longer the time for

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Treasury rate with a rate based on long-term corporate bonds for certain pension plan funding and included a "sense of Congress" provision holding out hope future Congresses would be able to make changes to the defined benefit pension system. Since then, concerns about the precarious position of the Pension Benefit Guaranty Corporation (PBCG) have risen measurably, raising the unappetizing specter—from a political standpoint—of Congress having to bail out the PBGC as more and more companies fob off pension liabilities onto the PBGC.

The bill passed by the House committee ostensibly makes a PBGC bailout less likely, but it stops short of making funding rules so restrictive—in order to ensure solvency—that companies will drop pension plans altogether rather than comply with the new rules. The menu of defined benefit changes includes some to cash balance pensions, which have been a particularly hot issue. The measure prohibits employers from reducing or cutting any vested benefits workers have earned during a conversion to a cash balance plan. In terms of a permanent fix for the interest rate companies must use to determine their future funding needs, the bill provides a permanent interest rate based on a modified yield curve, requires employers meet a 100% funding target, prohibits the use of credit balances for severely underfunded plans, and phases in reasonable increases in employer premiums paid to the PBGC. The fee per employee would go from $19 to $30 over time. ■

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strategic planning, and have a greater ability to understand and weigh risk-reward equations in their decisions."

More than 60% also believe there will still be a significant external risk in the next five years, given recent history: the 9/11 attack, continuing wars, and corporate scandals and failures, Ellen Hexter, senior research fellow and program director for The Conference Board's ERM conferences, explained. "Although it might not be possible for businesses to control external risks, understanding how such risks are interrelated can help companies anticipate major surprises."

For more information about or to download the Oversight Systems survey, visit www.oversightsystems.com/survey. For more information about The Conference Board study, contact Frank Tortorici at f.tortorici@conference-board.org or (212) 339-0231.

FASB Issues Three Exposure Drafts

The Financial Accounting Standards Board has issued three Exposure Drafts on which it is seeking comments. The first is "Accounting for Transfers of Financial Assets." The Board says the proposed Statement of Financial Accounting Standards "seeks to clarify the derecognition requirements for financial assets" that were developed initially in SFAS No. 125, "Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities," and revised in SFAS No. 140 (a replacement of SFAS No. 125). The other two Exposure Drafts are "Accounting for Servicing of Financial Assets" and "Accounting for Certain Hybrid Financial Instruments."

All three would amend SFAS No. 140, and the Exposure Draft on hybrid financial instruments would amend SFAS No. 133, "Accounting for Derivative Instruments and Hedging Activities."

The deadline for submitting comments to the FASB is October 10, 2005, and should be sent electronically to director@fasb.org. The Exposure Drafts are available on the Board website at www.fasb.org. ■

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positive cash flow to occur."

Pithy one-liners about the managerial implications of his analyses enliven the text. And there are several case studies that provide practical examples of how ABLCC and Monte Carlo methods can predict future risks and manage costs. Anyone with an interest in managing an organization's risk and predicting future costs may find this book helpful. ■