Driving Corporate Accountability via Business Performance Management

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Hyperion®

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Recent events have caused worldwide concern about the integrity of the financial statements of publicly traded companies. Completeness, accuracy and compliance with generally accepted accounting principals (GAAP) are being called into question as never before. For many years, Hyperion has helped thousands of companies gain control of their financial information, ensuring that management is aware of potential financial issues before they become problems and that audit reports contain no qualification (red flags) that can lead to precipitous drops in share price and even bankruptcy.

Hyperion's business performance management solutions help companies measure performance, anticipate results and drive profitability, as well as enhance the internal control environment to ensure that global corporations are following company procedures set by senior management. Though no solution can prevent intentional fraud, this white paper discusses the current business environment, including various types of risk that need to be managed. It then suggests how Hyperion's business performance management solutions reduce control and detection risks, ensuring the integrity of financial statements to the highest degree possible.

Recent Headlines from Across Corporate America

Ethical problems aside, there appear to be fundamental issues with reporting and understanding financial information. WorldCom CEO John Sidgmore, on July 2, 2002, referred to his role when addressing why the now infamous accounting lapses weren't detected earlier. Labeling WorldCom "a far-flung operation," he said, "No single operating unit knows what's going on in the rest of the organization, and it all came together at CFO Scott Sullivan's level." WorldCom fired Sullivan on June 25, 2002, after the internal audit found improper accounting of almost $3.9 billion in expenses and Sullivan failed to sufficiently explain his bookkeeping practices. Worldcom filed Chapter 11 bankruptcy on July 21, 2002.

The federal government is investigating corporate wrongdoing as never before. From a Senate panel, the Permanent Subcommittee on Investigations, on Enron in June 2002: "The board (of Enron) knowingly allowed Enron to engage in 'high-risk' accounting and failed to ensure auditor independence. The panel's report cited more than a dozen red flags that lawmakers said should have resulted in board members challenging management and asking tough questions."

Unfortunately, board members are in the dark more often than not. In a poll conducted by the executive search firm Christian & Timbers in July 2002, about 59 percent of the 225 executives surveyed from Fortune 1000 and other leading companies believe their company boards do not have the financial understanding to identify material issues and ask the right questions. "It shows there's a need for a major overhaul of corporate boardrooms," Jeffrey Christian, chairman and chief executive of Cleveland-based Christian & Timbers, told Dow Jones Newswires. "Board members need to be better educated and spend more time on companies' financial statements."

Finally, from Maryland Senator Paul S. Sarbanes addressing the U.S. Congress, regarding the Public Company Accounting Reform and Investor Protection Act of 2002: "It is becoming increasingly clear that something has gone wrong, seriously wrong with respect to our capital markets. We confront an increasing crisis of confidence that is eroding the public's trust in those markets. I frankly believe that if it continues, this erosion of trust poses a real threat to our economic health.

Let me begin with one of the most obvious symptoms of this problem: The extraordinary increase in restatements of corporate earnings. The Wall Street Journal, citing a study last year by the research arm of Financial Executives International, the organization of chief financial officers of corporations, reported that there were 157 financial restatements by companies in 2000; 207 in 1999; and 100 in 1998. The three-year total of 464 was higher than the previous 10 years combined, during which the average number of restatements was 46 each year. This is a dramatic increase in the number of restatements.

Indeed, for the first time in years, financial analysts are focused on the quality of financial statements rather than the numbers themselves. “Everybody wants to make it clear that they’re squeaky clean on the accounting issues because there’s a cloud over all companies,” said Chuck Hill, director of research at Thomson First Call. “Earnings are important, but if you can’t reassure people that your earnings are legit, why bother?” Natalie Walrond, an analyst at Pacific Growth Equities, said, “Before it was, ‘What were your numbers?’ and ‘What are your numbers going forward?’ Now it’s ‘What are your numbers?’ and ‘Why do we believe these numbers?’” Lehman Brothers accounting analyst Robert Willens commented, “The numbers that are being produced now are less important than how they were produced. People are almost more willing to accept lower earnings as long as those lower earnings were derived from an accurate internal accounting system.” And, finally, Tim Woolston, a portfolio manager at Boston Advisors Inc., said, “Accounting issues are absolutely the issue du jour. When Enron started to unwind, it was viewed as basically an isolated event. But many veteran investors were dumbstruck by how pervasive the fast-and-loose use of GAAP has become to the point of outright fraud.”

By contrast, Chairman Rob Walton of Wal-Mart told his audience at their annual meeting in June, “Please blow the whistle if there is an issue.” Chief Executive Officer Lee Scott quickly followed up with a discussion of how the company was “world-class” in the corporate governance arena. Wal-Mart’s systems of internal control and resulting high-quality financials are one reason highlighted by analysts as to why the stock price has not suffered as much in the latest market correction.

The Risk Environment

Internal and external auditors are required to evaluate a company’s financial information systems during quarterly or annual financial audits to help determine the overall control risk. Evaluations are typically performed in the early phases of an audit and will determine how much substantive testing is required. For example, if there is only a spreadsheet-based system with no real structure or controls, there is a much greater possibility for fraud and error, and more testing will be required. Organized data in a controlled financial information system gives assurance to the auditor that the financial statements are representative of the financial transactions of the period. Then, during the audit, financial systems help reduce an auditor’s detection risk – or the risk of failing to detect material misstatements in the financial statements.

One example would be in the data mining activities that may be required in an audit. Auditors may take focused samples if they see a particular control weakness and look for transactions that are outside of an acceptable range. Robust financial information systems can help auditors weed through large databases to detect the transactions with the most potential risk. Also, auditors need to bear in mind a company’s inherent risk profile during the planning and execution of the audit; companies in higher-risk industries may require more focused auditing.

Let’s look at the risk environment in more depth.

Control Risk

Assessing control risk is defined as the "process of evaluating and documenting the effectiveness of an entity's internal control structure, policies and procedures in preventing or detecting material misstatements in the financial statements." (Statement of Accounting Standard 55).

The internal control structure policies and procedures can generally be classified into three elements:

- Control environment
- Financial information systems
- Control procedures

The control environment comprises the attitudes, abilities, awareness and actions of management as they affect the overall operation and control of the business. Financial system implementations will reflect the management teams' attitudes about integrity, accuracy and financial controls. According to Statement of Accounting Standard 94, properly implemented financial information systems will have the following benefits:

- Consistently apply predefined business rules and perform complex calculations in processing large volumes of transactions and data
- Enhance the timeliness, availability and accuracy of information
- Facilitate the additional analysis of information
- Enhance the ability to monitor the performance of the entity's activities and its policies and procedures
- Reduce the risk that controls will be circumvented

Inherent Risk

Unlike control risk, inherent risk usually cannot be controlled by the enterprise – changes in business conditions and new regulations can increase the inherent risk within an enterprise. Financial auditors define inherent risk as financial misstatements caused by a condition that exists at the macroeconomic, industry or company level, or by a characteristic of an account balance or class of transactions. Examples of businesses with a high degree of inherent risk include those in declining industries, businesses in distress and companies with a lack of flexibility that can influence management to deliberately or inadvertently misstate financial statements.

While inherent risk conditions cannot typically be controlled by the enterprise, the control environment created and supported by management can help ensure that the financial statements reflect underlying economic realities. No affordable control structure can be 100 percent effective, therefore some risk is normally associated with every control structure – but less effective control structures carry a higher risk in environments with a higher degree of inherent risk.

Detection Risk

Regarding detection risk, or the risk of not detecting material misstatements in the financial statements, auditors are expected to use analytical procedures in planning an audit and leverage technology wherever possible when conducting one. In meeting that requirement, the auditor typically reviews and analyzes recent financial statements and performance indicators to highlight changes in the client's business, material balances and unusual or unexpected relationships. Also, comparing a client's financial results with those of other companies in the industry group as a whole may be a useful way to determine whether the client's performance is consistent with that of similar entities.

Information compiled by services like Dun & Bradstreet and Standard & Poor's give the auditor standard benchmarks by which performance can be measured. Prudent financial managers will take their cue from the auditors and perform these analyses themselves on an ongoing basis.

The Regulators Step In

In the United States, corporations have been generally self-regulating regarding the completeness and accuracy of financial statements. The theory is that companies and public accounting firms with poor controls or a lack of ethical leadership would ultimately pay the price when the market forced them into bankruptcy. Though this theory appears to be working in the "market-cleansing" bankruptcies of Enron, Worldcom, Andersen and others, the collapse of these major corporations has become a public policy issue. Mounting job losses, the impact on the world's financial markets and the loss of faith of the investing public make it clear that while self-regulation may work in the long run, the short-term upheaval caused by a laissez faire approach is becoming harder to defend.

The Securities and Exchange Commission (SEC), in its proposed Framework for Enhancing the Quality of Financial Information Through Improvement of Oversight of the Auditing Process, states, "Congress, through the federal securities laws, imposed on public companies the obligation to disclose complete and accurate financial information. Cognizant of the lessons of history, however, Congress built into the securities laws a significant safeguard: requirements that a public company's financial information filed with the SEC be audited by certified or public accountants that are independent of that company. The current system of oversight has not produced a credible result. Flaws in the system have contributed to the confluence of several factors that have undermined investor confidence in financial information and market efficiency."

In response to the SEC's recommendation and pressure from the public, President George W. Bush signed into law a massive corporate reform measure in August 2002 (The Sarbanes-Oxley Act of 2002) that demands more auditing oversight and requires CEOs and CFOs to certify the financial results or suffer severe personal penalties. Specifically, Section 302: Corporate Responsibility for Financial Reports requires the CEO and CFO to prepare a certification statement to accompany the audit report.

The certification must state that the financial statements and disclosures fairly present, in all material respects, the operations and financial condition of the issuer. The law also requires each annual report of an issuer to contain an "internal control report," affirming the responsibility of management for establishing and maintaining an adequate internal control structure and procedures for financial reporting. The report must also contain an assessment of the effectiveness of the internal control structure and procedures. Maximum penalties for willful and knowing violations of this section are a fine up to $500,000 or imprisonment of up to five years.

Furthermore, white-collar crime penalty enhancements include an increase in the maximum penalty for mail and wire fraud from 5 to 10 years, creates a crime for tampering with a record or otherwise impeding any official proceeding and gives the SEC authority to seek a court freeze of extraordinary payments to directors, offices, partners, controlling persons and agents of employees.

The SEC also has adopted new filing rules that require public companies to file 10Q quarterly statements in 35 days from a quarter's end, a reduction of 10 days from the current 45 days. And annual 10Ks within 60 days of a fiscal year's end, a reduction of 30 days. These changes will be phased in within a three-year period. And, a House committee that oversees the financial services industry is considering legislative action on accounting rules. Ultimately, legislation may require companies to make such changes as reporting material events immediately, such as certain loan defaults, even if they are mere technicalities.

Other Proposed Rules

The SEC is considering proposing rules and amendments on the following:

- Use of pro forma financial information in company earnings reports and a rule to require companies to discuss off-balance sheet arrangements in their management's discussion and analysis section in annual and quarterly reports.

- Rules that would prohibit a company's directors and executives from purchasing, selling or otherwise transferring any equity securities of the company during a pension plan blackout period in which line employees are also prohibited from making equity transactions in company stock. This rule would also require companies to provide advanced notice of pension plan blackout periods.

- Requiring companies to designate a financial expert on their corporate boards, adopt internal controls and disclose whether they have a code of ethics. Another proposed rule would bar corporate executives from coercing, manipulating or misleading the firm's auditor(s).

- Rules establishing standards of professional conduct for attorneys who represent companies before the commission. The SEC said these standards would include a rule requiring an attorney to report evidence of a material violation of securities laws or breach of fiduciary duty by the company or its officers to the chief legal counsel or the chief executive officer of the company. If these executives don't respond appropriately, the attorney may be required to report the evidence to the audit committee, another committee of independent directors, or the full board of directors.

Rating agencies are also evaluating financial disclosure as never before. Standard & Poor's decided to evaluate the companies in the S&P 500 index on how much information, both financial and nonfinancial, they provide in their annual reports and regulatory filings. The ratings agency also announced the launch of a governance services unit that will assess a company's governance either for investors or on behalf of the company itself.

What impact will the new rules and measurements have? Recent stories in Information Week illustrate the challenges of these new rules. Gartner analyst Lee Geishecker expects to see accounting department resources strained if the government mandates greater transparency because large companies without comprehensive financial and performance-management systems will struggle to meet the new requirements for more timely and better-quality data. This will be especially true in multinational companies that have language and currency conversion problems. John Van Decker from Meta Group adds, “Companies have a lot of legacy processes, including old client-server versions of consolidation software, and there’s typically a lot of manual intervention during the consolidation process.”

Hyperion’s Business Performance Management Solutions

Hyperion’s business performance management solutions provide comprehensive support for strategy setting, modeling, planning, monitoring, reporting, and analysis needs of finance and operating staff in enterprises worldwide. These solutions are a great complement to existing ERP and transaction systems – integrating data from multiple sources, providing a common view across the enterprise and enabling an integrated financial and performance management process that aligns individual goals with corporate objectives. Hyperion’s business performance management solutions are key components in a world-class internal control system that can ensure the completeness, accuracy and timeliness of financial information.

In addition to providing an internal control framework, these solutions provide companies a means to enable executives and managers enterprisewide to proactively manage business performance by identifying opportunities for future growth and profitability while optimizing the allocation of their resources.

Hyperion’s business performance management solutions feature a comprehensive suite of packaged applications built on an integrating business intelligence (BI) platform. Individual applications can be implemented separately, but if used together leveraging Hyperion’s powerful BI platform, Hyperion® Essbase® XTD, they provide a complete environment for collaborative and coordinated financial and operational management across the enterprise. Hyperion Essbase XTD delivers the underlying technology components necessary to support both packaged business performance management applications and tailored applications.

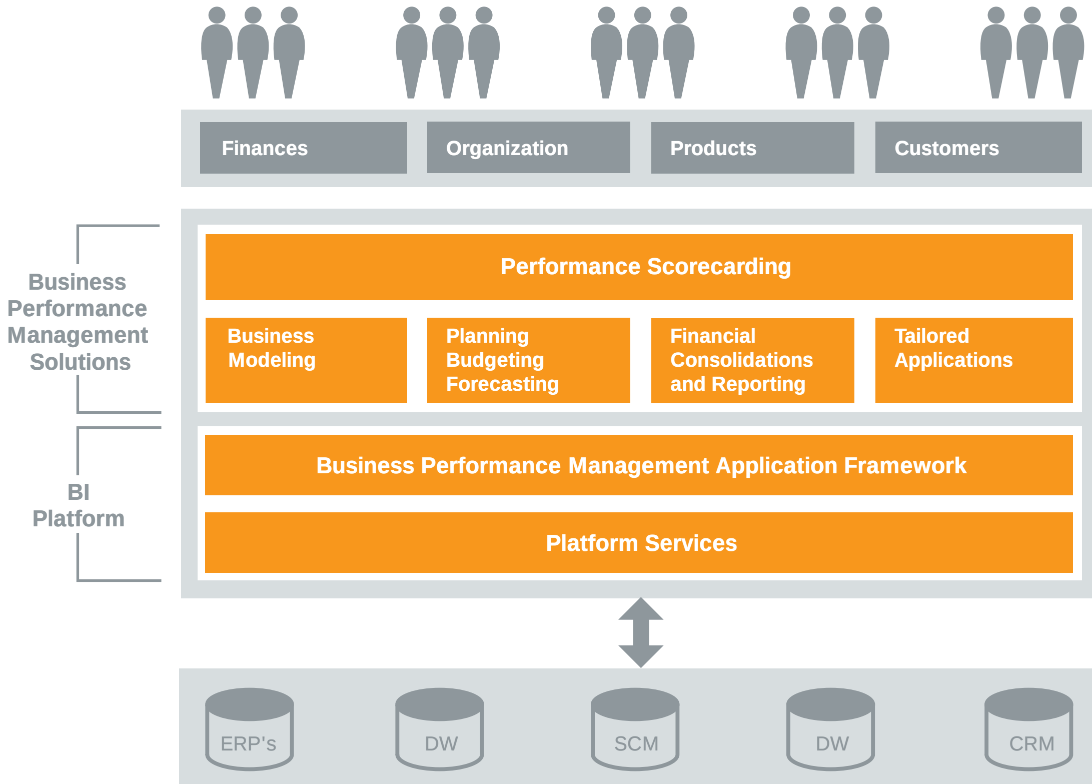

Figure 1. Hyperion's business performance management solutions.

Performance Scorecarding helps companies set and communicate goals, establish key performance metrics and accountability, and continuously measure performance against company goals and objectives. Hyperion® Performance Scorecard is a balanced scorecard collaborative certified application includes Stern Stewart's Integrated EVA® Scorecard. It enables leading quality initiatives such as the Baldrige Criteria and Six Sigma and includes nearly 3,000 metrics from experts like Hackett Best Practices that allow companies to quickly target performance against best practice data. As a control mechanism, major deviations from best practice benchmarks should be a red flag to CEOs and CFOs, auditors and board-level audit committees. An executive dashboard of closely monitored key performance indicators can reduce control risk, especially in an environment of higher inherent risk.

> *"With Hyperion Performance Scorecard, we can focus on our shared company objectives, define our direction and collectively head north. Hyperion Performance Scorecard is a powerful product that helps to keep us focused on our basic business model."*
>
> *Tom Akright*
> *Director of Performance Excellence*
> *Nestlé Purina PetCare*

Planning, Budgeting, Forecasting and Business Modeling allow companies to move away from the yearly budget and embrace the concept of continuous planning. Hyperion® Planning allows companies to make smarter business decisions with dynamic, event-based plans that provide improved visibility and collaboration in real-time. Hyperion® Business Modeling helps generate a range of scenarios and helps identify the best course of action factoring in resource constraints. This reduces control risk by enhancing the timeliness, availability and accuracy of information, facilitating the additional analysis of information and enhancing the ability to monitor the performance of the company's activities, its policies and procedures.

> *"Hyperion helps us to not only meet our corporate objectives, but also to make these objectives more transparent throughout all levels of the company. We can now better evaluate the operational performance and results of each of our cost centers by accessing a single system from any location. With Hyperion we are more nimble, which is especially important as we continue on our path of rapid growth. The discipline of Hyperion Planning pushes department managers to commit to their numbers. Decisions need to be made to make sure the company is operating along expectations."*
>
> *Gloria Fan*
> *Vice President, Finance*
> *UTStarcom*

Financial Consolidations and Reporting help customers reduce financial consolidation and reporting cycles while providing the detail and process control to meet the most stringent of regulations. Hyperion® Financial Management helps satisfies new shareholder, investor and government requirements for disclosure, transparency and accountability. CFOs and CEOs not only acquire the fastest possible access to financial results, they can also review an audit trail of approvals throughout the consolidation and reporting process so they are comfortable in signing off on the financial statements as now is required by the Sarbanes-Oxley Act. Also, controls that prevent or detect errors can be added to the system to ensure completeness and accuracy during the financial consolidation reporting cycle. Improved timeliness, automated detection controls and enforcement of review and approval procedures will reduce control risk.

> *"Hyperion Financial Management is that first step to linking strategy and measurements, tying that to performance and then iteratively learning how to run the business better – so that we get better results and better shareholder value. You can't go out and manage earnings per share, but you can manage things like on-time delivery and purchasing variances. By getting that kind of information to the right people, we'll be able to improve the business. Then the bottom line, share price and shareholder value will improve as a result."*
>
> *Todd Naughton*
> *Vice President and Controller*
> *Zebra Technologies Corporation*

Tailored Applications, such as specialized financial applications, can be created for an extended analysis environment to meet strategic, operational and tactical business analysis needs or to help manage customer relationships and supply chains. Companies use Hyperion Essbase XTD to help build rewarding and profitable relationships with their customers, suppliers and business partners. By quickly analyzing and delivering multifaceted views of customers, suppliers and business partners, managers gain operational control to make faster, smarter decisions to grow revenue and improve customer satisfaction. Having this type of information available in a single system improves transparency, ensuring that customers and suppliers are being treated fairly and in compliance with company policy. Furthermore, highly sensitive, predictive applications can be built to enable assessment of the financial impact of risk factors that may require immediate disclosure under proposed SEC guidelines. For example, if an increase in interest rates has a material impact on sales in the coming accounting period, immediate disclosure may be required.

> *"Prior to deploying Hyperion Essbase XTD, we were using nine Excel spreadsheets to produce revenue by customer reports, which took four days to generate. Not only this, we found we were spending too much time, effort and resources maintaining these unwieldy spreadsheets. With Hyperion Essbase XTD, we are able to generate these reports within minutes, not days. When looking at revenue by customer, we have 47 different billing feeds that we need to take into account. Hyperion Essbase XTD allows us to load the required data from all these sources and analyze it to provide a holistic view of revenue by customer."*
>
> *Richard Peel*
> *Director of Financial Development*
> *Cable & Wireless*

Experts Agree

> *"Hyperion, with its long-term market leadership in the consolidation and financial reporting space, is well-positioned to assist public companies to address the critical aspects of the Sarbanes-Oxley Act. The quality of an organization's financial systems reflects management's philosophy about data integrity, accuracy and financial controls. Best practices suggest that internal control and data integrity checkpoints must be imbedded in financial applications. Hyperon's business performance management solutions can be a key component of a high-quality, best-of-breed system of internal control."*
>
> *Paul Pilao*
> *Managing Director in charge of World-Class Finance*
> *BearingPoint (formerly KPMG Consulting, Inc.)*

Summary

Recent events have caused worldwide concern about the integrity of financial statements as never before. Hyperion's world-class business performance management solutions help companies address these concerns by controlling business assets and by maximizing their potential, which helps fulfill the requirements of auditing standards to ensure companies are able to:

- Consistently apply predefined business rules and perform complex calculations in processing large volumes of transactions and data
- Enhance the timeliness, availability and accuracy of information
- Facilitate the additional analysis of information
- Enhance the ability to monitor the performance of a company's activities, policies and procedures
- Reduce the risk that controls will be circumvented

At the same time, Hyperion's business performance management solutions allow management, finance and operating staff to spend less time on gathering and processing information and more time on analyzing financial results to ensure accuracy and support strategic decision-making. This gives them competitive advantage and the agility to capitalize on business opportunities, acquire additional capital and outperform their stakeholders' expectations.

About the Author

Michael J. Malwitz is senior product marketing manager responsible for Hyperion's financial consolidation and reporting products. Prior to joining Hyperion, he was director of financial information systems at a Fortune 500 company where he held management positions in internal audit, contracts, financial planning and analysis. He holds degrees in business and accounting from Florida State University and New York University.

About Hyperion

Hyperion, the global leader in business performance management software, creates solutions that help companies measure performance and drive profitability. Hyperion's Business Performance Management Suite of packaged and tailored applications and its open, integrating business performance management platform, Hyperion Essbase XTD, enable companies to set goals, model and plan performance, monitor and report key results, analyze underlying business drivers and anticipate future performance of core business activities. Hyperion products are used by more than 6,000 customers around the world to enable financial, organizational, customer relationship, supply chain and channel performance management. Hyperion has a network of more than 330 partners to provide innovative and specialized business performance management solutions and services.

Headquartered in Sunnyvale, California, Hyperion generated annual revenues of $492 million in fiscal 2002. The company employs more than 2,200 people in 20 countries and is represented in 16 additional countries through distributor relationships. Hyperion is traded under the Nasdaq symbol HYSL. For more information, please visit www.hyperion.com, www.hyperion.com/contactus or call 800 286 8000 (U.S. only).

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