Avoiding Hidden Conflict of Interest

For years, major consulting firms and technology vendors have tried to control the strategic sourcing activities within their client base, so as to bypass any formal request for proposal (RFP) activity. By doing so they could create an environment where, for better or for worse, their product was introduced without competition. For the big consulting firms it was the sole sourcing for a major project that they could undertake, for the technology vendor it was the sole sourcing of hardware and software. This type of controlled sales activity does not ensure best-of-breed purchases. When corporate governance fails to block this type of sales approach, the firm can be exposed to unnecessary business risks.

The Old Farmer's Rule

The old farm rule, *'never let the fox guard the chickens',* is equally applicable to business where the fox is an opportunistic vendor who will benefit from co-opting purchasing processes from which they should normally be barred, by corporate governance rules. However, in many firms, there are no fences to keep this particular fox out.

The issue to be addressed is that business critical decisions, that can have long term negative impacts on the survival of the company, may be taken, with advice that is provided under a condition of 'conflict of interest'. As a result, the decision can be made with insufficient or questionable input and usually no process exists to test for or mitigate this risk. This risk stems from a type of approach often used to plan for and acquire strategic computing equipment and associated processes. When the potential for material damage exists, executives need to gauge the seriousness of this governance risk and define a process to protect their firm from falling victim to it. *This paper addresses that process.*

Sarbanes-Oxley Act

During the last 12 months there have been a number of articles published about Board of Director's (BOD) responsibilities and wider corporate governance. These have been sparked by the political embarrassment caused by the collapse of Enron and WorldCom. Countries are now passing laws to curb this type of abuse. In the USA, accounting firms with consulting divisions are now tightly controlled by the Sarbanes-Oxley Act which prevents accounting firms from selling certain services to their audit clients. The intent of this act is reinforced by new rules passed by the Securities and Exchange Commission.

The public focus on conflict-of-interest provided by the Enron/WorldCom problems provides an opportunity to correct the strikingly similar, IT-based conflict-of-interest problem, as it also can result in the loss of corporate competitiveness and shareholder value. Creating a process to bar this form of abuse, is necessary in the IT industry as there is no equivalent to the *Public Company Accounting Oversight Board* which oversees accounting firms and as of yet, no law like the Sarbanes-Oxley Act to control the IT industry which is actively cloning the original 'tied' consultants approach that failed so publicly in the accounting industry.

©Copyright Ashburnham Group 2003 - April 30, 2003

Separation of Task

The provision of protection against this problem, centres on providing a fundamental segregation of tasks for the acquisition of corporate computing technology *– the advisor should never be the beneficiary of that advice.* With segregation comes increased security – without it – the 'fox' has the run of the chicken coop. Without it, the fox can advise, plan and deliver, and the buyer may never know, if that solution is best-of-breed or one that will ultimately have negative impacts on the corporation.

Why is it so important to segregate tasks in IT? The reason is that IT is closely integrated with corporate cash flow and shareholder value. Thus, it is essential to carry forward the new approach of *segregation of task to accounting independence and transparency* to the similar conflict of interest in the IT world. Surprisingly, it has become common managerial practice in the private sector to turn a blind eye to this potential for *conflict of interest.* Corporations that do fail to enforce this key piece of corporate governance never know if they are buying 'excellence' or are buying just what the sales person had been targeted to sell!

Why is the Risk Increasing?

Computing has become the life-blood of many corporations. At the same time, computing hardware has become almost a commodity and software and hardware sales are in a slump. To boost their revenues, computer technology vendors are now scrambling to find ways to:

- find net new revenue streams such as consulting and charging for pre- and post-sales support;
- control their clients in order to minimize the risk of losing client 'mind share' and ultimately the associated 'captured' revenue streams;
- influence any pending Request for Proposals (RFP).

To achieve these three goals, vendors are increasingly resorting to offering formal consulting services. Some even buy consulting firms and incorporate them into their offering. This creates what is known as ***'tied consultants***'. The growth of the *'tied' consultant's* phenomenon within the IT market, means that corporate managers must be more vigilant if they are to avoid employing consultants in a manner that could create a potentially injurious conflict of interest situation!

It is only human nature and common sense that the *'tied consultant'* guides your firm towards the solution that the consultant's firm supports (it is after all, the one they know the most about). This *'tied guidance'* may be as subtle as proposing questions for an RFP so that their firm will have a greater chance of winning and, thus, supplying their technology. Allowing a *'tied consultant'* to add such lock-outs is clearly breaking the farm rule concerning foxes and chickens. One has to ask the question -- could you guarantee that the '*tied consultant'* would tell you if their parent organization did not have the best-of-breed solution? Clearly, a situation for caveat emptor!

PO Box 59 (Main) · Peterborough · Ontario · Canada · K9J 6Y5
©Copyright Ashburnham Group 2003 - April 30, 2003

Is the Problem Common?

This potential conflict of interest problem is common. However, issues of technical sub-optimization or associated embedded business risks are rarely identified for Board review. The only signal of pending trouble, may be, for example problems with billing systems that delay cash flow, setbacks to major application implementations, an unseemly short RFP process or just too much of one vendor's presence in the account.

As another measure of the extent of this problem, just consider how often major hardware and software companies are seen indirectly 'crowing' on the television, etc., about *vini vidi vici*. Or put in English: *we studied them, we managed their corporate expectations, we sold them what we wanted to sell them*. As more and more vendors of hardware and software attempt to expand their revenue streams and increase account 'control' by adding a consulting arm, the opportunity for abuse of corporate governance increases.

How to Estimate the Scale of the Risk?

In computing, the 'quality' of the computing solution often has a direct impact on the competitiveness and therefore the cash flow of the company. The potential risk becomes very clear when you:

1. estimate the percentage of daily corporate cash flow that is controlled by the firm's computing system. If the system is substandard, then the cash flow will ultimately be negatively impacted.
2. determine if the effectiveness of the computing system can affect the competitiveness of the corporation. If so, then much more control is required. Consider that K-mart, in the end, could not compete with Wal-Mart because of IT weaknesses. Inversly, many cases exist where competitive advantage stems from the use of best-of-breed IT solutions;
3. determine how many independent consulting companies versus *'tied consulting' companies* are used by the corporation and how often the owners of the *'tied consultancy'* bid on the subsequent technology opportunity.

Arguments Against Action

There will be people who will argue that *'tied consultants'* give the best advice. This is easy to debunk. Ask the question, when does a vendor share its best competitive information with a competitor – the answer is – ***never***. Thus, a *'tied consultant'* clearly represents a one-sided and potentially limited view. This is why the British Government implemented new laws controlling *'tied financial consultants'*. Now severe financial penalties are applied to any *'tied financial consultant'* that does not offer 'best-of-breed' advice. The onus is on the *'tied consultant'* to prove that they have offered such advice. Any individual harmed by poor advice can claim damages.

In our opinion, the same rules should apply to 'tied consultants' in the IT world. But in the absence of Government action, the individual corporate Board of Directors need to take direct action.

©Copyright Ashburnham Group 2003 - April 30, 2003

Where should the line be drawn?

Given that the Directors now recognize that a risk could exist, what should they do? They could simply ask the CIO to use judgment. Would that be sufficient? *The answer is no,* as this issue is actually both an ethics issue and a survival issue (due to the critical nature of IT). As such, the line should be drawn at the Board level and not at the operating level. Specific and concrete Board action is required resulting in a clear, written, corporate policy on the use of *'tied consultants'*.

There is precedence in the public sector too. There, any vendor, including large international computer companies, which provides consulting services that make recommendations regarding or leading to the acquisition of hardware, software or systems, is barred from bidding for any of the work recommended by their *'tied consulting group'*.

If public money should be protected in that manner, then it is difficult to argue that shareholder value should not be protected in the same manner. Clearly, the Director's fiduciary responsibility demands a clear policy statement on both internal conflict of interest and vendor conflict-of-interest.

What should be done by Directors to improve Corporate Governance?

There are three key steps that should be undertaken by the main corporate Board:

1. pass a main Board resolution, that any vendor or group providing '*tied consultancy'* cannot participate in any way in the provision of the associated service or supply;
2. instruct the director of purchasing to ensure that all vendors sign a statement that they have no financial or ownership relationship of any sort (including finder's fees), with the consulting company, involved in the preparation of the advice behind the RFP or the writing of the RFP or the Report that is generating the acquisition of material or services. This document should allow for financial damages if the consulting firm, or the vendor of technology, do not fully declare their relationships;
3. make it company policy to issue an RFP, except in extraordinary circumstances, for any major IT technology. Never just take a vendor's word for what is best-of-breed in this complex, multinational, technology-driven market.

By implementing such a process as part of a review of corporate governance, not only will the Board reduce the chance of an Enron-like conflict-of-interest consulting problem arising from the use of 'tied' consultants, but they will increase the chance of their firm obtaining best-of-breed advice, technology and vendor participation in driving your top and bottom line, rather than perhaps just enhancement of the vendor's business.

If you would like to be sent a copy of the Ashburnham conflict-of-interest avoidance form, please send an email requesting the document to: requests@ashburnham.com or call us at 1-705-939-2300

PO Box 59 (Main) · Peterborough · Ontario · Canada · K9J 6Y5
©Copyright Ashburnham Group 2003 - April 30, 2003