Alliances and ICT Audits

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An alliance is a strategic management tool. It helps one organisation to cooperate with others in order to achieve specific product development, sales or distribution goals. The relationship between the allied organisations is in most cases a loose one, but the investments are substantial. Controls may play a critical role in the success of the alliance. This article describes the phases in which an alliance is established and deals with the corresponding risks and controls. It also addresses the relationship between the ICT auditor and alliances in the financial audit.

Introduction

Several worldwide trends can be discerned in business and industry. The most important of these are:
* Blurring of national borders: consumers are increasingly able to buy products abroad.
* Distribution channels: expanding opportunities for selling products via 'non-traditional' distribution channels.
* Market concentration: the drive to obtain competitive advantages through economies of scale has triggered a wave of mergers and acquisitions.
* Consumer demand: consumers are becoming increasingly critical and demand more added value and better service.

In their endeavour to achieve an optimal performance, players must be able to rapidly adapt their organisational structure and operational focus to the needs of the market. In order to achieve this, decisions must be taken at a strategic level to lay out the most appropriate course for the company. Practice shows that more and more companies choose to form alliances in response to these developments.

In this context an alliance is defined as *'every formal form of cooperation between two or more organisations with a view to achieving a common benefit'*.

Most alliances are, to a greater or lesser extent, faced with the new developments in information technology. Examples of such alliances include:
* Microsoft and Barnes and Nobles.com: sale and distribution of e-books;
* SAP and CommerceOne: development of products for online marketplaces for various sectors;
* GM, Ford and DaimlerChrysler: creation of online marketplace for purchasing parts;
* ABN Amro and KPN Telecom: establisment of financial website for consumers.

As the number of alliances continues to grow, the ICT auditor is increasingly confronted with questions from clients with respect to the selection of partners and the management of alliances. Clients require assurances regarding the alliance's future activities.

This article gives the ICT auditor insight into the formation of alliances, the factors to be considered during this process and the risks involved. An in-depth understanding of these risks enables the ICT auditor to provide clients with structured assistance in setting up alliances and controlling the operational processes within the alliance. This article also outlines the services that an ICT auditor is able to offer in this respect. Specific attention is devoted to the role that the ICT auditor plays in alliances as regards the annual audit.

Stages in the formation process

The process of creating an alliance usually follows a series of identifiable steps (see figure 1). The process should start from the business strategy and end with an evaluation. The latter may lead to the decision to dissolve the alliance. In principle, all alliances have a limited lifespan.

The alliance framework shown in figure 1 can be used as an instrument for the successful structuring and management of alliances. The ICT auditor uses the framework to identify the most important issues at an early stage and provide his client with well-informed advice.

The following sections look at the various stages in the proces in greater detail.

Figure 1. Framework for alliance formation.

Start-up phase

The start-up phase in the alliance formation process consists of three sub-phases. These sub-phases are: the business strategy, the alliance strategy and the partner selection.

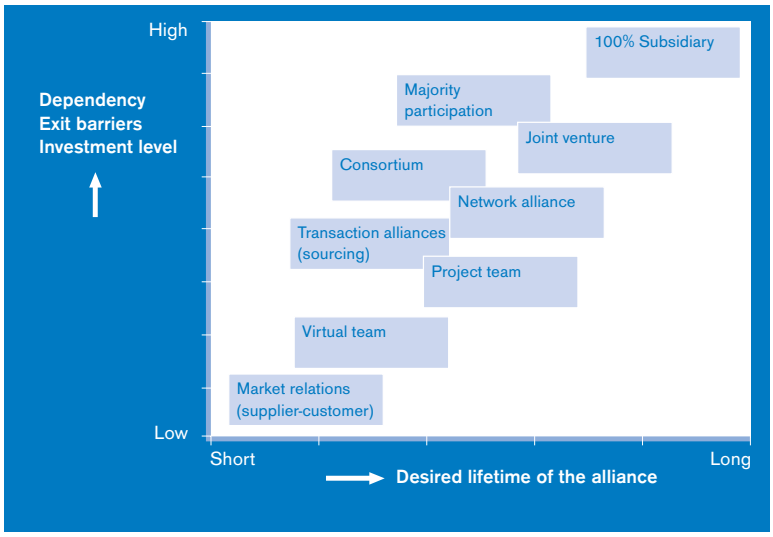
Business strategy
Apart from the internal and external analysis, the business strategy sub-phase also includes the assessment of whether an alliance will help to attain the organisation's goals. Only when the management in question knows what it wants to do with the organisation and what the organisation is capable of doing, can it decide whether an alliance is a sensible solution.

On the basis of the business strategy, it can be determined whether
* missing competences (specific know-how),
* performance improvements (economies of scale/scope, outsourcing), and
* additional market access (distribution channels, emerging markets)

should be developed or purchased (acquisition). Or, alternatively, whether a form of collaboration with another party (alliance) is the most appropriate strategic route. Once an alliance is opted for, the next step is to lay down the alliance strategy.

Alliance strategy
The alliance strategy serves to provide insight into the organisation's own skills and know-how, the potential partner's complementary skills and expertise, and the extent to which the organisation is able to work together with and adapt to a third party. The organisation's own adaptability, reinforced by its skills and know-how, determines the organisation's synergetic potential. On the basis of these data, the framework conditions for the future alliance can be formulated and the alliance strategy can be established. Key aspects in these phases include:

Figure 2. Overview of types of alliance ([Wild97]).



* the organisation's own contribution (set limits);
* required input from the partner;
* design of the alliance (lifespan, control);
* form of cooperation (network, joint venture, virtual organisation);
* how predictable is the market and what risks emerge if the predictions prove inaccurate?;
* costs.

The overview in figure 2 shows the various types of alliance and relates a number of alliance characteristics to each other.

Three types of alliance mentioned in figure 2 are discussed below.

Joint venture
A joint venture is a more or less independent legal entity set up by two or more partners. The activities carried out by the joint venture are generally an extension of the partners' business operations. The object of the joint venture is laid down in the articles of association. The joint venture is usually entered into for an extended period of time (more than two years). A termination date is usually not set.

A joint venture normally involves a high level of investment, giving the partners a strong incentive not to abandon or dissolve the alliance. This (usually) high investment level means that the partners are generally keen to retain tight control of the joint venture. For this reason, they will opt for an 'equity' alliance. The actual activities within the alliance, however, are 'cut loose'. In other words, these activities are managed and administered by the joint venture as if it were a completely independent entity.

Consortium
A consortium is a (one-off) alliance for large-scale projects, often involving the creation of a limited partnership. The object of the consortium is clearly described in a consortium/partnership agreement. On completion of the project, the consortium is usually dissolved. Here too, the high investment level and the high degree of partner interdependence, due to the contribution of knowledge and expertise, counteract a premature withdrawal by either partner. The partners will therefore insist on tight control of the consortium, in the shape of joint management and frequent reporting. The consortium usually does its own independent accounting.

Transaction alliance (sourcing)
A transaction alliance such as ICT outsourcing is an alliance with a clearly demarcated objective that can be realised in a relatively short term. In a transaction alliance, some parts of the company, such as the ICT function, are transferred to the alliance partner. The objective is explicitly described in the agreement between the alliance partners. The level of investment is relatively limited. However, the degree of interdependence, as results from the contribution of knowledge and expertise, makes it difficult for the partners to end the alliance prematurely. Moreover, contract penalties make an early withdrawal costly. In

this case too, the alliance partner will therefore insist on tight control. The alliance partner requires adequate service level management. Consequently, a detailed service level agreement (SLA) is a prerequisite.

Partner selection
On the basis of criteria defined in the alliance strategy, the process of seeking, selecting and approaching a partner can be started up.

Companies often attach great value to their being sought out by another party. There is, however, a danger that the proposed alliance is not in line with the organisation's own strategic objectives. The organisation may also fail to realise that the alliance is for a limited period only. A common interest must lie at the heart of every alliance, i.e. it must lead to a win-win situation for each of the participating parties.

When looking for a partner, the chemistry between the two companies deserves to be given serious attention, as does the business fit. One of the important reasons for failure concerns the absence of chemistry. This is not confined to senior level cooperation, but extends to all levels in the organisation. Another important aspect in this phase is the development and adoption of a business plan that defines critical success factors (CSFs) as well as key performance indicators (KPIs). The organisation of the alliance (control, adequate contracts, employees, processes, ICT) also plays an important role.

Operational phase

In this phase the central focus is on the actual management and control of the alliance, for which communication, management information and the input of the partners are vital elements.

Management attention will be principally directed at various aspects of the new relationships. Normally, a substantial amount of time is devoted to ensuring smooth cooperation between the partners. The success of this phase depends largely on the compatibility of the corporate cultures, (arrangements to ensure) open communication and the distribution of the financial revenues.

Clarity with respect to the objective of the alliance, the CSFs and SLAs, the customer approach, effective team rules and the business plan all reduce the need for additional tight control structures. Furthermore, it is important that participating organisations define KPIs, norms and monitoring techniques, so that timely adjustments can be made if necessary. The management information supplied to alliance partners must be geared to these KPIs and norms.

Mutual trust constitutes a critical component. Although the success of alliances depends on subjective factors such as corporate culture, management and control measures increase the degree of confidence in each other (see figure 3).

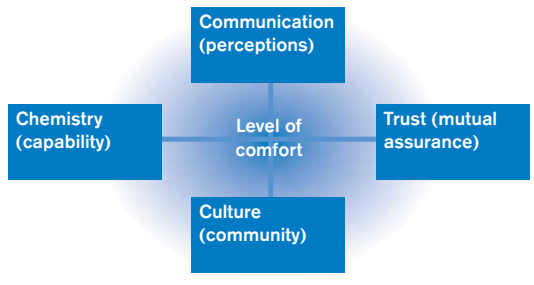


Figure 3. Alliance success factors [Wild97].

Evaluation phase

Alliances are partnerships with which to achieve a common objective and are normally of a temporary nature. This means that the partners must set an evaluation schedule and matching criteria in advance to permit the periodic evaluation of the alliance. As soon as the objective of the alliance has been achieved, the alliance is dissolved. Alternatively, it is reassessed in order to establish whether it fits in with the formulated business strategy at that time, allowing the process to be started up all over again.

Though evaluation enables the individual partners to assess the alliance's contribution to their strategic goals, alliances are often not consciously evaluated in this light. Even though this was the very reason for setting them up in the first place. A clear schedule for periodic evaluation is crucial to the success of an alliance.

The role of the ICT Auditor

General

The introduction already referred to the growing number of alliances: recent surveys by KPMG show that the majority of the respondents expect a further rise in the number of alliances in the future ([Wild96], [Wild97], [KPMG98]). This means that the services of the ICT auditor will be increasingly required in the formation and subsequent management and control of alliances.

The extent to which organisations will require these services depends on the risks to which the management is exposed. The table below contains a number of common business risks and shows to what extent specific risks occur with respect to the different types of alliance. The types of alliance featured in the example are the joint venture, consortium and outsourcing (transaction alliance). It should be noted that the risks, as listed in table 1, may vary in every other situation.

An ICT auditor must be informed of the alliance process to provide the best service possible. The role of the ICT auditor can be developed in different ways. He can be engaged as ICT expert to, for instance, select an outsourcing partner in the strategic phase.

Risks	Joint venture	Consortium	Transaction alliance
Preparation/start-up phase			
1. Business strategy			
* Alliance is incompatible with the company's strategy	+	+	o
* Alliance is incompatible with the current organisational structure	+	+	o
* Cultural misfit	++	o	+
* Incorrect valuation of alliance	++	o	o
2. Alliance strategy			
* Wrong choice of alliance	+	++	o
* Limits of own organisation's contribution (knowledge, resources, capital etc) is not defined	+	++	o
* Partner's input (capital, knowledge etc) is not defined	+	+	o
* The design of the alliance is not clearly defined (objectives, CSFs, KPIs, lifespan, ownership, dependence)	++	++	+
3. Partner selection			
* Profile(s) of partner(s) is/are inaccurately determined, both in rational and relationship terms	++	++	+
* Wrong selection criteria (complementarity, chemistry)	++	++	+
* Incomplete inventory of partners	++	+	o
* Insolvency	+	+	o
* Unclear, flawed draft business plan (timing, objectives, targets etc)	++	++	++
* Unclear, incomplete contract (evaluation schedule, partners' contribution, valuation, liability in case of dissolution, control schedule, etc)	++	++	++
4. Operational phase			
* Poor elaboration of draft business plan into definite business plan	++	++	++
* Poor organisation of alliance (organisation of business processes/ICT, staff, directors)	++	+	o
* Financial risks (completeness of sales, accurate records of costs, inter-company pricing, distribution of results, valuation, transfer prices)	++	++	+
* Poor management and control of alliance (accounting information, communication, relational aspects)	++	++	++
* Wrong assessment criteria (e.g. corporate culture is not evaluated)	++	o	o
* Evaluation takes place too late	++	o	o
5. Dissolution phase			
* Financial risks (cut-off, valuation, unlawful withdrawal)	++	++	+
* Takeover activities by partner(s)	++	+	o

Table 1. Alliance risks.

Alternatively, he can also be requested to assess the ICT processes that underly the alliance as well as the relation between the ICT processes that support the alliance and the alliance partners, and the annual audit.

Table 2 describes the potential role of the ICT auditor for each phase. The list is not exhaustive but gives an indication of the range of available services.

A large number of ICT auditors will be confronted with alliances as part of the annual audit. The next section examines this relationship in greater detail.

Table 2. Role and type of involvement ICT auditor.

Phase	Role of Information Risk Management consultant	Type of involvement
Business strategy	**Advice**	Second opinion business case
Alliance strategy	**Advice**	Second opinion alliance strategy
Partner selection	**Advice**	Draw up an RFI en RFP for e.g. an ICT outsourcing partner and support the assessment process
	ICT Due diligence	Assessment of the risks that arise from the integration of processes/systems. Assessment of the quality of ICT
Operational phase	**Advice**	Advice on integration of processes/systems of alliance partners
	Third party reports	Provide alliance partners with assurance regarding continuity, security, based on generally accepted audit standards
	Service Level Agreements (SLA)	Advice on the formulation of an SLA (completeness, measurability, CSFs, KPIs)
	Service Level Management (SLM)	Set up the processes in such a way that the conditions stipulated in the SLA can be satisfied
	System audit	Assess to what extent the processes at alliance partners are controlled
	Support annual audit	Provide the audit with guarantees regarding the ICT-supported (joint) processes
Evaluation	**Cost/benefit analysis**	Assess ICT costs/benefits

Alliances and the financial audit

This section takes a closer look at the involvement of the ICT auditor in the financial audit. KPMG's financial audit approach, based on the Business Measurement Process (BMP) approach is used as an example ([KPMG97]). Within this audit approach, a distinction is made between five phases, as shown in figure 4.

As indicated in a previous section, the ICT auditor can be confronted with alliances in various ways. He may be working on the annual audit of a customer who frequently enters into alliances in the ICT field. In this case, the control of the entire alliance process as well as the control of the business processes in the operational phase are important. The ICT auditor can also be working on the annual audit of the alliance itself. In this case the Information Risk Management consultant can make an important contribution to the assessment of the ICT-supported business processes (see previous section).

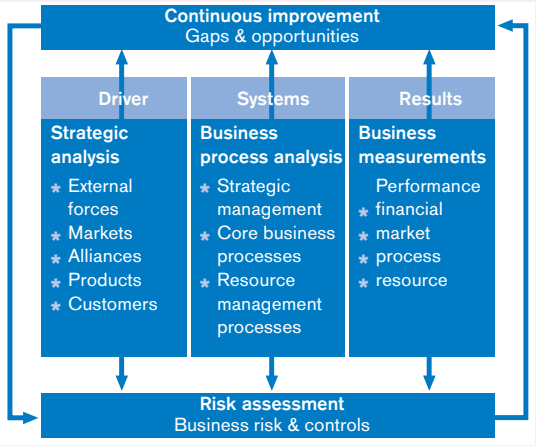


Figure 4. BMP method.

The ICT auditor and strategic analysis

In the strategic analysis phase, it is important to establish a picture of the strategy and objectives of the company regarding the sector and environment in which it operates. The ICT auditor can use business

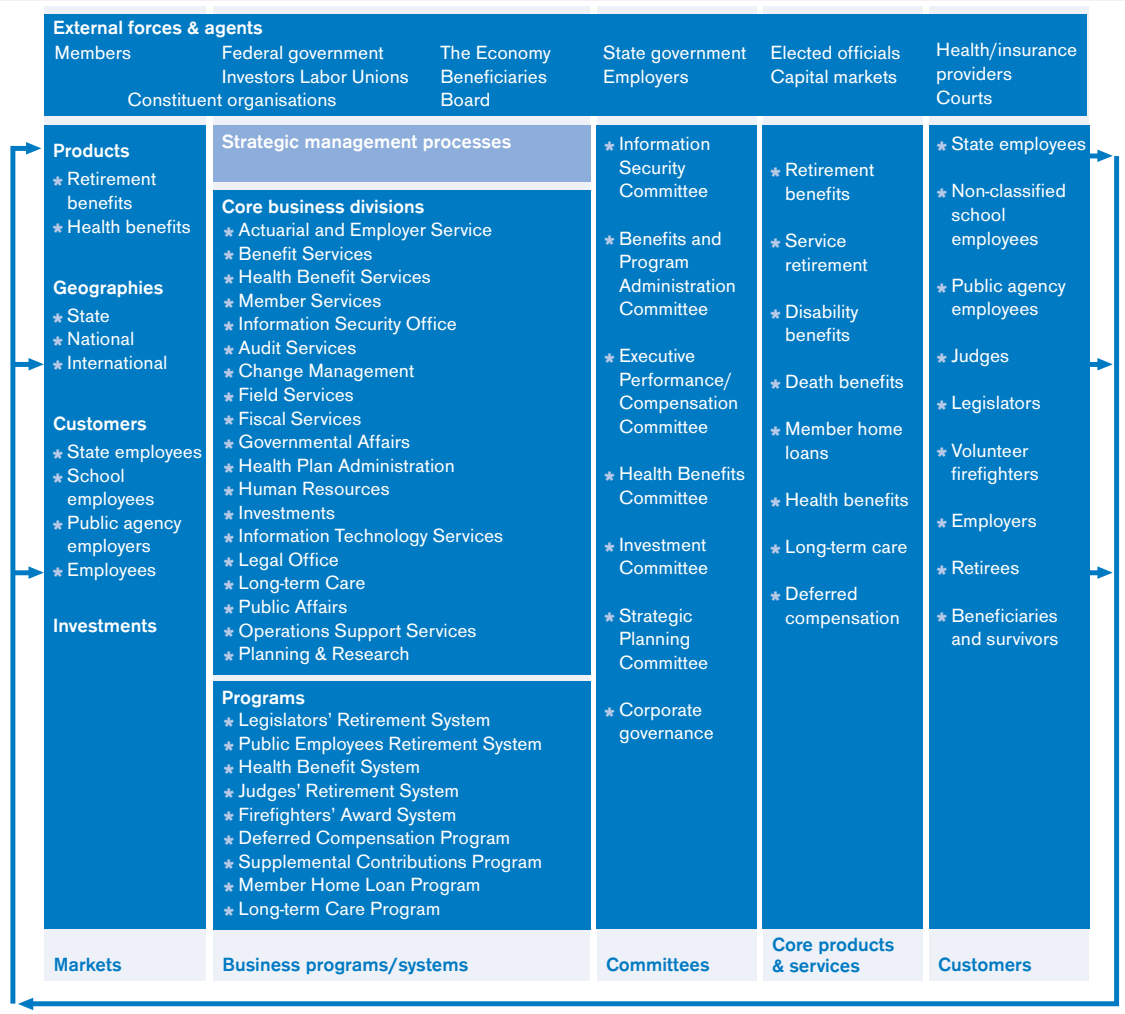


Figure 5. Business model US state pension and health care fund.

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models as an analytic tool. Figure 5 provides a simplified illustration of a business model of a US state pension and health care fund.

The business model provides a summary of the sector and the organisation's position within the sector. Knowledge of the role that strategic alliances play in the sector is obviously important.

Next, the organisation's risk management process and the quality of the internal control environment must be assessed on a strategic level. The question is addressed whether sufficient attention has been paid to all potential business risks and whether the audit environment has been organised in such a way that the identified risks can be adequately controlled. Table 1 gives an overview of the business risks that occur in the various stages of setting up an alliance.

During the operational phase, the partner's auditor will adopt as his starting point the management controls set up to achieve the alliance's goals. This is done in conformity with the KPMG audit approach. He will then assess whether these management controls adequately cover the business risks. In addition, the ICT auditor will assess to what extent the defined KPIs and norms are realistic. Next, the quality of the control framework must be assessed in order to certify that the management information for the assessment of the KPIs (business monitoring) is adequate.

As regards the business monitoring phase, the auditor will compare the results of the alliance with the predetermined business objectives (CSFs and KPIs).

The ICT auditor and the audit of the alliance

In the strategic analysis, less attention needs to be devoted to the business strategy, alliance strategy and partner selection. A key issue could be to establish if the alliance is still able to achieve the objectives formulated in the partnership agreement. The continuity of the alliance, after all, is an important risk factor for the Information Risk Management consultant to monitor.

The ICT auditor of the alliance will want to find out whether the objectives laid down in the partnership agreement have been converted into CSFs and KPIs for the business processes (business process analysis). The ICT auditor will assess the reliability of the criteria, taking the management controls as his starting point. Depending on their quality, the ICT auditor will be able to obtain audit evidence from these management controls.

In the business monitoring phase the ICT auditor will compare the results of the alliance with the predetermined objectives laid down in the partnership agreement.

Conclusion

Alliances are the future. Many alliances are set up in response to ICT developments, in order to reduce costs. Frequently these reductions can be achieved by making optimal use of ICT. Substantial risks are involved in the management and control of alliances. The participation of an ICT auditor in an early stage could add to the effectiveness of the process. In order to substantiate the added value, the ICT auditor must have insight into the alliance process, the risks involved and the services required.

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