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Feedback

Comments and suggestions about **FINANCE & MANAGEMENT** should be addressed to Chris Jackson BA FCA, head of the Faculty, at the address on the back page.

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FINANCE & MANAGEMENT is edited and produced on behalf of the Faculty by Silverdart Ltd, Unit 211, Linton House, 164-180 Union Street, London SE1 0LH.
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A new co-ordinator at the Faculty

Hello, my name is George Karasoulos. With Jacqui Newell on maternity leave until next spring, I am pleased to say that I will be assisting the Faculty of Finance and Management as the new Faculty co-ordinator.

My responsibilities will include co-ordinating conferences, lectures, mailings and general marketing of the Faculty. I have recently come to the UK from Australia, where I was employed as a training consultant for Cable and Wireless. I have a bachelor's degree in business management (marketing) and an associate diploma



in wine marketing. The Faculty has many exciting prospects; I look forward to the challenge and the chance to meet Faculty members either face-to-face through the Faculty lectures and conferences or via the phone. Finally I would like to wish Jacqui Newell all the best on behalf of the Faculty.

Deductible subscriptions

We occasionally receive calls from Faculty members who have claimed their Faculty subscription as tax-deductible, only to have it questioned by their tax office.

The Inland Revenue has accepted that Faculty subscriptions are tax-deductible. For further information, please contact members' registration on 01908 248250 or e-mail finnreg@icaew.co.uk.

More about MQ Online

In response to the very positive feedback we have received from the membership about *Management Quarterly*, the Faculty is working on a new initiative: *MQOnline*.

MQOnline will be a web-based series of streamed multimedia lectures that cover and expand upon the subjects addressed in the *Management Quarterly* journal. When the series is up and

running, members will be able to access these 20-30 minute lectures via the Faculty web-site.

MQOnline is being trialed with a series of finance lectures covering aspects of shareholder value.

The Faculty is seeking volunteers to take part in these trials. If you are interested, or if you want to find out more about *MQOnline*, please contact Chris Jackson by email on CDJackson@icaew.co.uk.

Directory of Expertise

If you have not returned your Directory of Expertise form, please do so now. If you are already in the directory and

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your data needs to be modified please mail or fax your completed form to us. Should you require a new form or further information please contact Debbie Came on 020 7920 8486.

Free recordings of lecture

If you were unable to attend the June lecture on people management by Dr Veronica Hope Hailey of the Strategic Management Group, Cranfield University, you can obtain a free video or audio recording of it from the Faculty. For full details, see page 11, and complete the tear-off response form.

Please note that all changes of address and other new details of Faculty members should be notified to the Institute's members' registration department (tel: 01908 248250 or email: finnreg@icaew.co.uk).

Developments in strategic performance measurement



Kevin Bounds of KPMG, the first speaker in the current series of Faculty half-day conferences, traced the evolution of the balanced business card, and suggested how it could be used to help the finance function. Helen Fearnley reports on his address to the first



conference in Huddersfield. Further conferences are planned – see page 11 for details.

Kevin Bounds began his address by stating his firm belief that, nowadays, finance should have a central role in any organisation, helping the business to move forward.

Then, turning to his chosen subject matter – strategic performance measurement – he set himself the task of addressing such issues as why this should be important for finance, how finance might become involved, how such involvement could be used to raise finance's profile in the organisation, and what impact new technological developments have had on the area.

The background

As Bounds observed, there is currently a wide range of ways in which organisations attempt to implement their strategies – as he put it, an alphabet soup of disciplines whose most obvious common bond is the three-letter acronym (ABC, TQM, EVA, KPIs etc) by which each is known. Tracing the background to this status quo, he identified the 1970s as an era of fairly straightforward financial measures with the major emphasis on budgeting, while in the 1980s planning came to the fore and the stress was on understanding the business and managing activities (ABM being the new 'must-

do'). The 1990s, he went on, was the period in which the corporate model became paramount with the balanced business scorecard (a term he used as a synonym for the balanced scorecard) gaining credence and prime importance given to providing value. But what now?

Accelerating change in the new millennium

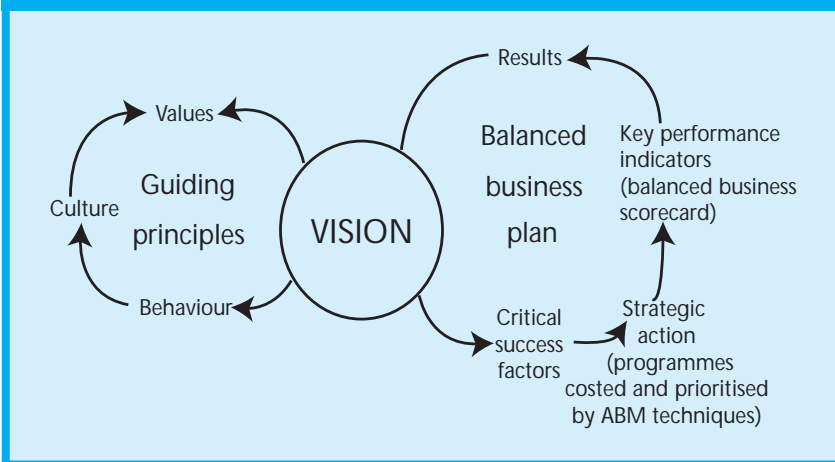
In the 2000s, Bounds reckoned, things are going to evolve more rapidly than ever before, with e-commerce driving that accelerated change. Finance, in particular, faces such problems as dot.coms being difficult to evaluate, and – given the pace of change – of three months rapidly becoming the equivalent of a year in terms of financial reporting. At the same time, new technology has replaced many of finance's old skills, such as double entry book-keeping, while there is the new concept of knowledge management with which to contend.

Companies in general will have to find a new way of responding in this increasingly competitive era. New business models are going to be required.

Bounds drew the analogy of two men alone and unarmed on the

FIGURE 1

MEASURING FOR SUCCESS



African plains, when they spot a very hungry lion. One starts to put on his running shoes, to which the other remarks “Are you mad? You’ll never outrun the lion.” But as the first man makes clear, “It isn’t the lion I need to outrun.”

In other words, it is your competitors you need to beat in any industry, and early adoption of a strategy gives you a head start before others change the nature of the market.

As Bounds concluded, despite the uncertainty accompanying this e-era, inactivity is not an option.

Finance’s best choice – integration into management processes

Looking at the ways in which finance might respond to these changes, he suggested that if it simply continued providing the financials, essentially being merely reactive, it would be failing to develop with the times.

A considerably better option would be to help co-ordinate the production of the balanced scorecard, becoming pro-active while at the same time maintaining its own professionalism.

But best of all, he said, would be for finance to integrate itself into the overall management processes, becoming a business partner, and at the same time achieving world class status.

This last choice, he revealed, is also what seems to be the favourite with non-finance colleagues. Research has

shown that what CEOs most want from finance is for it to become a true business partner.

How to achieve integration

But how to achieve this integration? First, Bounds set out to define integrated management processes, describing them as those which link strategy to action, balancing hard and soft measures, driving the business to success. They touch on culture, remuneration, behaviour and the use of scarce resources, and can be communicated throughout the organisation.

Thus one possible business model for the above is as in Figure 1. The guiding principles, Bounds believes, are almost a social contract between management and employees, while the balanced business scorecard helps to manage the results of programmes costed and prioritised through the use of activity based management (ABM) techniques.

Finance still reluctant to change

Yet in many cases finance is still reluctant to seize the new opportunities presented, and go with them. Bounds suggested this is the result of a variety of factors, including the feeling that it has no mandate to do so, that it also does not have the resources, that the venture is high risk, using inappropriate capabilities, and that the exercise is out of its own comfort zone. And it may also be a result of not realising the risk in failing to evolve.

His recommended remedy was for finance to claim the mandate for

making changes, eliminate non-value-adding activities to free up resources, recognise the risk in inaction, upgrade the skills in the department and give talent an opportunity, at the same time realising that development generally only takes place when one operates outside the comfort zone.

The balanced business scorecard

In his own experience of start-ups and turn rounds, Bounds said, the balanced business card – in conjunction with re-engineering the finance function – was one of the swiftest ways of making a big impact on a business’s performance. So, looking in more detail at the way in which the BBS transforms finance from the not very motivating role of lag indicator to that of influencing financial performance, he set out what it tries to measure and do (see Figure 2).

Customer viewpoint

For the assessment of customer viewpoint, he went on, typical measures considered are customer satisfaction, market share, persistency, value added for the customer, the return probability of that customer, the percentage of perfect transactions, and the level of complaints.

These are quite powerful measures but need constant monitoring – by benchmarking against other companies, and against oneself over a period of time. (Such monitoring can reveal critical information, such as that a follow-up call six months after a successful sale takes the probability of a reorder up from 60% to 80%; that ensuring value added for the customer can be effective in combating the challenge of e-commerce; and that monitoring complaints gives valuable insight into inconsistencies of service within your organisation).

Operational performance

Operational performance needs to be examined very carefully, and continuously. Service standards may seem adequate but should be rigorously questioned – for example, a level of service such that we respond to 90% of customers within three days should be examined from the point of view of failing to deal with the remaining 10% in that time frame. Stretch targets – over a

number of years – should be set for improving productivity relative to the rest of one's industry. Staff should be monitored for over- as well as under-experience (the former producing burnout where people are kept too long in some of the more stressful jobs). And robust controls should be in place and monitored regularly, being reported on as part of the BBS.

Organisational development

The organisational development can be guided and tracked through setting and reporting on achievement milestones, measuring internal satisfaction levels by means of indices of staff satisfaction and cultural values, and self-assessment through the European Quality Award (EQA). Products should be monitored to ascertain that the new products are kicking in with a reasonable contribution to revenues (too high a proportion of turnover from products of five or more years' standing risks heavy revenue loss in the future). Skills also need constant upgrading through training, with the development of project management and e-commerce capabilities particularly important.

Not a perfect solution

The BBS, Bounds maintained, is a way of providing an integrated assessment of performance, and gives alignment – ie everyone pulling in the same direction – on the areas the business needs to address. All its key areas should be communicated to all staff, along with a set of appraisals, plans and – where targets are met – rewards.

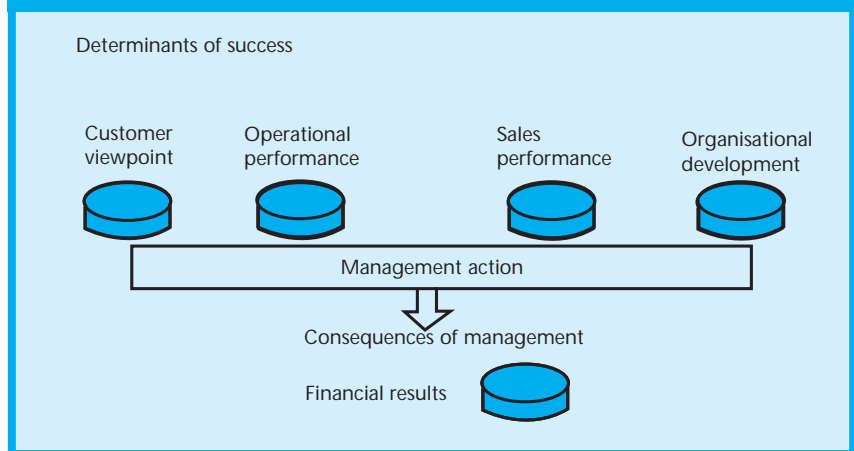
However, he emphasised, the BBS is not a perfect solution – it still requires those human elements of judgement and balance. The BBS only works if there is constant dialogue and communication at all levels, targets are set, and external surveys are carried out.

Issues needing to be resolved, in its adoption, include:

- formulating a clear statement of corporate strategy and objectives;
- being willing to measure;
- undertaking genuine benchmarking;
- finding a high level sponsor (eg CEO);
- agreeing on responsibilities; and
- making a commitment to communicate.

FIGURE 2

BALANCED BUSINESS SCORECARD



However the rewards, Bounds said, include that 'what gets measured gets valued', and also – with the help of stretch targets – gets done. And the alignment of goals means that considerably more power is harnessed for progressing the business.

Latest developments in strategic performance reporting

Finally, moving on to look at the most recent developments in strategic performance reporting, Bounds said that the world had moved on significantly in the last six months, largely because of developments in enterprise resource planning (ERP) applications. Software is now available providing all the functionality finance might need, including data warehousing facilities. As a result, organisations are becoming more sophisticated in the way they manage their performance monitoring.

Technology is also emerging which provides efficient and effective interfaces from legacy systems into ERP systems and data warehouses, without extensive reprogramming of the legacy system.

The new prototype ePM portals can now integrate, on an individual's PC, everything that needs to be done, will access all the external information necessary to perform those tasks, and bring down all the relevant role-specific internal balanced scorecard information. They even inform that individual when a given task has become pressing.

A common feature of these new portals is that, if integrated with ERP,

they provide the backbone for ABC analysis of the organisation and its products. (Bounds here mentioned his own experience in one particular organisation where, through use of data warehousing and ABC analysis, he was able to manage products much more efficiently at a micro level. Using this more precise analysis, the organisation in question was able to keep a certain mature product in the market, profitably, for six months after all competitors had withdrawn similar products.)

For finance, Bounds pointed out, these new developments open up the possibility of integrated financial and management information systems that free up finance's resources to focus on real value adding activities.

Conclusion

Summing up, Bounds pointed out that as the rate of change continues to accelerate, focusing on the financials is no longer enough. In the 2000s, the balanced scorecard will continue to be a key tool in implementing the organisation's strategy, while advancing technology will both change the rules of the game and open up new possibilities for finance itself.

Kevin Bounds is director of world class finance-insurance at KPMG Consulting, after a line career in financial services, which included being finance director for NatWest Life. He also sits on the executive committee of the Faculty. He can be contacted on tel: 020 7311 5949; fax: 020 7311 6154; email: kevin.bounds@kpmg.co.uk

What your bank may not tell you about leasing

Leasing is not just a matter of finding someone to lend you the money. As **Alan Clements** (*right*) and **Ray Mackie** of Capital Value Brokers (CVB) explain, potential lessees need to adopt a well thought-out strategy for best results.



Entering into a lease is a relatively straightforward exercise, however obtaining maximum financial advantage from the lease is unfortunately another matter. The difference between a well thought through strategy on asset finance, and simply taking what finance is on offer from an immediate source, can amount to hundreds of thousands of pounds and an unpleasant and unnecessary increase in the interest charge.

The would-be lessee needs, above all, to be sure that the terms of the lease fit in with his, rather than the lessor's agenda. For example, banks will happily provide leases for shorter rather than longer periods as their credit risk is thereby reduced. This can create problems, as, since the introduction of the Inland Revenue Statement of Practice (SP3/91), the relationship between lease period and depreciation policy has been critical to the economics of a finance lease. SP3/91 dictates that tax deductions on finance lease rentals must be taken in line with depreciation, and Figure 1 (*below*) illustrates this issue:

If the lease is amortised faster than the period of book life remaining, rentals flow out faster than tax relief driven by depreciation accrues. This is why mismatched leases are uneconomic, and the example in Table 1 carries a preset value disbenefit of some 10% when compared to the matched lease. It should be noted that this type of penalty occurs whenever the primary lease period and the remaining book life of the asset are mismatched in this way.

The mismatched lease shown is a live example as offered by a house bank which we were asked to check. For reasons of confidentiality identities cannot be divulged, but needless to say the lessor was turned down. This is just one of a great many examples of banks promoting their own interests rather than those of their customers. Not a surprise, but an issue never highlighted in their presentations.

Another example of this attitude is the unwavering propensity of banks to promote the product they currently wish to sell (and their most profitable) as the one you really need. An example of this came from a company who contacted us in early 1999. ABC was a management buy-out from a FTSE company in 1995 and was funded by a mixture of venture capital and bank debt.

They wished to finance £14 million of plant and equipment which was depreciated over eight years, and we were brought in after ABC had received advice from their main banker that what they needed was a three-year hire purchase facility. CVB ran a finance lease vs. purchase analysis which showed conclusively that leasing was the cheapest option. ABC checked and also obtained independent proof of CVB's cash flows (which the bank did not produce at any stage), and despite initial strong opposition from the bank who advised ABC that they would do the whole deal themselves, chose CVB to arrange a lease for the full £14 million.

A comparison of the two options is set out in Figure 2 (*opposite*).

The house bank knew the arrangement of low cost finance was a pressing issue for ABC. However, the formal offer approved by the credit committee increased the initial HP rate from 2% p.a. to 3% p.a. through fees and charges, and put a maximum exposure of £4 million and four years on ABC. Not surprisingly the bank remained silent both on how the £10 million shortfall should be financed and also on the mismatched period (four-year finance vs eight years' depreciation). The CVB leasing alternative not only achieved savings amounting to £740,000, or an NPV benefit of 5% (£14.62 million/£0.74 million), but also provided long term finance which added stability to the balance sheet.

We find that the experiences of ABC very accurately mirror those of all types of company, irrespective of whether they are smaller than ABC – and more vulnerable – or are FTSE 100 companies. As with all debt instruments and the way they are documented, leases require careful evaluation. This is because they do

FIGURE 1 DEDUCTIONS (SP3/91)

Depreciable life (years)	Lease period (years)	NPV saving/(cost)
15	5	(6.1%)
15	15	4.2%

FIGURE 2

LEASING OPTIONS

	House bank	CVB	Saving
Asset value	£14m	£14m	
Amount ultimately offered	£4m	£14m	
Period	4 years	8 years	
Method of borrowing	Hire Purchase	Finance lease	
IRR	LIBOR + 3.00% p.a.	LIBOR + 0.90% p.a.	2.10% p.a.
If the house bank had offered the full £14m for 8 years the comparison is: NPV cost	£14.62m	£13.88m	£740,000

perform differently from company to company and depend on specific tax, accounting and other financial criteria. Unfortunately, these complexities preclude the use of a simple checklist approach, which is why a key part of CVB's role is to analyse all the financial, commercial and legal implications of each client's transaction.

There is, though, one hard and fast rule of thumb, which is that

prospective lessees should never judge the economics of any lease by relying on performance measures provided by the lessor. Companies must always carefully analyse how finance and operating leases will perform for them as lessees. Independent advice and rigorous analysis based on old fashioned discounted cashflows for each option (ie not merged), and a financial audit trail through the document, are the

only safe ways of ending up with the correct structure at the right price.

Alan Clements, formerly finance director of ICI, and Ray Mackie, formerly a partner with KPMG, are directors of Capital Value Brokers, a consultant and arranger for plant and equipment finance. They can be contacted on: tel: 020 7253 2005; fax: 020 7250 3985 or email: mail@capitalvalue.co.uk

ANBAR ABSTRACTS

A selection of abstracts from various sources with comments by the abstractor.

29AK229 Are your processes fit for e-commerce?

Hall J, *Management Services*, (UK) Apr 2000, Vol 44 No 4: p12 (5 pages)
 ● *Argues that in order to stay in business in an environment of internet-based technologies companies have to embrace electronic commerce either by launching a separate e-company or incorporating an e-commerce stream into the current organisation. Discusses the impact of e-commerce on business processes and offers guidance on how an organisation*

can transform its business processes so they are suitable for e-commerce. Credits = 2

29AJ600 Bringing up the next generation

(shared service centres)
 Robb A, *The Banker*, (UK) Mar 2000, p94 (2 pages)
 ● *Explains the nature of shared service centres (SSCs), where scattered common activities such as finance, treasury and customer service are grouped in centralised processing centres. Recommends consolidating regions, business units*

and functions, and creating regional links. Suggests that, with internet growth, personalisation and customised services will be expected, while straight-through-processing means a SSC may become virtual with no physical centre. Credits = 2

29AM004 Beyond shareholder value

Mills R, Weinstein W, *Journal of General Management*, (UK) Spring 2000 Vol 25 No 3: p79 (15 pages)
 ● *Notes the widespread adoption of value based management and balance sheet restructuring in Europe. Observes a trend in business measurements away from accounting measures and towards economic profit and increasing value. Draws attention to the European legacy of the stakeholder model and the dilemma of balancing shareholder interest with that of other stakeholders. Credits = 3*

<http://www.anbar.com>

These abstracts are taken from the Anbar International Management Database, which is an on-line source for management literature. Management subjects covered include: accounting & finance, marketing & logistics, operations & production management and quality management. The full texts of all articles are available through document delivery at a cost of £6 + VAT per credit. The number of credits required for each full text article is given at the foot of each abstract.

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Internet abuse – when employees enter dangerous waters

Dubious internet material downloaded by employees can trigger legal action against the employer, as protector of the environment for all workers. Yet new privacy regulations, effective from October, restrict employers' right to find out

just what web sites are being visited, as Baker & McKenzie partner **Sarah Gregory** reveals.



Many employees now have the world wide web at their fingertips. The advantages of the internet are legion, but so too are the opportunities for abuse.

A number of internet-related employment law cases have already been heard by tribunals. There is much to be learned from them, by employers and employees alike.

Legal rulings featuring internet abuse

In *Franxhi v. Focus Management Consultants*, a Liverpool employment tribunal ruled in June 1999 that an office manager who had spent many happy hours holiday shopping on the internet during working hours was guilty of misconduct. She claimed unfair dismissal, maintaining that the true reason for her dismissal was her pregnancy. She lost her case, the tribunal ruling that she had indeed acted in breach of contract. The case centred on the amount of time Ms Franxhi had spent, which time should have been spent more constructively.

In other cases, employee misuse of the internet has been less benign

In *Dingwall v. Highlands and Islands Enterprise Board*, which came before an employment tribunal in September 1999, an employee accused, and then dismissed, for accessing pornography via the internet, took the unusual step of asking to see a psychologist in an attempt to prove that it was unlikely that he had acted thus because, being confined to a wheelchair and disabled, he would not have found pornography stimulating or satisfying. The specialist agreed with Mr Dingwall that this was the case, but nevertheless, Mr Dingwall was sacked from his job as co-ordinator of European Funds to Highlands Fishing Projects.

Mr Dingwall said that the discovery of pornographic material on his office computer was a set-up and claimed unfair dismissal. His employer said that he considered the discovery of deleted pornographic files in Mr Dingwall's computer was sufficient ground for dismissal, describing the material found as filth and continuing to maintain that accessing such material, whether within or outside office hours but within the employer's premises, was totally unacceptable.

During its evidence, the company indicated that the case had prompted it to install a software system which allowed senior staff to monitor which websites were in use by staff. The case has been adjourned and will be decided at a later date.

The internet has become an invaluable tool. In some cases, it has also become a weapon. In *Morse v. Future Reality Limited* [1996] a London tribunal ruled that male employees who downloaded pornography from the internet harassed a female colleague, with whom they shared an office, even though the material was not aimed specifically at the woman. Eventually, the woman resigned and claimed she had been subjected to harassment, citing the pornographic pictures, bad language and general atmosphere of obscenity in the office as the basis of the complaint. The tribunal considered that the male employees had created a hostile working environment for which the employer was responsible, having failed to control the environment or prevent the harassment. This constituted sexual harassment.

This decision should not be seen as particularly surprising – just as employers who permit employees to display material which is sexually or racially offensive will be found liable for permitting such a situation to exist or continue, so they will if the material is disseminated (even more efficiently) by the internet or email system.

The problem is, of course, how an employer can maintain control over such systems.

In *Dunn v. IBM UK Limited*, a London employment tribunal decided in 1998 that an employer had dismissed a male employee unfairly for accessing



sexually explicit material. The tribunal found the employee's summary dismissal to be unfair because it had not been clear that the employee had breached company policy. This case did not involve the dissemination of such material to any third parties.

In *Humphreys v. V H Barnet & Co*, Humphreys was asked to leave a family firm when it was discovered he had used computer facilities to download pornography. He was placed on garden leave for a month, during which his employer discovered the extent to which he had used his office computer for these purposes, and was dismissed.

He claimed wrongful dismissal – and won, because the tribunal concluded, reluctantly, that the employer's decision to place him on garden leave meant that the employer had waived his repudiatory breach of contract.

General guidelines

On a more general, but practical, front, employers and employees must recognise that casual email exchanges can have serious consequences. In particular, an exchange of emails can constitute a legally enforceable document. Rude and/or offensive emails can cause upset and disrupt the workplace. They

can also give rise to defamation actions.

In light of these cases, what should an employer do to protect his employees – and himself?

As will be seen from the Morse case, ignorance is far from bliss. An employer is under a duty to provide a safe workplace for all his employees – 'safe' includes safety from harassment or bullying, in whatever form.

However, an employer must, generally, also be aware that he owes a duty of trust and confidence to all employees. Surveillance – by whatever means, however sophisticated, and for whatever reason, however worthy, could amount to a breach of this duty of trust and confidence which is implied into every contract of employment.

Unhelpful developments

Whilst it is clear that employers must assume legal responsibility for their employees' internet use, certain recent developments in the law are not entirely helpful:

- the Human Rights Act entitles employees to privacy (it comes into force in October 2000). The extent of the right will in due course be tested; and
- the Regulation of Investigatory

Power Bill in its present form may well curtail employers' rights to intercept employee communications.

The government promises to rectify this situation by means of regulations to authorise such interception by employers and others for specified purposes – but these regulations have not yet seen the light of day.

Meanwhile, careful employers will, by way of written policies and procedure available to all employees:

- establish the guidelines, make clear what type of work and non-work related internet and email usage is acceptable, and what is not. This can be measured by time spent, and/or sites or types of site which may and may not be visited;
- make employees aware that monitoring systems are available and that internet use can or may be monitored by management; and
- confirm how breaches of the policy will be dealt with under the employer's disciplinary procedure.

Sarah Gregory is a partner in the employment law department of Baker & McKenzie. Tel: 020 7919 1000; fax: 020 7919 1999; email: Sarah.Gregory@bakernet.com

Letter from Brussels

(continued from page 12)

However, the EU policy-making apparatus has begun to take seriously on board the importance of creating a pan-European environment conducive to pan-European entrepreneurship. In the past, the Commission was notorious for undertaking broad-ranging studies and launching programmes drawn up on the basis of an idealistic rather than a pragmatic approach to the needs of business; now business and entrepreneurship appear to be at centre-stage of the EU edifice. And this is extending to the accounting profession.

In a long-awaited 'communication', the Commission has set out its vision for financial reporting in Europe. A legislative proposal will be unveiled before the end of the year which will enforce the adoption of International

Accounting Standards (IAS) by all listed companies in the EU by 2005 at the latest – that is IAS supplemented by an enforcement mechanism established at EU level. Composed of a technical and a political tier, this mechanism will effectively decide which IAS apply.

Comparable

The drive towards comparable financial information is part of a broader package of proposals that could ultimately lead to the revival of the long-since buried European company statute. Legislation is also currently being discussed to create a level playing-field across Europe for takeover bids, to simplify the VAT system and to introduce pan-European patents.

Much of the attention of EU policy makers is taken with the needs of small and medium-sized enterprises. In a very real sense Brussels has been downsizing over the last few months.

At the last summit, in Portugal, European leaders supported a European charter for SMEs. The charter opens with the rather unfortunate description of SMEs as a breeding ground for business ideas and is very much a declaration of intent. Some of the intentions are manifestly more generic than others, such as the nurturing of entrepreneurial spirit and of a new generation of entrepreneurs. Others are of more direct relevance to business, such as the revision of bankruptcy laws, facilitating access to finance, reducing the cost of business start-ups and promoting the use of information technology.

While the media will focus on fraud, federalism and failure, the ICAEW Brussels office will go behind the headlines to ensure that our members are at least forewarned. Meanwhile, if you need more help on Brussels, why not call our office on the international freephone number: 0500 893369.

How much debt?

Chris Mansell looks at the issues involved in gearing your balance sheet; and at the effect of smaller countries joining the euro.

The old adage 'what gets measured, gets managed' breaks down when discussion turns to gearing the balance sheet. The ways of calculating the relationship between debt and equity are legion (gross debt-to-equity/net debt-to-equity etc). Add in the available off-balance sheet tricks and the spread of reference points is bewildering.

The problem doesn't end there. Even if you agree on the calculation, what constitutes an appropriate level of gearing? There are some guidelines.

- *Industry norms for asset and cash flow characteristics* – property companies, with high and fairly stable value assets, for example, obviously attract a high level of debt. Businesses employing developing technologies will find borrowing hard to come by. Retail operations typically have low gearing since cash flow and profitability are more closely aligned.
- *Consistency* – the gearing ratios will fluctuate in the course of the trade cycle but a regular pattern gives confidence to lenders. Participants in the bond market will look to regular issuance when the conditions are favourable rather than borrowing according to need. For the smaller company, smoothing out volatility, whether in earnings, raising equity or new borrowing, is certainly advantageous if it can be achieved.
- *Cost of capital* – interest rates, tax rules and rates, the cost and availability of new equity: all these will influence the debt/equity ratio and the cost of capital.
- *Lender's policy* – banks monitor the balance and pattern of their lending

to avoid going overweight in particular sectors. This can have a direct impact on a business's capacity to borrow. For the smallest organisations the opportunities to approach other banks may also be restricted.

- *Planning* – none of the previous points can be given effect if there is no coherent, formal financial planning. Cash flow planning is notoriously difficult and needs to be subjected to some hard-nosed 'what if' risk analysis. Key elements of the balance sheet such as inventory can be very volatile.

Some light on recent patterns of gearing has been shed by the Debt Advisory Group of Close Brothers. A study of 120 UK mid-cap companies over the last 10 years shows that gearing levels have risen significantly in the last three. There was a fall during the early 1990s recession, but sharply lower interest rates and economic recovery has seen them rise again. Between 1997 and 1999 gearing (debt to net assets) doubled to 53%. Interest cover – a key measure in a lender's assessment of a company's debt capacity – has not been affected as rates have come down. The average level of interest rate cover for 1999 is still well above that for 1992, when debt levels were low. The implication is that there is still room for further gearing.

Interestingly the levels of gearing found by the study were modest by the standards of private equity where the motivation to grow economic value is clearly less inhibited. Perhaps that explains, in part, the stream of buy-backs.

Greeks bearing trouble

The euro project is evolving, with Greece lined up to join in January 2001, and the debate is becoming more persistent – will the 'one-size-fits-all' interest rate work in the long term?

Normally the level of interest is determined by an economy's position in the cycle. When demand is high and inflation threatens, rates move correspondingly. Euro interest rates are set by the European Central Bank Council on which each participating country has a representative (the central bank governor) to reinforce the six executive members. The smaller countries, eg Ireland and Portugal, are living with interest rates below what the pressure of local demand would dictate. The result,

as visitors to Dublin will confirm, is severe inflation – especially of asset prices. Yet the four major economies (Germany, France, Italy and Spain) account for over 80% of 'euro-land' GDP and have no particular need to choke off demand.

The pressure of the smaller countries, holding eight out of 18 seats when Greece joins, may well be to raise rates higher than might have been expected. The recent hike of 0.5%, rather than 0.25%, might be an example of that. Following through, this might raise the euro against sterling thereby making the notion of entry more attractive within the UK quite apart from bringing long overdue relief to exporters. But will higher rates be politically acceptable, especially in Germany?

FORTHCOMING FACULTY EVENTS

Please note that due to the holiday season there will be no lectures in August.

● CONFERENCE PROGRAMME	The Faculty is holding a series of half-day conferences, with a range of speakers. The timetable will be the same for these events (the first was in Huddersfield in April):		
	2000	9.00	Registration and coffee.
		9.25	Welcome and introduction.
		9.30	'The development of strategic performance measurement'
			<i>Kevin Bounds, director of world class finance – insurance, KPMG Consulting.</i>
			'The balanced scorecard – what and why?'
			<i>John McKenzie, director, Armstrong Laing.</i>
		10.30	Tea/coffee.
		11.30	'The inner business of creativity and innovation'
		11.45	<i>Marian Moriarty and Dave Smith, Inner Business.</i>
		1.00	Buffet lunch.

**20 September
LONDON**

**29 November
SOLIHULL**

Kevin Bounds is director of world class finance – insurance at KPMG Consulting, after a line career in financial services, which included being finance director for NatWest Life and then Nationwide Life. Kevin also sits on the executive committee of the Faculty. John McKenzie is director of sales and marketing at Armstrong Laing. He is a member of the Finance Faculty of the Management Centre of Europe, based in Brussels, where he teaches on performance measurement and financial planning and control courses. Dave Smith spent 15 years working in R&D: amongst other qualifications, he has a degree in applied biology. Dave has a deep interest in metaphysics, which led to him create Inner Business with his partner Marian Moriarty. Marian Moriarty, a founder of Inner Business, works as facilitative consultant, trainer and coach in the fields of creativity, innovation and change management. She spent eight years as a marketer with an American multinational.



From left to right: Kevin Bounds, John McKenzie, Marian Moriarty and Dave Smith – pictured at the April Huddersfield conference

- 31 October
LECTURE
LONDON

Matt Davies of CPD ATC Ltd provides a review of both the theory of value based management (VBM) and the evidence which is emerging about how VBM is being used in practice. Registration 6.00pm – 6.30pm, lecture 6.30pm and buffet 7.30pm.



Matt Davies is a director of CPD ATC Ltd, a company that provides tailored finance training for corporate and professional clients. Prior to joining ATC last year, Matt spent six years at Aston Business School where he specialised in VBM-related teaching, writing and research. Through his research, Matt has interviewed senior executives of more than 20 major UK companies that have experience of using VBM in practice. Matt's main publications in this area include 'Shareholder Value' (FT Management, 1997) and 'Value Based Management: context and application' (Wiley, 2000). Matt is currently responsible for the VBM components of the MBA programmes at Warwick University, Queen's University Belfast and Aston Business School.

**TO ATTEND ANY FACULTY EVENT,
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MAIL IT OR FAX IT TO DEBBIE CAME AT
THE FACULTY'S ADDRESS
GIVEN ON THE BOTTOM OF THE FORM**

RECORDINGS OF FACULTY LECTURES

Recordings are available, in both audio and video, of London lectures. To obtain a recording, please tick the audio or video box on the response form opposite. There is **no charge** for these recordings. However, please note that the recording shown here is available for **one month only**.

If you have any queries, please call Debbie Came on 020 7920 8486.

Keeping an eye on the European Union

Whichever side of the euro debate you are on, developments in the European Union will affect your business life. Here **Martin Manuzi**, from the Institute's office in Brussels, begins a column for *Finance & Management* about the hot issues on the EU agenda.



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LETTER FROM
BRUSSELS

The establishment of the ICAEW's Brussels office six years ago was a recognition of the growing impact which the European Union was having on the development of the accountancy and auditing profession. However, the work of the office has never been restricted to monitoring EU developments and channelling the ICAEW's views in Brussels on accountancy related matters. Its remit is broader – the office operates an enquiry service assisting members on a wide range of subjects including EU legislation, programmes, grants and consultancy opportunities.

For many in the UK, the mere mention of Brussels usually evokes images of Eurocratic red tape and cumbersome regulations which act as obstacles to their business interests. And the recent spate of scandals, fraud and resignations has done little to foster enthusiasm about the EU. Most European countries have problems with the EU but none so bad as the UK.

However, whatever you think of the EU, it is clear that no forward-thinking business can afford to overlook Brussels. After all, Brussels initiates around half of all new legislation in the UK and 70% of this legislation directly affects business. This column will draw attention to new legislation as well as other initiatives originating from the EU machinery which will not only impact on your business but open up new opportunities too.

Naturally, the larger political issues, such as the euro and the projected enlargement of the EU to 20 or even more members, grab all the headlines. Too often, though, in focusing on these issues, there is a tendency to overlook the important steps which are being taken to create a genuinely European market for goods and

services. Never mind what the brochures say, a common market simply does not exist. The launch of the euro and the easy comparability of prices which this will produce across the greater part of Europe will certainly put this fact into a new and clearer perspective. Whether it is accountancy rules, fiscal regimes or commercial law, the business environment still differs markedly from one EU member state to the next. It is not only the existence of different national regulatory regimes though, there is all the cultural baggage which comes with them.

Backlog

Even where the European Commission has already been active in seeking to smooth over these great differences – largely through initiatives based on the principles of mutual recognition and subsidiarity rather than the more politically sensitive policy of harmonisation – there is a backlog of EU legislation still awaiting transposition at national level. The latest edition of the Internal Market Scoreboard – the Commission's very own league table – provides indisputable evidence in this respect.

The Scoreboard confirms a slowdown in implementation of EU directives and a growing gap between member states which implement and those which do not. Well over a third of the delays are down to Greece, Portugal, Luxembourg and, most notably, France. Not for the first time, the most pro-Europe member states fail to match words with deeds. All this presents the Commission with a formidable challenge even before it embarks on the task of simplifying existing regulations and creating a new legislative framework for the high-tech business of the 21st century.

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