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Faculty of Finance and Management

Dealing with the banks

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Faculty faces

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Pearce becomes Faculty chairman at AGM

At the Faculty's annual general meeting (AGM) on 28 May, outgoing chairman John Edwards introduced Christopher Pearce as his imminent successor. Christopher, who has a wealth of business experience – perhaps most notably as long-standing group finance director of Rentokil Initial until 2001, and as a past chairman of the Hundred Group of Finance Directors (1997 to 1999) – was elected by the committee. His appointment took effect immediately after the AGM, and extends until the AGM in 2004.

Before addressing the formal business of the meeting John Edwards took the opportunity to thank all members of the committee for the time and expertise they had provided. He made particular mention of Martin Kimber, who was forced by ill-health to resign from both the committee and his role as deputy chairman during the year. Sadly, Martin died in March.

Pearce: elected till 2004

Edwards: outgoing chairman

Gratitude

John also expressed his gratitude to Chris Jackson who, as Head of the Faculty from its inception, "has lived with it, day in, day out, for 10 years", always managing to balance a large number of conflicting priorities with skill and integrity. The other members of the Faculty team – Judith Shackleton, Kirsten Fairhurst and Debbie Came – were also thanked for their enthusiastic support.

Turning to the Faculty's future, John stressed that there was no feeling of complacency. The Faculty is relevant to many more Chartered Accountants than are currently members, he said, and one of the future tasks is to persuade them that Faculty membership really can add value to their businesses. If appropriate, he added, "we will leverage our existing resource outside the Institute for the benefit of members".

John concluded the informal part of the meeting by saying he felt privileged to have been associated with the success of the Faculty so far, and confident that it will continue to thrive and prosper.

The meeting went on to vote in favour of receiving the annual report of the committee and the financial statement. It also approved the changes in the committee – both since the 2001 AGM and as a result of the 2002 elections – such that Douglas Shanks, Mark Garrett and Charles Bartholomew were re-elected, and Helen Jesson was newly elected.

John Edwards welcomed Helen as the committee's new member, and once again thanked the Faculty team – this time on behalf of Faculty members – for their valuable work. After a brief period of invited questions from members on the Faculty's activities, the meeting was concluded.

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Comments and suggestions should be addressed to Chris Jackson BA FCA, Head of the Faculty (see left).

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10 ways to get a better deal from your bank

Bankers and managers of small businesses can make uneasy fellow travellers on the often circuitous route towards commercial success. If your bank is hogging the driving seat, how can you regain some control? **Andrew Austin** recommends you reassess 10 key areas of the relationship.

The banking relationship is vital to most businesses; and in its management, the banks have traditionally been in the driving seat. Although this may remain true for companies over-reliant upon their bank for financial support, in the majority of cases this should no longer be the case. The relationship should be mutually beneficial, with businesses able to achieve both cost competitive and efficient banking arrangements. In fact, finance directors attempting to improve the deal from their bank should take heart from the findings of the recent inquiry by the Competition Commission and the consequent changes to be imposed upon banks in their dealings with SMEs.

The main finding of the Commission was that SMEs were overcharged an average of £725 million a year from 1998 to 2000 because of high bank charges and a lack of interest paid on current accounts. Before adjustments, the banks were getting a 36% return on their equity from their SME businesses. The remedy to be imposed on the banks is that they should pay current account credit interest to their SME customers at a rate no lower than 2.5% below base rate. If this had applied during the 1998 to 2000 period, the Commission estimated that overcharging would have been reduced by £525 million a year.

Notwithstanding the changes that are now to be imposed upon the main banks, there are further improvements that finance directors can achieve within their business banking arrangements. This article looks at how these improvements can be achieved by focusing on the following 10 key areas.

1 The relationship

It is still all too common to see a relationship in which the bank manager is visited once, or possibly twice, a year for the renewal of borrowing facilities. Bank managers are under pressure in terms of numbers of customers to manage and new business targets to achieve and this can be the inevitable result. By proactively seeking contact with your bank manager not only are you able to keep him/her up to date on business performance (thus avoiding any surprises or urgent requests for additional financial assistance) but also with regard to challenges and issues facing the business where the bank might be able to assist. It is worth remembering that bank managers generally have a wide experience of different businesses and situations and therefore can often add value. Regular contact with the bank also helps place the focus on many of the key areas discussed below.

2 Services made available

Banks have a tremendously large range of products and services that can help finance directors to reduce costs and streamline banking arrangements.

However, bank managers are not consultants and do not necessarily always match a customer's need to a product or service. By discussing problems and issues, therefore, appropriate services and products may well be identified. It is also worth scrutinising inefficient or costly processes (in terms of bank charges/other costs and labour intensity) and seeing if your bank can improve matters via an alternative or additional product or service. For instance, we often see electronic banking being utilised only for basic balance and account reporting when there are many more applications available that could benefit companies and organisations of all kinds.

3 Use made of the banking system

Just as important in helping to reduce costs and increase efficiency is the need to ensure that the best possible use is being made of the banking system. This refers in part to using cheaper and more efficient payment and collection methods and can normally be tackled through the use of alternative banking products and services. One of the more obvious areas here is the use of BACS instead of cheques and cash. Improving a company's use of the banking system also means taking a close look at internal processes and assessing whether there is improved technology available to streamline processes or the option exists to outsource labour intensive procedures which could reduce costs.

4 Structure of borrowing facilities

For many companies the structure of their borrowing facilities will be simply a working capital overdraft. If an overdraft is also used for longer term funding of a business, there can be benefits in converting this to a loan both in terms of rate paid and releasing additional working capital back to the business.

Businesses with historic fixed rate loans could potentially benefit from restructuring borrowing at today's rates. Care should be exercised when considering this as certain loans attract early repayment penalties.

5 Margins paid on borrowing facilities

It is important to understand the manner in which banks derive the margin levied on borrowing facilities, with a view to reducing the level paid.

For larger companies, the bank will extract key financial details from audited accounts, and together with non-financial information, use these to generate a range of margins to be levied on borrowing facilities. Like any negotiation, they may well offer the higher end of this range when in fact they have the ability to reduce this to a target or minimum level. If, even after negotiation, the margin quoted is still high it is worth checking with the bank what feature of the risk assessment is adversely affecting the margin to be levied as it may be possible to remedy this.

Smaller companies will have their interest rates derived from some or all of the following factors:

- conduct of the bank account;
- level of security available;
- analysis of financial accounts; and
- non-financial information/sector analysis.

As above, it is worth negotiating as there may be room for manoeuvre. It is also worth ensuring that the company's bank account is operated within set limits so that any adverse impact on the calculation of the interest rate is avoided.

6 Alternative sources of finance

Traditionally, companies have utilised bank loans and overdrafts to fund their businesses. Over recent years we have seen a rapid increase in the use of leasing and invoice discounting/factoring to supplement the more traditional sources of finance.

Leasing is particularly beneficial for some forms of capital expenditure. It is generally well suited to the purchase of cars/equipment and can also bring some tax benefits to a business.

Invoice discounting and factoring have also become more acceptable ways of funding particularly fast growing businesses. The former is confidential: the latter – in which trade debts are sold to a finance house – involves customers being aware of the process. Although in the past the use of such finance has been seen as evidencing trading difficulties, this is not in reality the case and it is simply another source of finance for businesses that can benefit from the rapid collection of debtor monies.

When considering alternative sources of finance it is advisable to discuss your plans with the bank as they will be affected and may be able to offer advice or recommend suitable sources for the finance.

7 Level of bank charges and fees

For all businesses except those that are too small to incur particularly high charges, it should be possible to reduce bank charges. Most banks will try to levy their standard published tariff upon businesses and resist any attempts to reduce charges from this level. Bank charges are in most cases, however, negotiable and the individual tariffs paid should relate to the volume of transactions processed by the bank.

To negotiate from a position of strength, however, finance directors need to ascertain what the 'market' rates are for transactions. If their bank charges are high enough to warrant the use of expert consultants to benchmark costs to the wider market place, then this should be considered. Alternatively, contacts and peers within other companies can be consulted to gain an understanding of the market (care should be exercised that like is compared with like and that an overall view of the relationship is taken) or the business can be placed to competitive tender (see below).

In conjunction with negotiating lower tariffs, use of more efficient and cheaper services such as BACS will also reduce bank charges.

Those businesses that accept credit and debit cards should include the costs incurred in their review of charges.

Banks also charge fees for arranging

or renewing borrowing facilities. All too often these are just accepted and can be linked to a percentage of the level of facilities put in place. The fee levied should relate to the work undertaken by the bank and any excessive fees should be queried and where appropriate negotiated to a lower level.

8 Internal cash management

When focusing on banking arrangements it is worth studying the cycle of cash within a business to ensure that vital working capital is being managed as effectively as possible. This means that the control of debtors and creditors should be analysed alongside stock control and the actual process of collecting cash and making payments.

9 Return on credit balances

The return received on any credit balances should be analysed and where possible improved by more active management of balances. The advent of interest bearing current accounts will help businesses to achieve this. For larger sums, however, returns should be improved via

higher interest bearing bank accounts (not necessarily with the business's main bank), the Money Markets and, increasingly, money funds (AAA rated investment vehicles offered by banks).

10 Tendering

For a business of any size there can be very real benefits in placing the banking and cash management business to competitive tender. For smaller businesses the process may simply involve 'shopping around' several banks for the best deal. For larger concerns, however, a more formal process is necessary to ensure that banks can see that a thorough and fair process is being adopted and to encourage banks to quote their best pricing and terms.

When considering a competitive tender, a balanced view should be taken of the overall needs of a business so that other areas are not sacrificed for lower charges or fees.

Conclusion

There are many benefits to be gained by reviewing existing banking arrangements. Although the banking relationship is one of the most vital to any business, a review of it can not only yield useful savings but also, if done sensibly and in conjunction with the bank, enhance it.

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Banking web sites for SMEs

Readers interested in exploring further banking/SME issues may find these web sites of value.

Checkyourbank.com – a site designed to allow holders of personal and small business accounts with UK banks to check bank statements for any charging errors by keying in statement information. The software used to operate the site is accredited by the Institute of Chartered Accountants in England and Wales.
www.checkyourbank.com

Practical Help and Advice for Setting Up and Running Your Small Business – checklists and advice for SMEs from the British Bankers Association, including help in evaluating how closely banks meet your needs, a listing of likely areas of discussion on setting up an account, tips on how to build a good relationship with your bank, and a step-by-step guide on handling your banking complaints.
www.bba.org.uk/public/smallbusiness

Review of Banking Services in the UK – official site of the UK government review of the banking sector led by Don Cruickshank. Contains the final and interim reports, responses, the original consultative document, press releases, contacts and a data bank. The final report was published on 20 March 2000, and includes a chapter on banking services and external finance for SMEs.
www.bankreview.org.uk

Electronic Banking – one of a range of BIF factsheets available on the BT Click for Business web site, which investigate practical issues for SME banking. This looks at how e-banking can benefit small businesses.
www.btclickforbusiness.com/public/biz/finance/bif340.html

More links are available from the ICAEW web site's links pages at: www.icaew.co.uk/library.htm

The silver lining of the new banking regulations

Alan Craft, associate director of TCA Consulting, explains the intricacies of the Basel II regulations – due to affect the banking industry in two or three years – and how they may prove an opportunity, as well as a compliance burden.

As if the recent woeful state of financial markets were not enough to turn hair grey in the UK banking community, there is possibly an even greater threat looming on the horizon. Between 2004 and 2005, the industry will be hit with a veritable revolution imposing regulation and industry best practice standards:

- the Financial Services Authority's new prudential source book;
- the International Accounting Standards Board's new set of standards;
- the Bank for International Settlements' (BIS') new standards of capital allocation for banking businesses (Basel Accord); and
- the EU's new capital adequacy directive – mandated on the back of the BIS effort – for all investment firms within its geography.

Also, conceivably, the UK could be adopting the euro!

There has been much debate, analysis, lobbying and distress over the potential impact of all these directives, not least in terms of their implementation costs. Managements of financial institutions are expressing strong concern about the proliferation of new, and in many cases confused or poorly thought-out, regulations.

However, recent experiences would seem to justify the views of others, who argue for more control. This article looks at the planned Basel II regulations, drafted to that end.

Basel II

The BIS initiative has been under way for some years, to introduce a set of rules requiring banks to retain capital against specific risk types that will replace the existing regime put in place in 1988. The aims of the new initiative essentially boil down to two:

- to 'encourage' banks to manage themselves in a prudent and comprehensive way so as to prevent individual bank failures; and
- to enable regulators to establish sufficient understanding of the financial markets to manage the systemic impact of any individual bank failure.

This Basel Accord, or Basel II, will be far more comprehensive and complex than its predecessor, aiming to be more sensitive to the actual risks being undertaken by a specific bank and to better align the regulatory requirement for capital with the economic reality.

The new rules have three 'pillars' or guiding sets of principles to their structure:

- specific capital requirements, particularly to cover credit risk and (newly) operational risk;
- the supervisory apparatus that will guide the regulators in their review process; and
- market discipline, primarily to develop greater disclosure of information and overall transparency.

One of the key tenets is that the overall level of capital required of the industry should remain the same as exists today. Within this, the allocation to individual banks and businesses would shift based on the regulator's assessment of risk.

A second key tenet is a tiered approach, giving a bank options to seek a sophisticated level of compliance, where for a material investment a real saving in capital can be made; or to invest in a lower level of compliance achieving a more modest capital gain. In reality, most banks and especially those considered 'internationally active' will be required by their regulators to take on a sophisticated approach. It is also expected that banks will move up the sophistication scale over time under the concept of 'continuous improvement'.

Although the BIS does not have formal cross border authority, more than 100 countries already utilise the 1988 Accord. Under the existing and new rules, the national regulators have the right of interpretation for implementation in their countries. This allows for a more sensitive application to a wide-ranging population of banks.

However, previous experience in the application of such regulation, coupled with current economic realities amongst the world's banks, suggest that issues of different interpretation and uneven treatment may cause competitive disadvantage to some players.

The new ingredient

The requirement to maintain specific capital against operational risk is the new ingredient in Basel II. To date, this area of risk has been considered to be the price of being in banking. But too many banana skins and high profile scandals have occurred to allow this generalist view to continue. At the same time, technology has provided an improved capability to capture, analyse, and distribute information.

By relating these two drivers the regulators will seek to improve control by demanding greater understanding and disclosure on the risks of the business. The draft rules are a first giant, if uncertain, step in this direction.

In these rules, operational risk is defined as: 'the risk of (direct and indirect) loss resulting from inadequate or failed internal processes, people, and systems or from external events.' (BIS, 2001).

Loss can be manifested in many ways:

- write-downs;
- loss of recourse;
- restitution;
- legal liability;
- regulatory and compliance; and
- loss or damage to a bank's assets.

The key proposals

The rules will not be finalised until late this year and publication of the next consultative paper for industry discussion has been delayed until the summer. However, the key proposals are well developed. In essence:

- 12% of a bank's capital should be allocated to operational risk;
- there is, however, scope within the rules to reduce this to 9% (or even beyond) through sophisticated techniques of management;
- there will be three levels of compliance – basic, standardised and internal measurement; and
- each compliance level is based around a measure of performance such as gross income or assets under management, depending on the specific business line, multiplied by a factor – alpha, beta or gamma – that the regulators will apply.

In the basic approach, which will be reserved for the smallest and least complex banks, the picture will be based on the total bank's overall gross income. In the higher level approaches, the bank will be subdivided into a set series of business lines as they apply to a given bank and the factors applied to each.

Only in the highest level approach will the bank's own historical loss pattern be an element for consideration. The gamma factor will relate the expected and unexpected losses to produce the actual capital requirements. This will require the bank to maintain a substantial historical loss event database, and to be able to model event characteristics and probabilities.

For many smaller and/or specialised banks, the regime may prove harsh and may seem like a new taxation.

In addition, regulators will want the more sophisticated banks to track not only direct and indirect events, but also near misses. Further, the mitigants available to cover such risks, in terms of collateral or insurance, will be scrutinised closely.

Such risks as reputation or business risk are not covered because they are hard to quantify. The emphasis is to be on the need to attach numbers to the risk events and benchmark them to a standard determined by the regulators.

The industry reaction

TCA Consulting's market research reveals that the banks' reactions are varied and the proposals (*see above, right)* are being treated with considerable foot dragging; at least until the definitive rules are published later this year. A majority of banks have done little to deal with the operational risk requirements. This reflects a level of confusion because the precise rules are yet to be published, and there is also a sense that 2005 is far off – and perhaps a further delay will be forthcoming.

Many of the banks that have begun to deal with the question have started with quantitative techniques and modelling emphases. They are approaching operational risk in a manner comparable to that required around market risk in the late 1990s.

Few banks have come to grips with the critical infrastructure issues – data, processes and technology – that will need addressing thoroughly if both the capital requirement and supervisory inspection hurdles are to be overcome.

Conclusion

To the extent that banks view Basel II as purely a regulatory compliance issue or the imposition of a new tax, they will not do much to deal with this. As rating agencies begin to measure banks on their operational risk standards, business flows and market capitalisation impacts will evolve.

Much of the back office function in the banking business has changed little in 25 years and productivity standards are poor compared with the best of the manufacturing sector. The new rules will happen to all banks. For those which see them as an opportunity to address deep seated behaviours and processes that have existed in the banking sector for decades, then a great opportunity may await.

Alan Craft is a director of TCA Consulting, which architects, integrates and implements technology solutions in the financial services sector. For more information and to download a copy of the report 'Operational Risk – making Basel effective' visit the TCA web site at www.tcaconsulting.com.

PPP – a new dimension in financial management

Political enthusiasm for public/private partnerships is making them an established feature of business life. But the nether world these partnerships occupy, between the public and private sectors, raises new issues and dilemmas for financial managers within participating private companies. Faculty committee member **Geoff Seeff**, who has a particular interest in the subject, outlines a few of the problems that may arise.

During the past decade a significant number of Chartered Accountants have entered a new dimension. These are the hardy souls who have taken responsibility for the financial control of organisations inhabiting the nether world between the public and private sectors, created with the privatisation of utilities and the establishment of various forms of public/private partnerships (PFIs, as introduced by the Tories; now PPPs). Such partnerships are dedicated to the delivery of what, for most of the 20th century, were known as 'public services'.

Private companies engaging with the public sector expect to receive reward for their skills and compensation for risk and, in principle, it is intended that they earn normal commercial returns on their investment. However, they also take on many of the obligations that accompany the provision of essential services. This factor has wide-ranging implications for business management generally and financial management in particular.

This article examines four of the most critical issues.

Public accountability

Private companies entering into agreement with a public sector body to provide facilities, take up a discretionary grant or assume a public service responsibility, are accepting accountability to that body and to the public at large. They must act with probity and ensure that funds or resources placed in their hands are used for the purposes intended. Although contract law may still apply, relationships between the parties differ from those under normal commercial agreements. Companies may be required to agree project delivery and business plans and commit to them, submit to inspections and provide detailed financial and management information to relevant government departments, regulators, monitors and auditors. They will also need to moderate the profit maximisation objectives of the project or business activity to take account of quality issues such as reliability, safety and environmental protection.

Of course, even companies operating in the 'free' market are not unconstrained in the way they manage their affairs – trade laws, safety and hygiene regulations and even attitudes of managers and stakeholders to quality issues all constrain profits. However, the question for financial managers is whether there is a fundamental incompatibility between the profit motive and public service provision.

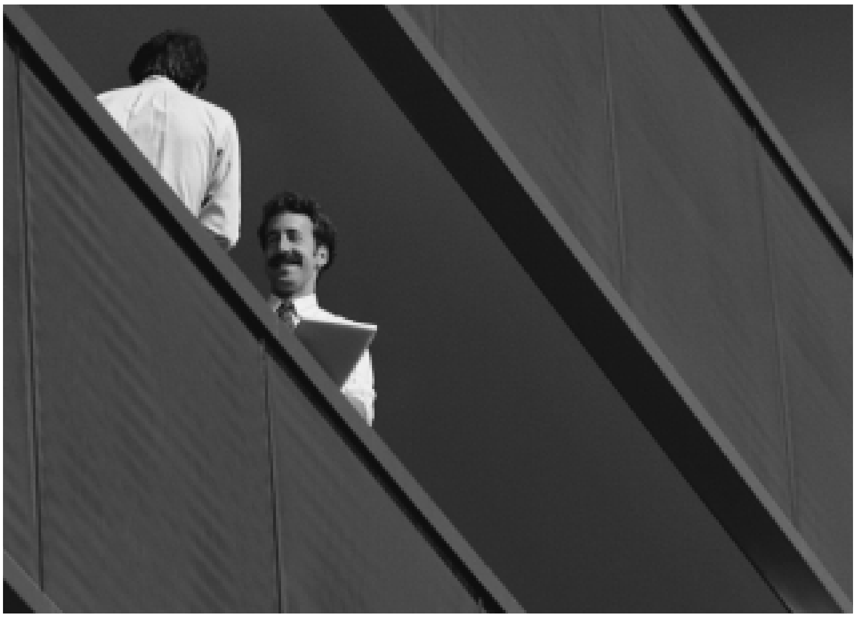
Is there a finite limit beyond which a private company will not be prepared to compromise its anticipated profit margins in order to meet targeted social goals? Can concessions, contracts and partnership agreements address all goals and legislate for all eventualities that are likely to arise in public service provision – is it practical to try to procure from the private sector a 'public service ethos' or is it beyond the scope of a written agreement? How does a private company report to its shareholders that it has sacrificed its margins for public benefits? Conversely how should it report if it is achieving financial success, perhaps meeting the terms of its contract, but nevertheless failing to deliver the sought after public benefits? These are practical rather than philosophical questions!

Regulation and pricing

In some respects the government-appointed regulators of the privatised industries, the sponsoring government departments of PFI/PPP projects or grant aid authorities may exercise more influence over the running of a company than its directors, particularly in the matter of pricing the relevant goods or services.

Most companies in partnership with the public sector gain a monopolistic position in the subject projects and services. Hence regulators and government departments will be concerned to ensure that customers are not unduly exploited and receive good value for money. Accordingly, they will endeavour to ascertain that costs and sales forecasts are reasonable and pricing policies produce returns that fall within an acceptable range. Regulators have wide-ranging powers to order inquiries, to call for changes in quality specifications and to secure price reductions as well as to adjudicate in individual disputes between the customer and company.

The powers of the sponsoring departments in PFI/PPPs have not yet been fully tested but it can be assumed that



if it were shown that the public was being exploited or was not receiving value for money, either the contract or the enabling laws would permit rectification. Most PFI/PPP contracts include a range of penalties as deductions from service charges if projects are not delivered to specification.

Accordingly, actual or potential intervention by government bodies is likely to affect management's ability to plan and control a company's financial affairs. Managers must therefore, for example, consider the extent necessary to set aside provisions for potential but inchoate liabilities or future changes in operations demanded by regulators or sponsoring bodies.

Risk assessment and externalities

Private companies supplying goods and services proving not fit for purpose may be liable for damages to the parties directly affected. The implications for companies supplying unfit goods and services on behalf of the public sector may be much wider ranging. Railtrack's liability to persons involved in recent train crashes plus the consequent disruption as the lines were checked and repaired is one example. Another might be the failure to repair or replace a school roof in time to avoid loss of school days.

When such work was under the control of local authorities' direct labour organisations, one arm of the authority would not claim damages from another, whereas under PPP arrangements there will be a commercial organisation to sue. Another example of an externality for which a private company may find it has to bear unanticipated costs is the case of the Channel Tunnel company and asylum seekers to the UK. The tunnel inadvertently opened up several means of unauthorised entry to the UK from France and the company has now been obliged to accept responsibility for preventing access, subject to fines and bearing the additional costs of perimeter security and guards.

Financial planning and reporting in such circumstances is fraught with difficulty. The question for financial managers is whether their organisation has recognised or can properly identify such risks (which may first appear to be external to contractual obligations), how they have been assessed, and whether an appropriate and feasible risk management strategy (eg insurance) is in place.

Funding

Clearly the implications of private companies having insufficient funding to provide the quantum and quality of services to which they have agreed are far more serious than for those failing in the commercial market. Ultimately the public sector has to step in and take over the project.

However, in many respects there remains something of an unlimited liability for a private company until such time as the public sector does in fact take over, and it may be required to continue funding the service irrespective of cost until it exhausts its resources.

A well-publicised example of this is the recent bankruptcy of Railtrack. Other problems currently looming include the possible shortfall in required investment in the air traffic control system consequent on the losses incurred by the NATS consortium after the decline of airline travel following the events of 11 September. Defining the precise amount of replacement and maintenance work appears to have been one of the stumbling blocks to earlier agreement on the PPP for the London Tube.

As in any commercial organisation, financial managers have to ensure that their organisations have sufficient funds to meet all their service commitments and cover their risks. The issue here is whether a company can rely on being able to renegotiate an agreed scope of works or outputs or revert to the public sector for additional funds if there are material changes in circumstances.

Many more questions...

These are just four aspects of financial management affected by the new approach which give rise to questions. In fact there are at least a dozen other significant areas that require consideration including, inter alia, profit recognition, profit sharing, depreciation, evaluation and reporting.

Despite some well-publicised problems, touched on above, the current government remains committed to assuming a more strategic role in service provision and is likely to seek more rather than less private sector involvement. It is difficult to imagine any government of whatever political complexion wanting to reverse this in the foreseeable future. Thus, as the frontiers of the state are rolled back, the issues will become relevant to an increasing number of accountants.

Geoff Seeff heads the regeneration division of cost consultants and project managers Currie & Brown. Email: geoff.seeff@currieb.co.uk

Building a revolution

In his Faculty lecture, **David Phillips**, partner of PricewaterhouseCoopers and European leader of its ValueReporting initiative, explained the growing need to communicate – as well as create – value. He described companies' and markets' mutual need for a more detailed exchange of information, and the potential ensuing benefits. Helen Fearnley reports.

David Phillips' lecture ran to schedule but the ValueReporting topic proved so riveting that after a plethora of audience questions the event overran by some 30 minutes.

Four years ago, Phillips became a key mover in developing a new PricewaterhouseCoopers (PwC) conceptual model, ValueReporting, aimed at narrowing the evident information gap between companies and investors. This resulted in a new framework designed to help companies move to more transparent reporting and, also, in Phillips' co-authorship of a related book: 'The ValueReporting Revolution: Moving Beyond the Earnings Game'.*

What is ValueReporting?

Phillips defined the practice of ValueReporting as:

- giving shareholders and other stakeholders the information they need to make decisions, in terms of financial and non-financial drivers, tangible and intangible assets and integrated management and reporting of risk and value;
- adopting voluntary transparency, beyond regulatory reporting requirements; and
- moving beyond the 'earnings game'.

Lest there be any doubt about this last point, he explained the seven (familiar) rules by which that 'earnings game' is dedicatedly played:

1. deliver a track record of consistent earnings growth;
2. manage earnings expectations carefully;
3. slightly beat earnings expectations;
4. make business decisions to meet or beat expectations;
5. hammer stocks that fail to meet expectations;
6. listen carefully for the 'whisper number' (ie US term for what the markets expect); and
7. hammer stocks that fail to meet the whisper number.

The significance

To understand the importance of ValueReporting, Phillips said, it helps to consider the 'value continuum' (see Figure 1, *below*).

Companies create value, preserve it (through effective management) and realise it (by communicating relevant information to investors). Indeed, the last stage becomes a value creating activity in itself, by providing enormous leverage in the share price, if done well.

Far from being a recipe for corporate 'spin', Phillips added, ValueReporting is about telling more of the true facts. It focuses on value realisation – ie what management does to ensure the company's stocks are properly valued, such as reporting all the information that the market really wants. Furthermore, if management makes such information available – publicly committing to targets, both financial and non-financial – the result will be a more disciplined, better managed company.

Why markets need it

This alternative to the 'earnings game' is revolutionary, said Phillips, because it is based on a philosophy of complete transparency, requires dramatic changes in behaviour, is fuelled by powerful new technologies, and is a challenge to the existing regulatory regime.

The need for ValueReporting, he continued, derives principally from three market-related factors. First, it is fairly clear that traditional valuation methodologies simply don't work very well any more. Whether it's P/E ratios, price to sales ratio or other measures, the tradi-

FIGURE 1 THE MARKET CANNOT VALUE WHAT IT CANNOT SEE

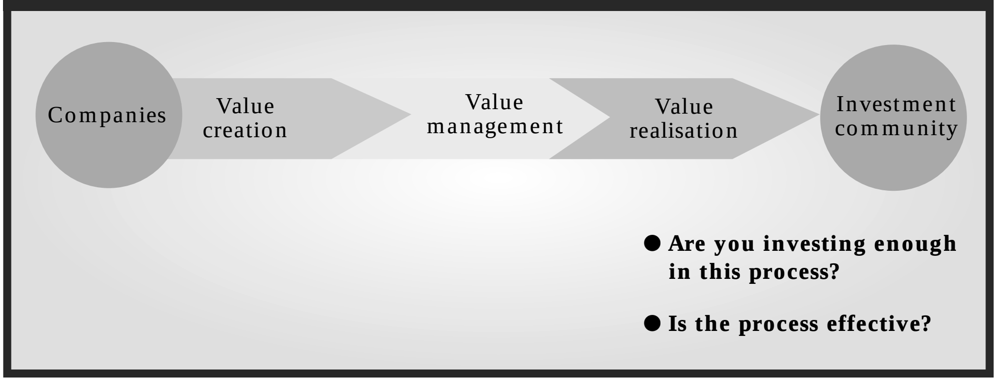


FIGURE 2 THE VALUEREPORTING FRAMEWORK

External	Internal		
Market overview	**Value strategy**	**Managing for value**	**Value platform**
● Competitive environment ● Regulatory environment ● Macro economic environment	● Goals and objectives ● Organisational design ● Governance	● Economic performance ● Financial position ● Risk management ● Segmental performance	● Innovation ● Brands ● Customers ● Supply chain ● People ● Corporate reputation

tional rules of thumb people use in making investment decisions fail to provide the type of decision making information that investors are demanding.

Second, the markets need ValueReporting to try to reduce the extreme volatility that exists in all markets and stocks today. Volatility will never go away entirely, but a proportion of it is certainly created by a lack of information.

A third, more subtle, reason the market needs ValueReporting is because of the high concentration of value in all capital markets. Stock exchanges all over the world show overwhelming evidence of this. Regardless of an exchange's size, the top 5% of the companies quoted on it account for between 60% and 85% of the total value of the entire market.

In some cases 10 companies account for half of the market's value. Overlay the shift to European and global investment and it is clear that companies have to work much harder to get themselves seen – and relying on others to get the story out is a dangerous game.

Hence, there is a crying need for a more effective means of communicating value.

Identifying the information need

Over recent years, Phillips continued, PwC has carried out research on the information needs of buy-side and sell-side analysts beyond those supplied by traditional financial reports. The findings from the initial research show, broadly, that capital markets are global in terms of what management information they require, and confirm the significant communication gap existing between the information companies report and the information the market needs to value a company's shares properly. It also shows that the executives in most corporations feel their company's shares are undervalued, while investors feel they can't get the kind of information they need to make sound investment decisions.

Subsequent research, centred on specific industries – chronologically the banking, insurance, pharmaceuticals, high tech, retail, and consumer products sectors – has enabled PwC to evaluate a customised set of performance measures in terms of their industry-specific importance to companies and the market, the quality of information, the systems companies use to produce information, how well managers think they are doing in communicating, and the market's satisfaction with the quantity and quality of information it receives.

(Further research is currently underway in the infocoms, metals, chemicals, diversified engineering, automotive, real estate, utilities and petroleum industries.)

In those industries where the research has been completed, some of the basic findings are consistent across those industries, including that:

- companies' corporate disclosure practices are often inadequate;
- substantial communication gaps exist in reporting on some of the most important performance measures; and
- there are significant perceived benefits to improving corporate disclosure.

Furthermore, the research revealed that in every industry both executives and investors placed a greater number of non-financial (as opposed to traditional financial) measures in their lists of 'most important' measures in valuing a company's shares.

Even in the banking and insurance industries, where one might expect traditional financial measures to have more importance, both executives and investors ranked at least twice as many non-traditional as traditional measures in the 'most important' measures category. In most other industries the preponderance of non-traditional measures was even greater.

Additionally, all the companies considered their own shares well on the way to being 'strongly undervalued' (with the exception of the pharmaceuticals companies, who rated their share prices as 'about right').

Further, in perception of the amount of disclosure companies provided to investors, the providers and the recipients had sharply contrasting views. The companies considered themselves fairly 'proactive' in this regard. The investors, on the other hand, deemed the information on offer as more in the region of 'minimal'.

The research, overall, indicated that a great deal of critical information is missing from investors' point of view, and companies are not doing a good enough job of supplying it.

The framework

PwC's next step, said Phillips, was to establish its ValueReporting framework. This was created through the codification of the research findings, together with PwC's own knowledge of best practice. The framework used for illustrative purposes was a generic framework which can be tailored to reflect the unique performance dimensions of a specific industry, and enables companies to communicate their value in a language investors understand.

The model includes management's view of the market place, its strategy for competing, its targets and objectives and the assets – tangible and intangible – that the company considers critical to its success.

The framework builds on a number of underlying principles, the key being transparency. It assumes that shareholders come first, but recognises that long term sustainable value is realised only if the needs of all stakeholders are properly understood and managed. The ValueReporting Framework (see Figure 2, *on page 11*) addresses four critical elements of information:

1. *market overview* – a clear explanation from management's perspective of the industry dynamics and market positioning;
2. *value strategy* – showing the depth and clarity of strategy;
3. *managing for value* – demonstrating how the company manages its financial resources from an economic and risk perspective; and
4. *value platform* – the critical activities and relationships which underpin the company's value creation, ie the areas of business activity which are lead indicators of future financial performance.

All this information needs to be presented to the outside world, Phillips stressed. (It is not constructive to cherry pick, in the manner of so many company reports, only the positive elements.) In return, the benefits of such transparency will include:

- increased credibility of management;
- more long-term investors;
- increased following among analysts;
- increased access to new and lower cost capital;
- higher share price;
- a better managed company;
- better retention of employees;
- improved reputation among customers and consumers;
- greater ability to find the right business partners; and
- the ability to provide early warning on adverse news, through good communication channels, and hence avoid reputation damage.

Reasons for adopting ValueReporting

The ValueReporting concept is already being put into practice, said Phillips. The reasons for adopting it as a model are various, including:

- dissatisfaction with the existing regulatory reporting model;
- awareness of a real or perceived information gap, and the need to provide key information;
- in response to a crisis (probably the worst reason, since management credibility will already be at a low point, and investors' trust limited);
- a strong corporate governance ethos, with a high awareness of being answerable to shareholders;
- a desire to show corporate social responsibility by being answerable to all stakeholders;
- visionary leadership, in the shape of a CEO or CFO who understands the need for transparency and stakeholder engagement; and
- for competitive advantage.

Conclusion

Phillips recommended that managements ask themselves three questions:

- are we investing enough in the whole measurement and communication process? (For those sincerely interested in value creation, some investment decision will be required);
- can we create a coherent internal picture of the business consistent with the ValueReporting framework? (Being able to communicate the picture internally is even more important than the external part); and
- how do our external communications measure up? (Business is, after all, about how you rate against the competition.)

Finally, he added, they should be prepared – reporting on value is taking hold, ready or not.

David Phillips is a partner with PricewaterhouseCoopers.
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**The ValueReporting Revolution: Moving Beyond the Earnings Game', is published by Wiley, price £21.*

HUMAN FACTORS **UPDATE**

Balancing work with 'real' life

Is the wrong mix of work and leisure jeopardising your performance? **Miranda Kennett** of The Management Due Diligence Company examines ways of redressing the balance.

Miranda Kennett is founding partner of The Management Due Diligence Company. Tel 020 7412 0016; e-mail: mkennett@mddco.com.

These days, when times are more difficult and many are concerned that their jobs are under threat, worrying about whether we have a proper balance between our working lives and our personal lives may seem like a luxury not worth consideration.

However, the opposite logic is just as true: if we can manage our time more effectively, and if every hour we spend at work we are feeling energetic and motivated, we'll be more productive and better at getting a good performance out of others, so our contribution will be greater.

When we factor in the costs of failing to address factors that make us feel more positive, which can include stress-related illness and poor performance, the case for paying some attention to what our personal work/life balance should be becomes incontrovertible.

An interesting phenomenon: time is finite, energy much less so. "If you want something done, ask a busy person", goes the saying, underlining the fact that if we are in a productive frame of mind, our output can be hugely greater.

Resourceful

So how could we go about making sure we are in that resourceful state that allows us to make a sustained contribution at work? Making sure we gain enough nourishment from the things we love doing is certainly a reliable place to start. Spend a little time, perhaps as you travel to or from work, thinking about the times when you feel happiest. These will be different for everyone.

For some, it will be relaxing time at home at the weekend, for others doing something active, alone or with family or friends. There's no reason our happy times shouldn't also include some work-based moments of satisfaction: completing a project, being praised for our achievements, working successfully as a team – all things that can be joyful.

Once you've identified these sustaining activities, have a look at how often you are currently managing to engage in them and what you'd prefer the balance to be. As we remember from our school physics, balance is achievable at different places along the beam from the fulcrum. We all have different ratios: work/life balance doesn't have to be 50:50 to be effective.

JP Garnier, the charismatic French CEO of GlaxoSmithKline, the global pharmaceutical giant, was asked recently by his staff about his own work/life balance. While discounting himself as an appropriate role model for others and encouraging his managers to get a life, JP admitted he loves his work, regularly does 18-hour days, but would fly back from Japan to Philadelphia to be with his family for the weekend.

Precious

One effect of listing the things that bring us joy is that we can immediately see many small ways in which these golden moments are being compromised or reduced in quality. Perhaps we are wasting precious time when we could be recharging our batteries, worrying about the unchangeable, anticipating problems, being irritated by unimportant trifles, neglecting niceties that in some way lessen the feel good factor. Once aware of how we contribute to our own lower energy levels, we can make some choices about what we want to change.

Thinking about how we work can also pay dividends. Do you find yourself doing things that someone else could do, maybe even better than you? Are you allowing the sloppy communication practices of others to cause you more work? Are you taking on things you can't hope to deliver? Or squandering precious thinking time going through your e-mails? Many of these problems are resolvable, if we can spot the patterns and decide to take responsibility for doing things differently – or even merely thinking about them differently.

There are lots of practical ways of improving the quality of your output and, at the same time, enhancing your life. Which ones you choose to adopt will depend on your personality and your priorities. Make sure that the way you live your life reflects the bigger picture.

After all, no one ever died wishing they had spent more time at the office.

LEGAL **UPDATE**

Recruitment – tangled up in red tape?

Two sets of changes in the law mean that the issue of recruitment is set to become something of a minefield. Further, breaches of these new legal requirements are potentially a criminal, rather than a civil, matter. In the latest Legal Update column, **Helen Cookson** explains these changes.

Helen Cookson is an associate in the employment law department of the HR group within international law firm DLA.

Traditionally recruitment has often been dealt with by personnel or line managers. Indeed, with the exception of key appointments, is there any reason why boards of directors should be involved? Unfortunately for overworked directors the answer to that question is now 'yes'. Two sets of recent changes not only threaten to entwine companies in red tape but, worse still, breach is potentially a criminal matter.

The Criminal Records Bureau (CRB) has been established to provide the mechanism for checking criminal and related records. At present the changes relate only to the special checks made in relation to the particular categories of 'exempted' posts such as certain financial services jobs and those working with children and the vulnerable. Those wishing to check and obtain information in connection with such posts have to register with the CRB and comply with its code of practice.

Checking

Later this year, however, further changes will be extended to the checking of all criminal convictions and it is likely to become illegal to carry out media checks, for example by obtaining information from old newspaper articles or similar sources.

At almost the same time the Information Commissioner (formerly known as the Data Protection Registrar) has started to issue the Data Protection Act 1998 Code of Practice. Part 1 relates to recruitment.

The Data Protection Act (DPA) covers not only current and former employees but also successful and unsuccessful applicants and agency, casual and contract workers (current and past). It may also apply to those on work experience placements or training. It is particularly significant in relation to recruitment because much of the information which employers traditionally seek is regarded as 'sensitive personal data'. This includes information relating to racial or ethnic origin, political or religious opinion and belief, trade union membership, physical or mental health problems or criminal convictions. Paper as well as computer records are covered.

To help organisations comply with the law the Code of Practice sets out a number of benchmarks designed to assist legal compliance. However, many companies will be taken aback by the extent of the obligations imposed. It is stressed that only information which is relevant to the recruitment decisions should be sought. Vetting and checking procedures should only be carried out in relation to successful applicants. If an automated short listing system is used, applicants must be informed of that and allowed to make representations about the process being used.

It is particularly important that managers conducting interviews and the recruitment process are properly trained. The DPA gives the right to all to see a copy of data being processed, subject to the payment of a modest fee. 'Data' includes even the scribbled notes made by managers in the interview and selection process and copies of references obtained from previous employers. Strangely the Act does not cover references prepared by a company about its own staff but employees have the right to see copies of references prepared from anyone who receives them!

Some commentators are suggesting that the best solution to this is to tell managers to stop taking notes during interviews. However this will still leave companies exposed if disgruntled prospective employees bring claims alleging, for example, racial or sexual discrimination because no contemporaneous notes will exist. This increases the risk of tribunals drawing inferences of discrimination.

Burden

Remember, too, that in relation to sexual discrimination at least, if an employee can raise an arguable case, the burden is now on the company to prove it did not discriminate. On balance the writer recommends that notes should be taken.

Unfortunately this is not the last of employment-related changes which employers will have to take on board. Over the next few months and years we will see significant new legislation in relation to parental rights, discipline, discrimination on grounds of sexuality, religious beliefs and in due course age, together with changes to information and consultation obligations.

FORTHCOMING FACULTY EVENTS – 2002

To attend any Faculty event, please fill out the form which adjoins this page, remove it by tearing along the perforation, and mail it or fax it to Kirsten Fairhurst at the Faculty's address given on the bottom of the form. If you have any queries relating to these or other events, please contact Kirsten Fairhurst on 020 7920 8486.

● 11 June
HALF-DAY INTRODUCTORY MEETING
(Golden Tulip Hotel, Manchester)

'BEYOND BUDGETING – HOW MANAGERS CAN BREAK FREE FROM THE ANNUAL PERFORMANCE TRAP' – JEREMY HOPE, CAM-I

Adopting 'Beyond Budgeting' has far-reaching implications for employees, customers and shareholders, as well as for the organisation's leadership and management processes. Jeremy Hope, the programme director of CAM-I's Beyond Budgeting Round Table, introduces the BBRT research and discusses its findings and its success. Registration 9.15am; meeting 9.30am to 12.30pm.

● 13 June
MORNING AND AFTERNOON SESSIONS
(Sopwell House, St Albans)
and
25 June
(Hilton Hotel, Stansted)

'ENTERPRISE AND INNOVATION – GROWING YOUR OWN BUSINESS'

This is a series of four master classes, spread over two days, which is being run in the East England region in conjunction with the CIM and the IoD. The sessions are intended to keep you informed about the latest thinking on enterprise and strategic business development and to consider how this may be put into practice within your business. These four half-day sessions may be purchased individually.

● 10 July
EVENING LECTURE
(Royal Commonwealth Society Club, London)

'BENEDICTINES AND BUSINESS – BEYOND THE OBVIOUS' – FATHER DERMOT TREDGET, DOUIA ABBEY

If 'people' are recognised as the key to business success, what besides material gain actually motivates people to make things happen? Father Tredget is a Benedictine monk who previously held senior management positions in the hotel and catering industry, and he has an MBA and a masters degree in applied theology. He will argue the virtues of sprituality in the workplace. Doors open 6.30pm; lecture 7.00pm; followed by drinks, buffet and networking. *This event is organised by the Association of MBAs.*

● 18 September
HALF-DAY CONFERENCE
(Chartered Accountants' Hall, London)

'MEASURING AND MANAGING INTANGIBLES' – VARIOUS SPEAKERS

This conference examines from several angles the growing interest in intangibles. David Phillips of PricewaterhouseCoopers discusses 'Finance'; Dr Robert Shaw of Marketing Best Practice Ltd, speaks about 'Marketing'; consultant Andrew Mayo looks at 'Human capital'; and Keith McMillan, professor at Henley Management College, speaks on 'Reputation'. Chairman of the conference is Tony Powell, director of Intellectual Capital Services. Registration is at 9.00am; the conference begins at 9.30am; summing up is at 12.45pm; and buffet lunch 1.00pm.

RECORDINGS OF FACULTY LECTURES

The following lectures and conferences held by the Faculty in 2001 and 2002 are available, in both **audio** and **video** format.

To obtain a recording, please tick the audio and/or video box on <u>the tear-off response form opposite</u>.

There is a charge of £5.00 for audio recordings and £10.00 for video.

CUSTOMER RELATIONSHIP MANAGEMENT
Professor Robert Shaw of Marketing Best Practice International Ltd describes the critical success factors and the role of financial management in the investment of CRM.

MANAGING THE CHANGE – PERFORMANCE MEASUREMENT IN THE PUBLIC SECTOR
Anthony Dart of the Highways Agency explains the changes he has made to the planning and implementation system at the agency, and looks at the future of the finance function.

VALUEREPORTING – A REVOLUTION?
David Phillips of PricewaterhouseCoopers explains this new technique including how to manage for value and the benefits of greater transparency.

STRATEGIC ENTERPRISE MANAGEMENT
Martin Fahy of the National University of Ireland, Galway, discusses strategic management accounting decisions aimed at increasing shareholder value.

Getting insurance cover in a tough market

Following 11 September, the task of obtaining insurance cover is both more complex and more costly. Below we outline the key changes in the market, as detailed by global insurance broker Willis Group Holdings Limited, with an eight-point plan for getting the best cover.

Willis Group Holdings' detailed view of the current insurance market can be found at www.willis.com.

Irrespective of the market or line, the climate now – and for the forseeable future – is one of premium increases, reduced capacity and stricter underwriting standards.

11 September accelerated the hardening of markets. For certain classes of business and certain industries premium increases now exceed 30% to 40% and insurers are reviewing in detail the risks they are accepting. Hence extended renewal negotiations and stricter underwriting standards are now the norm. As a result of the latter, an increasing number of programmes will not find cover, and demand will grow for innovative solutions such as alternative risk transfer and captives for complex cover needs.

Specifically, in addition to sabotage and terrorism, other areas of risk that have become difficult to place include computer viruses and e-risks.

Despite this difficult scenario, there are some practical steps which can help companies in managing their exposures, including:

- *covering the core* – do not let ancillary coverages interfere;
- *dealing from strength* – build a persuasive underwriting case;
- *retaining more risk* – if, and only if, it makes sense; and
- *reinforcing front-line risk management* – everyone in the company is responsible for managing risk.

An eight-point plan for business insurance would comprise the following:

1. *make sure that your key business is covered* – because insurance markets will no longer want to cover all risks, make sure that you concentrate insurance cover only on the essential parts of your business;
2. *make the best case you can* – identify and highlight the characteristics that distinguish you from other companies (both in and out of your industry) and those practices, systems and technologies you are adopting which may improve your risk profile;
3. *decide how much risk you can carry yourself* – the essential questions to ask, to ensure choosing the 'right' level of risk retention are: what is our capacity to bear risk? what is our appetite for risk? how are retained losses funded? what are our company's cash flow requirements? and what restrictions impinge on the ability of our organisation to retain risk?
4. *understand the value of staff* – be cautious about cutting back staff activities that enhance product quality, asset protection, employee safety, and environmental vigilance. Promote their commitment to the marketplace, as it is a differentiator;
5. *communicate and educate* – ensure any changes to the risk coverage adopted or enforced are fully understood across the organisation. All employees should be made aware of the implications for the cost of risk, the potential for uninsured loss, the need to re-budget or re-allocate insurance costs to operating companies, the impact on cash flow and the pricing of the company's products and services;
6. *encourage front line risk management* – everyone in the company can reduce corporate risk;
7. *partner with professional intermediation* – forming relationships of trust with quality providers takes time. However, establishing good working relationships secures major benefits and a professional broker can help you to do so; and
8. *augment your competitive position* – uncertain times invariably offer opportunities to gain relative competitive advantage. Companies available and willing to maintain a quality risk transfer structure can often gain market share and reduce the cost of debt.

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