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CORPORATE REPORTING

COUNTRY RISK AND THE COST OF CAPITAL

STRATEGY

BRIDGING THE GAP WITH OPERATIONS

MARKETING

HEALTHCARE AND THE IMPACT OF THE WEB

FINANCE

VALUATION OF INTANGIBLE ASSETS

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Manager Update helps the general manager keep abreast of the latest articles in specialist management journals in a number of key fields, such as strategy and organisation, marketing, accounting and finance, and human resources management, plus other contemporary issues (see Foreword, right).

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FOREWORD

HOW DO YOU USE YOURS?

__Emma Riddell__, technical manager,
Finance & Management Faculty, ICAEW

I like to read mine from cover to cover. But everyone uses our material in different ways and that was one of the points coming out of May's AGM, at which members discussed the strategic direction of the Faculty.

Preferences for electronic or hard copy publications were divided and whilst some members saw reading the material on the train as a leisure activity, others liked to flick through and then access the articles via our website when they needed them. Insights like these are invaluable to us at the Faculty, as we can use them to refine our offer to you and make sure that we are providing the information you need in the format in which you need it.

It is also interesting to understand the way your usage differs between our publications. Do you use *Manager Update* and its high-level look at management developments and concepts in a different way to the shorter and more practical articles in the monthly *Finance & Management*? Your feedback to the survey that we sent out with the last edition of *Manager Update* told us that 11% of you read it cover to cover, 65% pick out interesting articles and 24% skim read it. What about our quarterly special reports, which focus in more depth on topical management techniques? How helpful do you find *Executive Summary,* our review of all of the articles and reports from the previous three months?

If you were unable to attend the AGM and express your views, then please get in contact with me at any time (details left). I would be interested to know your views on the mix of publications, format, content and anything else that could assist us in supporting you as a chartered accountant in business.

EMMA RIDDELL

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IFRS – COUNTRY RISK AND THE COST OF CAPITAL IN EUROPE

__Roger Mills__, professor of finance and accounting at Henley Management College.

Thanks to International Financial Reporting Standards (IFRS), British and European companies have accelerated their annual financial reporting to the UK and European stock exchanges, and have closed the gap on their US counterparts in the speed of auditing year-end results. So what effects other than a step towards global harmonisation of financial accounting has this mandatory adoption had?

It is interesting to uncover the links between IFRS compliance, country risk and the cost of capital, to see whether a unifying framework will improve international reporting.

BRIDGING THE GAP BETWEEN STRATEGY AND OPERATIONS

__Bill Weinstein__, professor of international business and director, the Henley Centre for Value Improvement.

Does success really depend 90% on effective implementation and 10% on sound strategy, and if so, what degree of success can be achieved through operational management? This article suggests we accept and move on from the reality of ‘macro’ failures and instead focus on smaller-scale operational improvements – ‘micro’ management.

Three different approaches to avoiding operational misfirings are explained, and while the fallibility of both systems and humans are inevitable, a perspective of humility is recommended.

THE LONG TAIL OF HEALTHCARE AND THE IMPACT OF THE WEB

Dr __Giampiero Favato__, a director of the Henley Centre for Value Improvement, and __Roger Mills__, professor of accounting and finance at Henley Management College.

What would be the marketing implications for drug firms if they adopted a ‘Long Tail’ strategy, whereby they sold large quantities of the usual blockbusters but generated more volume from niche products? This article discusses the evolving world of pharmaceutical marketing, in which:

- social computing is transforming the healthcare industry;
- ‘cyberchondriacs’ are a new segment of consumers; and
- Direct To Patient marketing is emerging as the new e-strategy, and an effective online customer acquisition programme is an innovative solution.

ACCOUNTING AND VALUATION OF INTANGIBLE ASSETS

__Nuno da Camara__, research fellow, The John Madejski Centre for Reputation, Henley Management College.

Up to 90% of a company’s market value can be attributed to intangible assets like brand and reputation. Exactly how to identify and measure them is up for debate, but understanding the surrounding accounting and regulatory issues is vital:

- accountants tend not to put a value on anything that isn’t sold or purchased and although intangible assets do not have a market price that makes them easily comparable they are intrinsic to a company’s intellectual capital; and
- progress has been made in valuing assets in acquisitions but for long-term value, more steps need to be taken.

ROGER MILLS

IFRS – COUNTRY RISK AND THE COST OF CAPITAL IN EUROPE

Given that over 50% of the FTSE 100 companies have reduced their reporting timetables by an average of four days to fall in line with International Financial Reporting Standards (IFRS), it is worth looking at exactly how this compliance has affected the cost of capital. **Roger Mills**, professor of finance and accounting at Henley Management College, reviews the state of progress towards internationalisation.

The decision by the Commission of the European Union (EU) to make listed European companies – from 2005 onwards – produce consolidated financial statements according to International Financial Reporting Standards (IFRS) was a major step in the internationalisation process of financial accounting in Europe. This update reviews progress in compliance and some of the implications of harmonisation, most notably the impact of IFRS on the cost of capital. Furthermore, it will review the incorporation of country risk estimates within cost of capital calculations.

IFRS update

British and European companies have accelerated their annual financial reporting to UK and European stock exchanges over the last three years, according to research by BPM International (BPMI).[1] Over 50% of the FTSE 100 companies have significantly reduced their reporting timetables, which have fallen by an average of four elapsed days. In the US, it seems, the position for US companies appears to have worsened in the face of Sarbanes-Oxley compliance and it seems UK and other European countries have closed the gap on their US counterparts in the speed of auditing year-end results. Yet the gap remains significant: US companies sign off their audits on average nine elapsed days earlier.

BPMI research shows that the average time to obtain the year-end audit sign-off in the 2006 reporting season was 60 days in the UK, 64 days in Europe and 55 days in the US. This contrasts markedly with the position three years ago, when the gap in reporting times compared with the US was a massive 20 days earlier than in the UK and 26 days earlier than with Europe.

Despite the Sarbanes-Oxley effect, BPMI research shows that the 100 largest US companies still command a significant lead over their European counterparts in terms of their result disclosure with an average of only 28 days. For example, by the time the largest British companies started to report (after 32-33 elapsed days) in January, over 70% of the US Top 100 had already declared their full year results. Companies who report within 20 elapsed days in the US include some of its largest including Cisco, Alcoa, Genentech, Dell Computer, Lehmann Brothers, Hewlett-Packard, IBM, JP Morgan Chase, Pfizer, Motorola and General Electric.

More worrying perhaps, is that despite the overall improvement in reporting timescales in the UK, BPMI's data suggests that several companies have done markedly worse: in absolute terms the bad performers lost many more days than the good performers gained, so overall averages for the UK hardly moved. For Alternative Investment Market (AIM)-listed companies, time is running out to comply with IFRS. Less than a quarter of the 150 AIM companies surveyed are fully prepared for IFRS, according to a survey conducted by Baker Tilly, the UK's seventh largest accountancy and business advisory firm and international law firm Faegre & Benson LLP.[2]

The transition date for AIM companies with December year-ends was effectively 1 January 2007, meaning that financial information published after that date will now need to be represented under IFRS. This also means that AIM companies need to have their 2006

For AIM-listed companies, time is running out to comply with IFRS – less than a quarter of those surveyed are fully prepared for it

***Roger Mills**, professor of finance and accounting at Henley Management College.*

comparative information and an opening balance sheet at 31 December 2005, in IFRS formats. In applying IFRS, there could be a material impact on the company income statement and on the balance sheet. Major variations from UK Generally Accepted Accounting Principles (GAAP) may include the treatment of pensions, deferred tax, leasing arrangements, share-based payments such as share options, accounting for goodwill and accounting for other intangibles.

The UK needs to address the reasons for its relatively high costs of debt capital

The cost of capital in Europe

Some analysts have argued that the mandatory adoption of IFRS in 2005 across the EU is a vital step towards the global harmonisation of GAAP. While the impact of IFRS upon financial reporting is clearly significant, there are other important results that impact upon the realms of corporate finance. For example, the cost of capital should in principle fall by improving corporate disclosure quality and creating the international comparability of financial statements.

Lee et al examined the cost of capital in Europe and changes in it over time based on analysts' expectations.[3] They calculated the costs of capital for large samples of European quoted companies and examined the evolution of the cost of capital in Europe from 1995 to 2005. They also compared UK companies' cost of capital with that for their counterparts in the rest of Europe.

The authors found that the equity premium (the cost of equity capital minus the risk-free rate of interest) is systematically lower in the UK than in the rest of Europe. This was taken to confirm that the higher disclosure requirement and general dominance of equity-based finance in the UK has resulted in systematically lower costs of equity capital. Importantly, however, they found that the WACC* premium, or the level of WACC above the risk-free rate shows no statistically significant difference between the UK and the rest of the EU. In other words, the impact of debt financing outside the UK was significant and they argue that if IFRS adoption improves disclosure quality and equity investor interest in companies in the rest of Europe, subsequent studies may observe a reduction in the gap between cost of equity capital for UK companies and that for European companies. If the rest of Europe can achieve this reduction in cost of equity capital, while at the same time maintaining its relatively low cost of debt capital, then the UK could find that its companies have relatively high costs of capital. This is taken by the researchers to suggest that the UK needs to examine and address the reasons for its relatively high costs of debt capital.

From a longer-term perspective, over the 10-year study period, the cost of equity capital and the WACC in Europe remained fairly stable. This trend persisted despite a continuing decline in the risk-free rate in the sampled countries and was taken to imply that there was a relative increase in the risk premium over the study period. In terms of sector variation in the costs of capital, Lee et al observed that the IT hardware, IT software, steel and materials, and mining sectors consistently appeared to be higher, while utilities, electricity and beverages sectors tended to be lower in both equity and WACC premiums.

Country risk and the cost of capital

Related to IFRS – and the Lee et al research – is the issue of country risk and the cost of capital, itself the subject of an earlier *Manager Update* article. Arguably, the implementation of IFRS should help lower perceived country risk in cost of capital calculations arising from the inadequacies of financial reporting. Has this happened yet and what are the implications for companies?

Clearly, the immense expansion of international trade and investment has stimulated interest in country risk. Issues such as the ideological conflict surrounding multinational companies that was intense before the collapse of the Soviet Union in the early 1990s, and restrictive or threatening policies towards multinational companies on the part of newly independent nations since the 1960s have each in turn stimulated concern about the security of foreign direct investment. However, some academics and practitioners question whether country risk should be considered as specific risk and then dealt with by adjusting the cash flows – or as a systematic risk and expressed in the additional premium increasing the discount rate.

Much research has focused on the equivalence of the free cash flows adjustments versus discount rates adjustments in discounted cash flow (DCF) models.[4] There is a consensus in academia that the cost of capital – the discount rate – should reflect only non-diversifiable risk, whereas diversifiable risk is better handled in the cash flows. This solution appears reasonably simple. Yet practical judgement between diversifiable and non-diversifiable risk causes problems and the estimation of particular elements for an appropriate country risk adjustment can be very expensive in terms of both time and money. Consequently, there has been the emergence of more convenient and less expensive solutions and the popularity of methods using a country risk premium added to the discount rate.

Brounen et al studied 6,500 companies with headquarters in mature European countries (UK, Netherlands, France and Germany),[5] focusing on common practices in capital budgeting, cost of capital,

* *The weighted average cost of capital (WACC) combines the costs of equity with the costs of debt.*

capital structure and corporate governance. They selected the following risk factors to consider when evaluating an individual project:

- interest rate risk;
- foreign exchange risk;
- business cycle risk;
- unexpected inflation;
- commodity price risk;
- term-structure risk; and
- distress risk.

Respondents were asked if they take these individual factors into account when valuing projects, and if so whether they adjust their discount rate, the cash flow estimations, or both. Interestingly, the authors identified a strong tendency to ignore most of these specific risks and most respondents didn't take such factors into account when performing capital budgeting (with the exception of interest rate and currency risk). In most cases, firms acknowledge these risks by adjusting either the discount rates or the cash flows or both. One exception – where there seemed to be a clear answer relating to the adjustment for commodity price risk – was the 46.6% of French and 26.3% of German respondents who admitted to amending cash flow estimations according to their perception of the risk.

Europe is the frontier of accounting harmonisation

Brounen et al accepted the assumption that the evaluation of the risk associated with cross border investments would be dealt with by applying an appropriate discount rate. The authors asked respondents how frequently they would use the discount rates when evaluating a new project in an overseas market. Interestingly, with the exception of the French, European organisations preferred to use a plain company-wide discount rate rather than more sophisticated risk-matched rates. The use of a company-wide discount rate ranged between 24.14% and 64.58%, whereas the adoption of risk-matched discount rates ranged between only 23.7% and 27.3%.

Mills et al also investigated the differences between the two competing approaches to accounting for risk in the discount rate or cash flows and the consequences of their use in cross border projects appraisals in 2005.[6] That work derived the country risk premium using the six most popular methods for which descriptions are publicly available. The results revealed that the potential user could manipulate the derived premium within the range of 10.42%, depending upon the method selected!

Conclusion

The move to implementing IFRS has many potential and significant implications. For users of financial reports it should be much simpler to make meaningful comparisons. However, the impact of IFRS goes beyond financial reporting to include issues such as corporate finance and cost of capital. Europe is the new frontier of international accounting harmonisation and the European experience will provide vital insights worldwide. Arguably, with a common unifying framework for improved financial reporting internationally, the scope for interpreting financial information should improve significantly. Optimistically, one might also argue that the variations in accounting for risk in project appraisals should decrease. **MU**

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BRIDGING THE GAP BETWEEN STRATEGY AND OPERATIONS

The chastening of optimism is a recurring theme in today's political and economic worlds, where whatever can go wrong, will go wrong. So can greater success be achieved in implementing small-scale strategic plans? **Bill Weinstein**, professor of international business at Henley Management College and a director of the Henley Centre for Value Improvement, discusses systems analysis and human fallibility.

Human control – bending things to individual or collective intentions – is notoriously elusive. To quote Donald Rumsfeld, former US Secretary of Defence, 'there are both known unknowns and unknown unknowns'.[1] 'Murphy's Law', which says that whatever could go wrong will go wrong, is cited as a warning to the naïve. 'No reasonable person could have foreseen these events' is a common plea for mitigation or exculpation when there are disasters, including ones involving the loss of innocent lives. Not for nothing have 'chaos' and 'complexity' theories in human affairs induced notes of heightened challenge and humility in recent years. They have been antidotes to the excess of managerial optimism.

The limits to omniscience and omni-competence are analysed by Paul Ormerod, whose book is appropriately entitled *Why Most Things Fail*: '… failure is one of the great unmentionables. Business gurus eulogise contemporary success, conveniently ignoring the fact that many of these firms often fall on harder times soon after they receive their accolade.'[2] He finds a parallel between the incidence of business failures and the weeding out of natural species and that extinction rates are marked by large 'spikes'. He attributes human failures to an inability to anticipate and adapt to changing conditions; the human species has not been able to do much to avoid being 'blindsided.' [3]

As if optimism has not been chastened enough, it has been recognised that misconceptions, mistaken assumptions, a lack of proportion between woods and trees, dogmatic blindness to counter-arguments or evidence, heedless inattention to the 'law of unintended consequences' and excessive ambitions are classical explanations of managements that set the wrong direction for whole organisations, including political regimes or major economic policies.

In consequence of this – together with unrealistic aspirations attached to formal strategic analysis in the past 25 years – it is often said that success depends 90% on effective implementation and 10% on sound strategy. Even if this is an exaggeration which promotes practice over theory and gung-ho over reflectiveness, there is an issue that requires close examination, namely, what kind or degree of success can be aimed at by implementation, ie operational, management?

The context for this question is an impatience in recent years to push management to higher levels of effectiveness with fewer misses. While socialist centralised planning has been discredited, macro-scale planning (in the form of monetary policy, or attempts to correct 'market imperfections') has not. Meanwhile, there are vehement calls for planetary-scale management of climate change. Characteristic of these demands is the widening of the scope for control over human phenomena; and waiting in the wings is disenchantment over the size of the gap between planning and control aspirations on the one hand and comprehension of the complexity of social systems and processes on the other. But we put aside the categories of 'strategic mistake', which are legion since the beginning of recorded history: 'macro' failures, as they may be roughly classified, are not the focus here. Surely, it will be insisted, 'we must be getting better at something', ie the smaller-scale operational things.[4]

There is disenchantment over the size of the gap between planning and control aspirations and comprehension of the complexity of social systems

__Bill Weinstein__, professor of international business at Henley Management College and a director of the Henley Centre for Value Improvement.

More elaborate management processes, but more progress?

At the level of management that is 'micro' – the implementation in small parts or sections of a strategy or merely everyday routine administration – there is an underlying question. Has management really raised its game in the UK, US, Europe or elsewhere in virtue of several new models, such as Total Quality Management, Defect-Free Performance, Business Process Re-engineering, etc?[5] And what of Business Process Management, various ISOs and certification processes, Six Sigma, various 'systems' approaches to organisations and technologies? Moreover, what is the real headroom for operational improvement, promised much since the 1980s in the widespread attempts to install change programmes and especially customer relations management as a key to raising the business game in everyday terms?[6] No doubt these questions would entail several large research projects to achieve answers. Here a broad impression will have to suffice, in order to provoke thought rather than establish a definitive opinion.

First, strategies can be wrecked or spoiled by relatively small-scale operational defects. Hence the '90-10%' proportion cited previously. The disastrous charge of the Light Brigade was initiated by Captain Nolan's flouting or misunderstanding of his orders. The mission of the Hubble space telescope was jeopardised by misalignment of the lens and the mirror, which was not discovered until it had reached a parking orbit, and in consequence 'glasses' had to be fitted to correct its vision. Small mistakes, large consequences. For businesses, a leading type of example is how much sales revenue may be lost by delays in delivery beyond a launch date. This was a defining factor in the issue of lost sales calculations and competitors' gains resulting from delivery delays for the Sony Play Station 3 and the European Airbus A380, both alleged to damage their respective companies. [7]

Secondly, the search for answers is normally located in the causes of human fallibility, which are notoriously familiar and wide-ranging and include malevolence.[8] Although this subject will not detain us here, it may be noted that the literature is abundant in its recommendations of how to reduce or eliminate operational risks or defects. A typical list consists of:

- training or drilling in procedures;
- improved organisational culture or a wider civic culture of responsibility;
- tougher disciplines including penalties or punishments as well as rewards;
- sophisticated monitoring through more finely granulated IT reporting;
- juniors and colleagues reporting on each other's mistakes or omissions;
- motivational leadership;
- inculcating an ethic of individual and collective responsibility; and
- personality profiling to identify 'rogues' or 'deviants'.

The objections to some approaches or techniques are well known. No doubt human nature is not unalterably and irredeemably resistant to improvement. It is not contested here that there have been improvements in some areas of business, government and not-for-profit administration. The approaches cited above have had some successes, sustained or not. Pessimism over cock-ups, as the English rudely put it in plain language, does not rule here. The issue is what has been learned about the intensity of effort that should be made and how it should be aimed.

What is the headroom for operational improvement, promised much since the 1980s in attempts to install change programmes?

Factoring in recent developments and observations

Among many reasons why the drilling down of finely detailed minute responsibility might still be ineffectual in raising the standard of conformity to avoid accidents or damaging incidents, three stand out at present. They are as follows:

- 'on my watch' or 'not on my watch'. These words are derived from the shift system of naval personnel on and off duty. They are being applied to contemporary top executives who are under pressure to assume responsibility (eg, Lord Browne over BP refinery fires or Patricia Dunn over secret surveillance of fellow board members in Hewlett Packard) for almost any or all actions 'on their watch' but in which other personnel were active. It is therefore a question whether resignation, at least in large corporations, is mainly a ritual gesture to accept accountability or an effective stimulus to tightening relevant operational controls. Consequently, the follow-up role of top management in improving operational behaviour may be problematic;
- the need to achieve highly detailed controls is actually beyond the minds and wills of individuals as either 'actors' or monitors: the exercise of guile by the former and innocence (or fear or indifference or complacency) in the latter are bound to be repeated (eg, rogue foreign currency traders such as Nick Leeson at Barings in 1990s and John Ruznak at AIB/Allfirst in the early 2000s); and
- the extreme complexity of organisations, marked by

strong vertical specialisation and therefore chains of accountability means that cross-functional, departmental issues elude monitoring or are unattended to. The importance of 'silo' effects will be expanded below.

No definitive conclusions but no impasse

Three different approaches are aimed at the issues under review here.

1. Proportionality based on cost-benefit probably rules

That is to say, either before or after a risk event, some of which do or could cost lives or ways of living as people had enjoyed before (eg, severe incapacity from injury or infection) it may be perceived that more steps in training or monitoring must be taken. Highly costly lax behaviour is resolved to be changed eg, after the bow doors of the cross-Channel ferry Herald of Free Enterprise had not been closed on 6 March 1987, leading to capsizing in less than one minute with resulting loss of life. Much the same post-event corrective behaviour is advocated, intended or seriously adopted after disasters such as nuclear reactor crises at Three Mile Island, US and Chernobyl and BP's refinery fires. The salient point here, however, is that on a cost-benefit basis, management tightness is made roughly proportionate to the costs of looseness, though it matters who bears the costs. In recent decades, high hazard processes have won much higher management attention to the smallest detail that could set off a damaging chain reaction.[9] 'Zero tolerance' has become the familiar phrase. The historical process of moving from previously accepted standards to high ones is familiar to executives of Health and Safety and public health authorities concerned with epidemics and pandemics. Ultimately though, no executives would want to defend publicly putting a cost on the acceptability of the risk of the loss of a life – though in fact many decisions about resource spending imply just that. This approach responds to the question above as to how resources are to be allocated.

2. Close management or responsibility education: the alternatives

Crucially, a debate about human nature is central to the effort to eradicate or radically reduce mishaps. At the centre of this is the urge not merely to threaten dire punishments for non-conformity or non-performance of mundane duties eg, avoiding sleep whilst on guard duty at a sensitive military post. The hard, tight disciplined approach today involves close management (CM). Cynically, it might be held that CM is sellable to top people because it would enable them to sleep at night. It is achievable because of computer programming which enables checks to be run or people to report on variations in conditions or procedures eg, a bank securing anti-money laundering procedures by checking each and every step in the personal identification process and each and every step carried out by its employees or its external security agents. In other words, the tightening of controls, their visibility to underlings down to the lowest level, the meticulous grading of reports, the movement of situation reports in real time to the right people with the right signalling content – all these precision-ruled steps are not merely a ruse to ensure that the organisation is covered in case something does go wrong. They do and they would authentically reduce or eliminate risks.

The tough approach may may be rejected by middle or higher management and may even produce rebellious attitudes

The tough approach, however, is often seen not to work or may be rejected by middle or higher management. It may even produce rebellious attitudes and resentment over not being trusted. Hence the well-known alternative is to empower people, motivate attention to detailed execution and to consult with colleagues when independent action in a discretionary situation would be risky. Such motivation would be nurtured in an organisational culture of cooperation, perhaps homogeneity of background, shared values, open discussion of faults, open-minded leadership, some tolerance for mistakes and reviews without blame of previous 'critical incidents' involving mishaps.[10] However, this approach is often perceived to be limited by employees' external culture and how socialisation varies by educational, neighbourhood and family circumstances: therefore it is too loose.

3. Will a judicious mixture of the two approaches succeed? Or a systematically elusive subject: the intractable nature of human 'systems'?

Much current practice in avoiding operational misfirings probably uses or oscillates between a combination of toughness and organisational culture development, and depends, as usual, on managers' judgments – and perhaps on how receptive they are to the opinions of people involved in implementation. Service organisations which jumble customer's accounts or send the wrong information or lose data – and worse – have to cope with these operational issues. A common observation is that the higher employee turnover, the more 'policing' methods must be used.

Nonetheless there may be a serious faultline underlying this whole subject. Analyses of 'systems' suggest inherent limitations in the anticipation and prevention of how social organisations will react to attempts to optimise their performance. The possibility has to be reckoned with that human systems produce unintended consequences made more likely by the fact that human behaviour is not fully pre-determined or 'programmed'. Systems analysts of organisations demonstrate the scope for faults, errors and failures as endemic. This is not to counsel despair or to depict an impasse, as not all organisations are the same in these ways and some methods do work better than others in specific circumstances.

Nonetheless, systems analysis may suggest inherent limitations and unforeseen risks, for example, in the cases where processes demand too much of the resources, physical or human, which they consume; or when resources demand too little of their supply resources. Just these two types of stress could produce sub-optimal reactions among people. For example, the focus to improve performance within specialised areas (often pejoratively called 'silos') may produce loss of overall operating coherence and balance, as specialised units react by growing inwards and more self-protective.[11] In addition to the orthodox focus on the manner in which small faults can shut down or deeply damage an organisation, insights from systems analysis may link operational mishaps by humans to the characteristics of the systems in which they operate. Recently the fallibility of systems themselves, as human constructs, has been illustrated in recent debates about the limitations and waste involved in attempts to achieve 'programme correctness' in computer systems development.[12]

However, such a perspective does not suggest futility but humility in seeking to understand and reduce operational mishaps in organisations. The efforts continue. **MU**

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GIAMPIERO FAVATO
ROGER MILLS

THE LONG TAIL OF HEALTHCARE AND THE IMPACT OF THE WEB

The application of the concept of 'The Long Tail' to healthcare could work well for drug companies by helping them to diversify and reduce risk. Using this strategy, Dr **Giampiero Favato**, a director of the Henley Centre for Value Improvement, and **Roger Mills**, professor of finance and accounting at Henley Management College, provide an overview of how to approach pharmaceutical marketing through using the internet.

For those not familiar with the concept of the 'Long Tail', Anderson[1] describes how Amazon, Netflix and other online retailers sell large quantities of the usual blockbusters but actually generate more total volume from hundreds of thousands of niche products. In healthcare, it is the left side of this distribution curve which inspires (for better or worse) Wal-Mart, Target and others to offer 'Doc In A Box' services – allergies, bladder infections, bronchitis, ear infections, pink eye, sinus infections and a full battery of vaccines – all served up for a fixed price while you wait.

On the right end of the curve though, the NIH Office of Rare Diseases[2] classifies over 6,000 conditions, each afflicting fewer than 200,000 Americans. Along this part of the curve, things become rapidly ambiguous in a hurry – both for patients and physicians. Specialisation is the response to this range of ailments ('nichefication' in Anderson's terms) and brings physicians repeated cases of a particular nature – giving them the confidence that they can routinely diagnose and treat a high percentage of these patients. However, even within a particular specialty area, cases will naturally follow a distribution curve from typical to atypical. Unto themselves – atypical cases are just that – they are one of a kind aberrations that force physicians to go outside their typical comfort zone of diagnosis and treatment. For each individual physician, these atypical cases feel like the exception rather than the rule. What the Long Tail suggests though is that taken in their entirety, these rare cases actually represent a large percentage of all medical cases. In fact, over 25m Americans suffer from a 'rare' condition.

Some companies, particularly Genzyme, have become very profitable by developing drugs for people with Long Tail illnesses. Genzyme's Cerezyme, for instance, is one of the only treatments for people with the rare disorder Gaucher's disease. Last spring, the FDA approved Myozyme for the first treatment for Pompe's, a muscle wasting condition. Aldurazyme is the first and only treatment for mucopolysaccharidosis I (MPS I), a genetic disease that affects approximately 3,000 to 4,000 people worldwide.

Treatments for rare illnesses are difficult and expensive to develop. This is one reason why Genzyme breaks rule no 2 of Anderson's Long Tail business strategy: 'Cut the price in half, now lower it.' For example, it can cost $200,000 per patient per year to treat Gaucher's. Genzyme has come under criticism for its pricing strategies; however, the company asserts that it has never denied a drug to a patient who cannot afford it.

The pharmaceutical industry has been criticised for developing and implementing a business model that relies on blockbuster medications to drive revenues and lift profits. After Pfizer pulled the plug on its 'good' cholesterol raiser Torcetrapib, some analysts wondered if the $800 million the company spent to test it should have been dedicated to the development of drugs targeted toward smaller markets. In a sense, they were asking if a Long Tail strategy might work better for drug companies, as it would help them to diversify and expose them to much less risk.

This raises an important question – if drug firms were to pursue the Long Tail strategy, what would be the marketing implications? In some respects, pharmaceutical marketing is already about targeting the niche customer. Companies routinely segment the market into 'customer types' or groups of people who will be

The pharmaceutical industry has been criticised for developing a business model that relies on blockbuster medications

*Dr **Giampiero Favato**, a director of the Henley Centre for Value Improvement (right), and **Roger Mills**, professor of finance and accounting at Henley Management College.*

more willing to prescribe or ask for a product. However, companies are also wedded to large-scale marketing efforts like advertising campaigns that drive patients into the doctor's office. It remains to be seen whether drug companies will be able to leverage the internet and other channels that have been shown to be an effective means of reaching niche audiences.

A recent study from *eMarketer*[3] analysed how the quickly evolving world of pharmaceutical marketing – driven by changes in consumer behaviour and attitudes towards healthcare – is rapidly changing direction and tactics. As marketers shift from consumer mass marketing to more targeted opportunities on the internet, *eMarketer* projects that pharmaceutical companies' internet spending will increase nearly 25% this year to $780m and perhaps more importantly, the ability to build a direct relationship with patients is now becoming a reality.[4]

Social computing is transforming the healthcare industry

In a recent interview by Johnmar Fard[5], OrganizedWisdom's co-founder Unity Stoakes outlined eight ways in which social computing is transforming the healthcare industry.

'Collaboration is nothing new to the healthcare industry. Scientists, physicians, health organisations, and educational institutions have networked, shared information, and worked together to solve the world's biggest healthcare challenges for a long time. But only recently, as a result of new internet technologies, have individuals been empowered to join this same discussion in a meaningful, collective way.'

1. Information windows have closed
New health-focused social networks, search engines and content distributors are making it easier for anyone to have access to the same information at the same time. That means the healthcare industry needs to educate consumer patients at the same time they educate physicians. Consumers now have access to information that was once privileged only to the industry. Social computing makes it possible for almost anyone to quickly arm themselves with information, ask more questions and take charge of their health decisions like never before.

2. Collaboration is making us smarter
Now that it's less expensive, faster and easy for health groups, physicians, health organisations and consumers to connect and collaborate, everyone is getting smarter. People are learning about new treatments, alternative solutions, less expensive options, and helping each other connect the dots with complicated health issues.

3. It is now possible to communicate directly with patients
For the most part, the healthcare industry has been based on the 'few to many' approach to communications, marketing, product development, etc. Technology is making it possible (and necessary) for the industry to connect with all of their constituencies in a more personalised, relevant way. These new direct links with consumer patients, for example, could mean better product design, new treatments, more effective trials and ultimately more personalised health solutions.

4. Transparency is a requirement
Social networks are lifting the veil of an often blurred and complex industry. People want to understand more about the companies providing their healthcare. They are learning about alternative treatments. And they are demanding a more open and forthright culture from the industry. Social networks are breeding savvy consumers, who are giving their trust to those who are opening the curtain and helping to communicate in more transparent ways.

5. Word of mouth marketing
Friends and family have shared and spread important wisdom since the beginning of time. But now, via social networks, they can do so with a click of a button. This means that industry marketers will need to rethink how they focus their efforts. They must figure out transparent and effective ways to leverage word of mouth marketing in a hyper-connected world.

6. Knowledge now lives forever
Over time, community-driven knowledge bases will become smarter and more meaningful. Archived information, shared wisdom and personal experience has a much longer life span than ever before.

7. Wisdom of crowds
The collective experience from millions can now be assembled to help people see trends, make decisions, and learn what worked (or didn't work) for millions of other people. Access to this data will change how people make their healthcare decisions in the future, and perhaps impact the very types of health-related products and services that become available.

Social networks are breeding savvy consumers, who are giving their trust to those who are helping to communicate in more transparent ways

8. The Long Tail effect

Healthcare will open up to thousands of new micro-segments, as the health industry learns that there is big business in small niche-focused healthcare needs. There will be new treatments and solutions for even the most rare of health conditions. It is also likely that social networks will make it easier for the healthcare industry to develop solutions for new areas.

Reaching a new segment of healthcare consumers: the cyberchondriacs

According to a recent research from Harris Interactive,[6] searching the internet for healthcare information has become more widespread in the past year after three years of little growth. Use of the internet to search for health-related information by online US adults has increased markedly both in terms of percentages (from 72% in 2005 to 80% now) and in numbers. This brings the number of all US adults who have ever searched for health information online to 136m, a 16% increase from 117m in 2005; these are the new 'cyberchondriacs'.

The number of US adults who have ever gone online to look for health or medical information has increased to approximately 136m up from about 117m last year. The main reason for this increase seems to be that the total number of internet users has increased somewhat (from 74% of all US adults in 2004 to 77% now) and the % of those looking for medical information is increasing as well. Cyberchondriacs now represent 80% of all online adults, up substantially from last year's 72%. Six in 10 (61%) online adults say that they have looked for information about health topics often (21%) or sometimes (40%), a slight increase of three percentage points from 2005 (58%).

The percentage of online adults who say they hardly ever or never search for health information has dropped to 39%, down from 43% last year. Interestingly, while three-quarters (76%) of those who have ever searched the internet for health information have done so one or more times in the last month, this is down from last year when 85% said that they had gone online one or more times in the past month looking for health information.

On average, a cyberchondriac searches the internet five times per month, a decrease from the almost seven times per month a year ago and similar to five times per month in 2004. Similar to 2005, a large majority of cyberchondriacs (88%) continue to indicate that they were successful in searching for health information online. 42% say that they were very successful and another 46% say they were somewhat successful.

87% of cyberchondriacs say that the health information they found online has been reliable (25% 'very reliable' and 61% 'somewhat reliable'). Interestingly, this has declined from 2005 when 90% felt this way. Of special note, the percentage of those who indicate that online medical information is 'very reliable' has declined substantially from 37% in 2005 to the current 25%.

Healthcare marketers must maximise the opportunities for capturing the highest volume of targeted consumer profile data

DTP: a new e-strategy to create value in healthcare

An online multi-channel approach that includes health-focused websites is a very effective way for marketers to conduct successful Direct to Patient (DTP) marketing programmes by helping them reach consumers that suffer from specific ailments. By implementing a multi-channel strategy, marketers optimise their opportunities for getting the right information to the right individual at the right time. The following scenario of a consumer's online behaviour provides an example of the benefits of this approach: a consumer conducts a Google search on heartburn medication where they find a link to Healthier.com, which features information on a new heartburn drug. The site offers opportunities for the consumer to sign up for more information on this drug by providing their contact information and health-related information, and granting permission to be approached by the pharmaceutical company.

Leveraging a variety of online channels is important because each consumer has unique preferences and online habits. For this reason, healthcare marketers need to maximise the opportunities for capturing the highest volume of targeted consumer profile data. This invaluable self-profiled information gives the customers' profile necessary to ultimately tailor direct product communications based on consumers' specific drug needs.

Leading online marketing service providers will also apply advanced optimisation technology across these online channels based on extensive performance, personal or contextual targeting criteria to ensure your offer is presented to the right consumer and maximise campaign results and return on investment (ROI). After collecting consumer profile data it is vitally important to verify the quality by using a strong data authentication, cleansing and validation process. This ensures the accuracy of critical contact data, such as email and postal address, telephone number and much more.

As a result of implementing a successful online customer acquisition programme, pharmaceutical marketers will achieve the following objectives and benefits:

- quickly build a database of highly targeted patients who suffer from the specific targeted diseases;
- lower customer acquisition costs and an improved ROI through better targeting and higher conversion rates. (Costs are dramatically lower when compared to television and print advertisements); and
- gain insight into market trends and access to demographic and attitudinal data.

To ensure the success of an online customer acquisition campaign, as well as the DTP marketing efforts, it is important to also abide by fundamental ethical principles which are:

- a quality database must be permission-based. That means the consumer has provided explicit permission to use his or her personal information to market products to them;
- marketers must also definitively state how consumers' personal information will be used through a clear and simple privacy policy; and
- consumers must have final authority; consumers should identify what drug products and treatment information they are interested in, how they want to receive it and how frequently. Offering them an easy opt-out or unsubscribe will help add to the trust factor that is being built.

An effective, online customer acquisition programme, based on proven best practices is an innovative solution for quickly connecting pharmaceutical brand with highly targeted, profitable consumers who suffer from the targeted disease in a cost-effective manner. **MU**

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NUNO DA CAMARA

ACCOUNTING AND VALUATION OF INTANGIBLE ASSETS

Intangible assets such as reputation and brand have an acknowledged effect on organisational value. **Nuno da Camara**, research fellow at The John Madejski Centre for Reputation, Henley Management College, explores the definitions and treatment of intangibles from a regulatory and accounting perspective, and suggests what further developments need to take place in order to properly capitalise on them.

Academics and practitioners in the fields of economics, accounting, marketing and corporate reputation recognise the impact of intangible assets like brand and reputation on organisational value. With increased competition in global markets, intangible assets can account for up to 90% of a company's market value.[1] The exact identification and measurement of intangibles has remained a matter of much debate. It is, though, crucial for practitioners concerned with branding and reputation to understand the accounting and regulatory issues in this area. This article summarises the key issues for a non-financial audience, explaining the classification and treatment of intangible assets from an accounting and regulatory point of view, as well as the case for better valuation and its potential impact on long-term growth and sustainability.

Defining intangible assets and goodwill

What exactly are intangible assets? Intangible assets range from intellectual property such as trademarks and copyright, know-how, innovation, well-established business procedures and management processes, to client lists, relationships, brands and reputation. Unlike physical and financial assets – which have a clear market price – intangibles represent subjective factors such as knowledge, relationships and perceptions that are difficult to identify or value. Consequently, they are generally ignored on a company's balance sheet. Notable exceptions are trademarks and copyright agreements that are legally identified and for which comparable market data exists, as well as some computer software and internally generated intangibles resulting from product development. Regular company accounting, though, doesn't usually require the valuation or disclosure of intangible asset values.

In acquisitions, however, it is common for a buyer to pay more than the book value of tangible fixed and current assets (plus recognised intangible assets such as trademarks), so the residual value which can be attributed to intangible assets is difficult to ignore. Historically, this has been lumped under what is known as goodwill, which effectively represents the total amount a buyer is willing to pay for the assets which cannot be tangibly identified and independently priced. Recent regulations require goodwill to be left on the balance sheet without being amortised because it is argued that goodwill is constantly replenished by ongoing business activity and investments such as advertising and marketing. Alternatively, in some acquisitions, goodwill has been paid for straight out of reserves and therefore disappeared from the accounts, which has led to some strange situations in which company balance sheets post-acquisition do not reflect the full value of the assets just acquired.[2] In either case, the general method of accounting for intangible assets post-acquisition has been highly unsatisfactory. Recent regulations have attempted to remedy the situation.

Recent regulatory developments

The relative value of intangible assets has increased sharply over the last 20 years because of the rapid growth of the service sector and knowledge-based industries that rely heavily on people-related skills and

The general method of accounting for intangible assets post-acquisition has been highly unsatisfactory

Nuno da Camara, research fellow, The John Madejski Centre for Reputation, Henley Management College.

intellectual capital. When large hostile takeover bids in the late 1980s first began to generate huge figures in goodwill, investors and regulatory authorities began to demand a proper breakdown of intangible asset values post-acquisition. A series of regulations cumulated in the International Financial Reporting Standard on Business Combinations (IFRS 3), which requires the purchase method of accounting to be used and thus the identification and valuation of intangible assets at fair value for any acquisitions undertaken since 31 March 2004. In the UK, the Operating Financial Review (OFR), introduced under the Companies Act legislation, has made similar recommendations, although the OFR is not mandatory. Nevertheless, most companies in the public eye have developed best practice and followed the general spirit – if not the exact letter – of the legislation and regulations.

The purchase method of accounting requires the split of the purchase price into the fair value of the identifiable assets, liabilities and contingent liabilities with the excess being recognised as goodwill. This allows investors to obtain a better understanding of what has been acquired and makes it easier for investors to assess the costs associated with intangible assets. Such assets are amortised over their estimated useful life – unless they are deemed to exist indefinitely – and a charge reflected in the income statement.[3] Goodwill, on the other hand, is simply held on the balance sheet according to most Generally Accepted Accounting Principles (GAAP)/IFRS regulations. The regulations also require companies to test for impairment of goodwill and intangible assets by allocating these into the cash generating units and demonstrating that forecasted revenue, discounted at the company cost of capital, exceeds costs.[4] This treatment encourages companies to identify what they have purchased and to recognise anything that is no longer revenue-generating as a cost in the income statement. Therefore, accounting has made a significant move away from the previously strong focus on cash accounting to fair value accounting. Perhaps understandably, this has caused confusion amongst users of financial statements.

Recent regulations such as IFRS 3, however, apply solely to acquisitions. Most internally generated intangibles are still treated as costs that must be immediately expensed, with no value being generated for the balance sheet.[5] Companies do not have to disclose any meaningful information about intangibles investments, except for expenditure related to research and development. Likewise, the financial reports provide no information on revenue generated by these investments, such as patent-licensing fees or the share of revenues coming specifically from new products.[6]

Valuing intangible assets depends on the concept of ‘separability’

Financial valuation

Accountants generally don’t put a value on anything that isn’t either sold, purchased or exchanged and which doesn't possess a credible valuation that is replicable, verifiable, objective or neutral to all stakeholders.[7] Indeed, as Kumar explains, they prefer to have market value as the fair value to satisfy all the above-cited criteria.[8] Unlike many physical and financial assets (ie loans, investments and financial options) intangible assets cannot be directly compared and traded as commodities on an open market. Indeed, the value of intangibles resides precisely in the fact that they cannot be easily bought and sold, or even imitated, and are intrinsic to a company’s intellectual capital. This, though, still raises the question of how accountants value intangible assets for regulatory purposes post-acquisition.

In general, regulations require that whatever is valued must be associated with identifiable items of value, and that the value of an aggregate must be the sum of the values of its constituent parts.[9] Regulators accept and suggest various methods that range from cost-based and market-based valuations to economic use or revenue- and royalty-based methods. Most – with the exception of ‘historic’ cost-based methods – employ a discounted cashflow analysis which calculates future related earnings and discounts backwards using an appropriate cost of capital to a present day value. Much, therefore, depends on the extent to which reliable cost or revenue-based figures can be ascertained and attributed to individual intangible assets.

An initial action is to consider whether a particular intangible would be saleable on its own, and then ask what revenues can reliably be linked to it.[10] Companies can, for example, value know-how and brand names by using data from licence fee or royalty rate arrangements, or even franchising arrangements in their sector as a guide. In addition, companies can attempt to value customer relationships, as sufficient information generally exists on new and existing customers – and the income they generate – to allow for revenue projections.[11] If market data exists on the worth of client lists (eg databases of contacts) these might also be valued reliably. Even business procedures and training might be valued if information is documented in manuals and could theoretically fetch a market price.[12] Valuing intangible assets, therefore, depends on the concept of ‘separability’, or the extent to which individual intangible assets can be reliably identified in isolation from each other as independent creators of operational value. Moreover, the operational value needs to be closely linked to an associated revenue stream for any calculation of value, whether discounted from future projections or historic, to occur.[13]

It is therefore difficult, at least from an accounting perspective, to link intangibles such as brand equity or reputation to revenues. Brand equity and reputation might follow from brand name – and could even result indirectly from know-how, training and customer relationships – but they operate as business outcomes in the minds of consumers rather than direct inputs in the business and cannot be separately sold. This is not to say that information pertaining to brand equity and reputation is not useful to accountants as supporting information for the valuation of other intangible assets such as know-how and brand name, client relationships and business procedures.

There is a clear lag in research and accounting regulations that would support long-term investment in key intangibles

Undervaluation and resource misallocation

Beyond acquisition-related accounting, the scarcity of proper information on intangibles means investors, reacting conservatively, tend to forecast lower projections of revenues, earnings and cash flows, often leading to a reduction in a company's market value. That can mean a higher cost of capital and an even higher discount rate being applied to projected future earnings.[14] Thus, at least in the short-term, stock prices might be lower than expected – if more and different information were available on intangible investments.[15] Consequently, many managers feel intuitively that their companies are about 20% undervalued, although research has yet to explore to what extent this relates to managerial bias.[16]

Longer-term, stock markets generally tend to adjust pricing errors and correct the undervaluation or overvaluation in stocks, sometimes dramatically as in the case of the dotcom crash.[17] Yet this might occur earlier if information on the value of both the tangible and intangible assets that underlie investor expectations were improved and made available.[18] In addition, a higher cost of capital leads companies to under-invest in intangibles, thereby squandering opportunities for the earnings and growth investors seek.[19] Thus, the increased generation of quality information on intangibles could break the cycle of undervaluation and higher borrowing costs and lead to healthier long-term growth.

The management information gap

As mentioned above, most types of investments in intangibles – employee training, brand enhancement, the development of new organisational processes – are not reported in public accounts. Moreover, because of the difficulty of linking these intangibles to revenue returns, many companies do not even systematically monitor and disclose the actual investments made.[20] Breaking out a company's expenditures in training, brand enhancement, information technology, and the like from general cost figures would let managers and investors see how those investments change over time and how they compare with those made at related companies.[21] Indeed, as Lev argues, if internally-generated intangibles were treated as assets that create future benefits it would radically change how managers make key decisions about intangibles-related investments such as marketing campaigns.[22]

What is needed is more economic research on the fair valuation of intangibles that accountants can then accept and use in their assessment of value. This requires the availability of suitable data on tangible and intangible inputs and outputs of production in organisations. However, as Kumar[23] and Lev[24] state, the information deficiency is actually perpetuated by the fact that accounting regulations only require disclosure of items for which there could be fair values. Since regulations like GAAP and IFRS do not oblige companies to report information on intangibles, managers have generally not set up systems to capture data on returns and costs associated with intangible investments. This is a vicious circle which cannot be broken until companies are asked to disclose information on quantitative inputs, for intangible assets over time even if they cannot value them directly.[25]

Conclusion

Intangible asset valuation is becoming an important issue for organisations. Most progress has been made in valuing such assets in acquisitions. It is an important element in terms of management information and investor appraisal of companies. However, whilst it is widely recognised that companies should focus on the creation of long-term value through developing key intangible assets like stakeholder relationships, employee motivation and customer service, there is a clear lag in economic research and accounting regulations that enable and require the type of disclosure that would support more long-term investment in these areas. Naturally, this results from the difficulty of valuing intangible assets financially and may ultimately lead to the validation of other non-financial methods of valuation by regulators and management accountants. For the moment at least, this still seems a long way off. Nonetheless, important steps have been made in the proper capitalisation of intangible assets on the balance sheet – rather than simply treating them as costs reported in the income statement. **MU**

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