The Institute of Chartered Accountants in England & Wales

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Feedback

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Accountants becoming strategists – you can help!

Richard Whittington of the University of Oxford explains the background to a new Faculty-backed survey of accountancy career trends.

More than any other profession, accountants occupy key strategic positions in British business. A recent study has shown that top managers are nearly three times as likely to have accountancy or finance backgrounds in the UK as in France or Germany. Accountants have a big influence on strategy. But how do they achieve this and what do they contribute?

Oxford University is launching an investigation into how accountants and marketers develop as strategists in British business. The investigation is sponsored by the government's Economic and Social Research Council as part of its programme on skills, knowledge and organisational performance (SKOPE). It also has the support of the ICAEW's Faculty of Finance and Management, the Chartered Institute of Marketing and the Institute of Directors.

The investigation is launching this year and is looking for accountants (and marketers) who have recently taken a substantial strategic role within their businesses for the first time. You might have joined a business unit management team, become a director or moved to a planning or business development role. We would like to interview you about your role in strategy-making so far, and then follow-up over the next couple of years to see how your role develops. We would also like to talk to a nominated colleague in your business team, to get another view of strategy-making in the business. All information will be treated confidentially.

What will come out of this investigation? First, findings will be fed into the ICAEW's developing education and training programme, pre-and-post qualification. Second, we hope it will give you a chance to reflect on your own strategic responsibilities. Towards the end of the investigation, we will be organising workshops to bring together participants, the professional bodies and academics to draw practical conclusions from the findings. Finally, the investigation will help national policy-makers understand why accountants are so important to British business strategy.

If you're interested in joining the investigation, or just want to find out more, contact me at Oxford University's Said Business School on 01865 271972 – or email richard.whittington@sbs.ox.ac.uk – further details of the project can be found at www.sbs.ox.ac.uk/sbs/strategy

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EVENTS PROGRAMME 2001

Please see page 11 for details of the Faculty's expanding programme of lectures and conferences in 2001. Further dates are being finalised and will be added in due course.

A happy and prosperous New Year to all Faculty members and readers of *Finance & Management*

PLEASE NOTE THAT ALL CHANGES OF ADDRESS AND OTHER NEW DETAILS OF FACULTY MEMBERS SHOULD BE NOTIFIED TO THE INSTITUTE'S MEMBERS' REGISTRATION DEPARTMENT (TEL: 01908 248250 OR EMAIL: finmreg@icaew.co.uk).

Value-based management – the theory and the practice

What is value-based management (VBM)? And does it work? In his recent Faculty lecture, **Matt Davies**, a director of ATC (CPD) and writer on VBM, discussed its underlying theory, the main metrics and some key implementation issues. Helen Fearnley reports.

The importance of shareholder value is now accepted, Matt Davies began; company executives generally agree that the creation of value for shareholders is a prime responsibility.

However, the real challenge is turning words into actions and, ultimately, results. In this context, there has been recent increased interest in an approach to management that attempts more explicitly to link business decisions and the principles of value. Known as 'value-based management', this can help in the delivery of value for shareholders, he said.

What is VBM in theory?

VBM originated in the US, largely as a result of pioneering work in the 1970s and 1980s by Professor Alfred Rappaport, Joel Stern and Bennett Stewart. Since then, other major management consultancies have made their names in the field – among them Holt Value Associates, Boston Consulting Group, Marakon and McKinsey.

However, although a growing number of companies now subscribe to this VBM approach, they differ in the form of value measurement used. The consultants specialising in VBM are promoting a variety of alternative VBM approaches, each with their individual so-called value metric, which are far from identical. Nevertheless, behind these different formulae lies a common management approach focusing on value creation principles, measures and techniques, across all management processes, and throughout the organisation.

The VBM approach

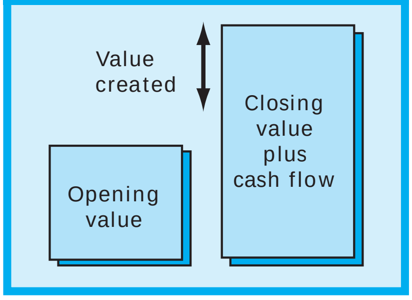
The rationale behind VBM is that shareholder value is the corporate objective but since traditional accounting methods fail to measure value creation effectively, other specific value creation measures must be used as part of an integrated VBM framework.

The VBM philosophy, Davies explained, is that by aligning its major processes with the principles of value creation, a company is enabled to take decisions more likely to improve the value of shareholders' stake in the company. However, there are also four theoretical underpinnings to creating value, namely:

1. investing in assets which provide a greater return than the cost of capital;
2. improving returns on existing assets;
3. divesting poorly performing assets (but only at a price greater than their intrinsic value to the business); and
4. reducing the cost of capital.

Additionally, Davies said, it is important to understand the fundamental

FIGURE 1 LONG-TERM VALUE vs SHORT-TERM PERFORMANCE



economic principles behind the term value. One must distinguish between the value (eg of an asset or a business) at a point in time, and the value created by the performance of a business over a period of time – particularly important when testing experts' claims of the accuracy with which the metrics truly measure value creation. Long term value can be measured as the present value of net future cash flow. In economic terms, value created over a period, on the other hand, is the increase in the value of the business over the period plus the free cash flow generated during the period (see Figure 1).

In practical terms, Figure 1's opening value could be taken as the market value of the company at the start of the period, the cash flow generated as the dividend paid to shareholders, and the closing value as the market value at the end of the period.

Thus value creation is partly based on delivered performance, and partly on the change in the business's value.

The value metrics – their classification, strengths and weaknesses

Davies went on (Figure 2) to classify the various metrics used in VBM, both according to whether they provide an absolute or relative measure, and to whether they are external or stock market-based measures (eg MVA and TSR), or internal/business measures.

He also broke the latter, internal measures, category into the more long-term strategic type of metrics (NPV, SVA, IRR, TBR) and those used more for monitoring (EP/EVA, CFROI and TBR). He then looked at the strengths and weaknesses of the four main metrics, namely (see Figure 3):-

- **Shareholder value analysis (SVA)**

Developed by Professor Rappaport, SVA's valuation methodology is based on discounted future free cash flows. But, as Davies pointed out, it is not primarily a measure that can be used for monitoring performance.

FIGURE 2 THE VALUE METRICS

	Absolute £	*Relative %*
External measures	MVA	TSR
Internal measures		
- Strategic	NPV, SVA	IRR, TBR
- Monitoring	EP/EVA	TBR, CFROI

SVA focuses on seven key value drivers – sales growth, operating margin, cash tax rate, rate of fixed capital investment, working capital investment, competitive advantage period, and the cost of capital. The calculation of free cash flow entails subtracting additional fixed and working capital investment from 'cash profits' for a period.

- **Economic profit/economic value added (EP/EVA)**

Advocated by consultancies Marakon and Stern Stewart ('EVA' being a Stern Stewart trademark), this measure is essentially a re-branding of residual income – a concept long used by management accountants for divisional performance measurement.

EP/EVA measures surplus profit after deducting a charge for capital employed (ie operating profit minus the product of the amount of capital and the cost of that capital).

This is a useful measure that can be used throughout the system of performance management, including for valuations (the value of a business equalling book value of net assets plus the present value of future residual income). However, it can be complex – Stern Stewart recommend 164 possible adjustments, albeit only a fraction of those are usually applicable.

- **Cash flow return on investment (CFROI)**

The favoured metric of Holt Value Associates, BCG, and Braxton Associates (part of Deloitte Consulting), CFROI is an internal rate of return (IRR)-type measure that assumes current cash flow will continue over the remaining life of the business's assets. This is generally agreed to be a relatively complex measure, though its advocates claim that this complexity is the cost of greater accuracy. Specifically, the calculation of CFROI involves finding the inflation-adjusted IRR which equates the current real cash flow projected over the remaining life of the businesses assets plus the cash flow arising from the release of non-depreciating assets at the end of the average life of those assets, back to the current value of the business's gross operating assets.

For instance, in the example shown, 15% is the IRR which equates the £20 million real cash flow arising each year of the remaining life of the business's assets (10 years), plus the £10 million cash released from non-depreciating assets (eg land and working capital) at the end of 10 years, back to the current value of gross operating assets of £103 million.

CFROI can also be used as an input for valuations. The logic behind CFROI-based valuations is that the business's rates of cash return will fade over time – as a result of competitive forces – towards the long-term economy-wide average.

This is a complex measure, not particularly easy to calculate, and requiring some subjective input. It is sometimes used in conjunction with total business returns, outlined below.

- **Total business returns (TBR)**

Like CFROI, TBR is favoured by BCG and Braxton Associates/Deloitte Consulting, and is another IRR-based measure. It is the internal equivalent of total shareholder returns, and equates the value of a business at the end of a period, plus the value of cash flow arising, to the value of the business at the start of the period. This is the purest measure, being conceptually identical to the theory of short term value creation (see, again, Figure 1).

TBR is used for the development of strategic plans and the subsequent monitoring of business performance.

However, the valuation of the business, in this measurement, can be problematic: if formula-based then it may be inaccurate, but basing it on discounted future cash flow projections can be very subjective.

FIGURE 3 WEIGHING UP THE VALUE METRICS

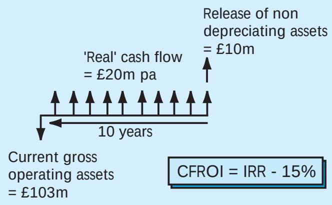
Shareholder value analysis: free cash flow

	£m
Sales	100
Operating expenses	(50)
Operating profit	50
Add: depreciation	10
Less: capex	(30)
Less: investment in Working capital	(5)
Free cash flow	25

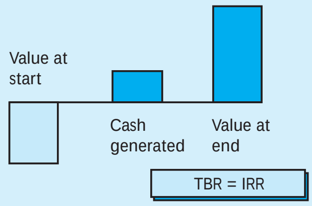
Economic profit/economic value added

	£m
Sales	100
Operating expenses	(50)
Operating profit	50
Less: capital charge (= cost of capital x capital)	(20)
economic profit/EVA®	30

Cash flow return on investment



Total business returns



Choosing the metric

Despite many consultants' claims of fantastic correlations between their own preferred metric and share price movements, the supporting statistical evidence is scant. This is unsurprising, he went on, given that short term value performance measurement requires a measure capable of capturing the change in value of the business's assets over a period, as well as 'delivered performance'. Nevertheless, though imperfect, all of the metrics discussed incorporate the cost of capital concept which makes them often more helpful than traditional profit-based numbers.

As for choosing between them, he emphasised that this can only be done in the context of a given company's needs and capabilities.

The feasibility of a given metric for a given business is important and involves not only that business's capability to generate the required information. There is also the question of the managers' ability to take on the new ideas. Simplifications are often necessary in practice, to make the metric understandable and usable.

Finally, Davies warned VBM-adopters against over-emphasising the measurement aspect: VBM is a management, not a measurement, tool.

The implementation challenge

Perhaps most significantly, implementation of VBM – getting the ideas into the business arena and getting them used – is invariably harder than first envisaged.

The three key tasks in implementation are securing commitment, developing capabilities, and changing behaviours. Put simply, for VBM to succeed managers must believe in it, be able to do it properly, and be in an environment structured to encourage – and reward – the necessary behavioural changes.

To achieve those three prerequisites, top management commitment needs to be accompanied by:

- communication, training and support. Training, in addition to the use of VBM tools, can mean the development of the softer skills such as creative thinking;
- managers' ability to convert VBM metrics into the drivers and sensitivities relevant to their business; and
- possibly a link to rewards. This could mean linking incentives to the value measure, or to specific value drivers. But given that, as discussed, value metrics do not necessarily fully capture long-term value creation, this needs to be treated with caution; overemphasising the short-term value measures could lead to short-termism.

In summary, the real objective for implementation is to get VBM ideas into the fabric of the organisation, so that they're regarded simply as 'the way things are done round here'.

Does it work?

Those engaged in VBM seem convinced that it leads to value creation; and those who take the discipline furthest are convinced that the further you spread the approach, the greater the benefits.

However, Davies admitted that making a balanced assessment of VBM is difficult. Anecdotally, success stories tend to be publicised more than failures. And strictly objective evidence is thin, although a PA Consulting study in 1997 found that, for the Irish and UK companies surveyed, the more VBM is used, the better the total shareholder returns performance. But, cause and effect is hard to demonstrate in this sort of area.

Whatever you want...

In conclusion, Davies – probably transgressing the first rule of prescriptive management consultancy – said that VBM can be whatever you want. But, he emphasised, its adoption involves hard (practical) work, over years rather than months.

Since VBM is as much about change management as corporate finance, he also recommended keeping things as simple as possible while remaining true to the VBM logic, and tailoring it to your individual (business) needs.

Once again, he stressed that VBM is not a panacea – being a good company still requires good strategy, good organisation, and good management.

Matt Davies qualified with Price Waterhouse and spent six years (1993-1999) at Aston Business School teaching, writing about, and researching VBM. Now, as a director of the continuing professional development business within Accountancy Tuition Centres (ATC) he runs finance and value-creation training courses for corporate and professional clients. Matt, in association with Value Partnership Ltd, is currently setting up a network for practitioners interested in the subject of value creation. To find out more, contact him at matt.davies@atc.co.uk

The significant practical differences between UK and US GAAP

PricewaterhouseCoopers partner **Mary Dolson** identifies the major difficulties in preparing financial statements under both UK and US GAAP, or reconciling from one set of standards to the other.

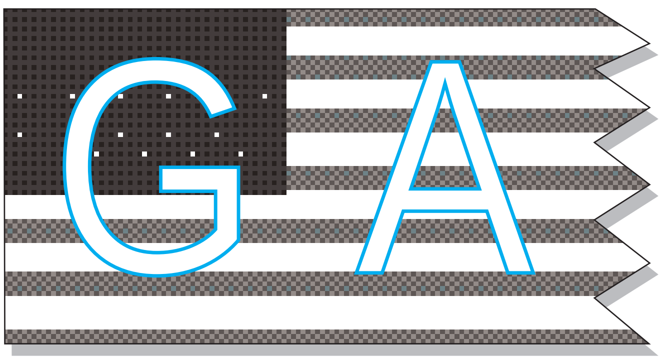
Is life getting any easier for finance directors who need to prepare financial statements under both US Generally Accepted Accounting Principles (GAAP) and UK GAAP, or to reconcile from one set of accounting standards to the other?

Some of the gaps have narrowed; efforts by the UK Accounting Standards Board (ASB) in the area of provisions, and by both the ASB and the US Financial Accounting Standards Board (FASB) on earnings per share, have reduced or eliminated a number of differences. FASB proposals on business combinations and goodwill could further reduce the gaps. Those that remain are difficult and can arise from apparently innocuous language in the accounting standards as well as from cultural differences in financial reporting practices.

Problems in reconciling from UK to US GAAP as part of an IPO

What are the difficult practical issues faced by companies when reconciling from UK GAAP to US GAAP for an initial public offering (IPO) in the US?

Consider an example of a UK-based multinational in the media and entertainment business. It has expanded over recent years through organic growth and acquisitions. It is active in a number of European markets as well as the UK with growing operations in the US. It has a treasury management function that is concerned only with risk management. Even from this brief description we can see two major issues that will arise in the reconciliation from UK to US GAAP; accounting for business combinations and hedge and derivative accounting. Both can create practical and record keeping issues. There is also the question of what constitutes materiality.



Purchase accounting issues

Let us assume that recent acquisitions do not qualify for merger accounting under UK GAAP or pooling under US GAAP. UK and US GAAP both require management to assign the purchase price of an acquired business to the fair value of assets acquired and liabilities assumed. The remainder is goodwill. Until recently, goodwill under UK GAAP was offset against reserves.

The current UK standard, Financial Reporting Standard 7 (FRS 7), requires that acquired identifiable assets and liabilities be measured at fair values that reflect conditions at the date of acquisition. A telling requirement is that identifiable assets are those that are capable of being disposed of or settled separately, without disposing of the entity. This is a straightforward requirement that gives rise to significant differences in application.

US GAAP has always required the fair value exercise to be carried out for acquisitions and the emphasis is on assigning fair values to tangible assets and identifying and valuing intangibles. Intangibles might include brand names, publishing rights, customer lists, trademarks, patents, proprietary software or processes and many others. There is no similar requirement that assets must be capable of being severed from the business to be measurable at fair value.

Management of US companies might prefer to leave the majority of excess purchase price in goodwill but this practice is not acceptable under US GAAP. Amortisation of intangibles and goodwill are both non-cash charges, but the choice between the two can have a major impact on when that charge is reflected in the profit and loss account. The impact of assigning excess purchase price to intangibles and tangible fixed assets typically means that the charge runs through profit and loss much more quickly as goodwill can be amortised over up to 40 years while most assets would have a far shorter useful life.

Acquisitive UK businesses face a major exercise in reconciling to US GAAP

Why does this create practical problems for UK businesses? In reconciling to US GAAP, management must look back at acquisitions during recent years and analyse transactions to

assign value to tangible and intangible assets. For management of an acquisitive business this can quickly grow into a major exercise, requiring discounted cash flow analysis to apportion excess purchase price to assets.

The amount of documentation surrounding the original acquisition decision and the detail of what was acquired will impact this exercise. Often, the need for this analysis might arise quite late in the process of preparing for the IPO, resulting in a scramble for old documents and records and the re-creation (or creation) of cash flow analysis.

Financial instruments

There are several standards in US GAAP covering financial instruments, derivatives and hedging activities; principally Financial Accounting Standards (FASs) 47, 105, 107, 119, 125 and 133. FAS 133 has been the subject of much debate and discussion. Under UK GAAP, FRS 13 deals with disclosure relating to financial instruments and derivatives but is not a measurement standard. Accounting treatment in the UK generally follows first principles in accounting for derivatives and hedging activities, in the absence of a comprehensive measurement standard.

This creates practical and record-keeping problems when attempting to reconcile to US GAAP, some of which may be insurmountable. The most problematic are the requirements to designate hedged exposure, the ban on net position hedging, contemporaneous documentation and assessment of hedge effectiveness on a quarterly basis. These determine whether hedge accounting, that is deferral of gains and losses with an eye to matching, can be achieved. Failure to achieve hedge accounting can result in volatility in the profit and loss account.

The language in FAS 133 that creates difficult issues when reconciling several years of history from UK GAAP to US GAAP is as follows:

> *At the inception of the hedge, there must be formal documentation of the hedging relationship and the entity's risk management objective and strategy for undertaking the hedge, including identification of the hedging instrument, the hedged item, the nature of the risk being hedged, and how the hedging instrument's effectiveness in offsetting the exposure to changes in the hedged item's fair value attributable to the hedged risk will be assessed. There must be a reasonable basis for how the entity plans to assess the hedging instrument's effectiveness.*

This requirement is repeated in the standard for different types of hedge. Any company with treasury activity may have a major record-keeping burden to meet these criteria. There must be specific documented matching of the hedged item and the hedging instrument. This documentation must exist at the inception of the hedge – ie when the derivative contract is entered into – and it must explain how the hedge will work and how effectiveness will be measured. In the absence of this documentation, gains and losses from financial instruments and derivatives are recognised currently in earnings. The Securities and Exchange Commission (SEC), in an early enforcement case on FAS 133, determined that the documentation must be contemporaneous with the creation of the hedging instrument.

Another problematic requirement is the effective ban on hedging of a net position, as this is how many businesses manage exposures. The designation requirements described above coupled with a narrow description of what can constitute a portfolio that can be hedged as a single risk, mean that assets and liabilities hedged on a net basis result in hedge gains and losses in the profit and loss account.

Hedges, once designated, do not necessarily continue to qualify for hedge accounting throughout. Hedge effectiveness must be reassessed every quarter and measured on the basis of the original designation.

FAS 133 is effective for calendar year preparers for 2001. Any company considering a US listing should address the requirements of US GAAP immediately; particularly the documentation to support hedge accounting which cannot be created after the fact.

Materiality

Differing cultural approaches to materiality can also come into play. Materiality has traditionally been evaluated on a numerical and overall judgement basis by preparers and their auditors. Thus, if the summary of unadjusted items following completion of the annual audit was not more than say 5% of results and the balance sheet was not significantly affected then recording of such items was waived on the grounds of materiality. This view was fairly consistent among UK and US GAAP preparers. Over recent years, the SEC has developed its own views on materiality which are focused on qualitative criteria of errors as well as the traditional numerical test. These views were codified in SEC Staff Accounting Bulletin 99 (SAB 99).

Some of the examples of qualitative criteria will be unusual to preparers of UK GAAP accounts. These include that individually material items cannot be offset to arrive at an immaterial aggregate amount and that unadjusted items perceived to be in aid of earnings management are de facto material. SAB 99 should be mandatory reading for any potential US registrant.

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For PwC's 'Similarities and Differences – IAS, US GAAP and UK GAAP' contact Debbie Pascoe on 020 7804 2117.

The core issues of successfully managing strategy

In this first in a series of articles on strategy, **Chris Hughes-Rees** reviews the core issues of having a total strategic process in place and the initial strategic steps of vision, shareholder value and portfolio analysis are reviewed.

Strategy is a word whose true meaning is invariably treated too lightly. So-called strategic decisions are frequently tactical, narrow and disconnected from the total business direction. An even greater concern is that the total business direction itself is often not fully mapped out and understood. Managements need to address the fundamental issue of whether there is a robust strategic process and is the entire organisation disciplined enough to stick with it ?

Certainly great strategic corporate success stories abound, but often it is difficult to understand exactly how these organisations got to the end result. What they will have had – what all strategic success stories require – is a total process coupled with an organisational discipline and culture that ensures it is rigorously and relentlessly pursued.

Strategy can be defined in different ways. Its span and the boundaries around it may be very fixed for some, open ended to others. I am an advocate of the open ended view as I cannot see a successful strategy being developed and implemented without considering how all key elements of the business will be structured, mobilised and run. Everything is necessarily integrated. A world class strategy will surely never succeed without the entire business pulling in the right direction, understanding the strategic deliverables, time lines and measurement framework.

The process model I suggest is certainly not cast in stone, but should be applicable to most environments. Any changes will be driven by the process and the need to make it a little more bespoke. But the red flag is not to start casually removing steps without a very sound reason for doing so.

Frequency ?

How frequently should an organisation address strategy ? Constantly. The strategic process must essentially become a real-time process that underpins everything going on in an organisation. It must be a rolling process – and certainly not some rushed annual procedure which in essence may be more akin to a business plan. Too many organisations – some of them major ones – spend the later months of one year frantically figuring out what plans should be enacted in the next.

Who does It ?

We all no doubt accept that the strategic process must be driven from the top. It is a leadership imperative. Indeed, the modern business model tells us that the senior management team should primarily be leading strategy, communicating with and supporting the people of the organisation plus also supporting a number of key external relationships.

Frequently, and even in an empowered business model, too many routine decisions, authorisations and business matters involve the top sector of the organisation. These tasks should never have been allowed to migrate upwards. Why do the best paid individuals in an organisation often persist in getting involved in the routine ?

Where ?

One of the best environments you can use is a strategy room that is virtually isolated from the rest of the organisation and the outside world – no phone calls, no pagers, no faxes, no unscheduled visitors. Those working on strategy should work in this environment and it must be a permanent fixture, unused for any other activity with the process rolling neatly forward into the next session, with data and plans getting constantly refreshed and developed creating the real-time concept. But don't forget the issue of corporate security here !

I am certainly an advocate of the virtual office and keeping the board on the move, but for the strategy effort, collective activities are crucial. If you want to win continuously, nothing less will do.

Your competitors will certainly be developing and refining their own strategy processes. The process and environment created by this strategy room must become a hobby, an obsession, a passion. Nothing less.

Step 1 – Vision

Great business leaders tend to have a clear and exciting vision of the future, the shape and characteristics of the markets they will operate in, what their organisation will look like and some reasonable idea of how they will get there. In short, they invariably have a talent for strategically orienting the business.

Vision is very clearly an integral part of the strategic process. To assume that vision is something to be looked at annually (or even less frequently), is to have dropped the first ball by becoming disconnected from the subsequent strategic process steps. A management team must constantly re-visit its vision, conduct extensive research, test and re-test. Vision involves the thorough application of the 'what if' question. This vision stage must have a rigorous content ensuring its credibility before moving on through subsequent steps.

A key technique is that of challenge sessions. At this stage, teams and individuals should be brought into the process and their objectivity and fresh views used to test the credibility and logic of the data developed, conclusions drawn and likely decisions. As well as providing different perspectives, judgement and know-how, this is a hugely valuable way of involving the organisation up front and working with some key individuals.

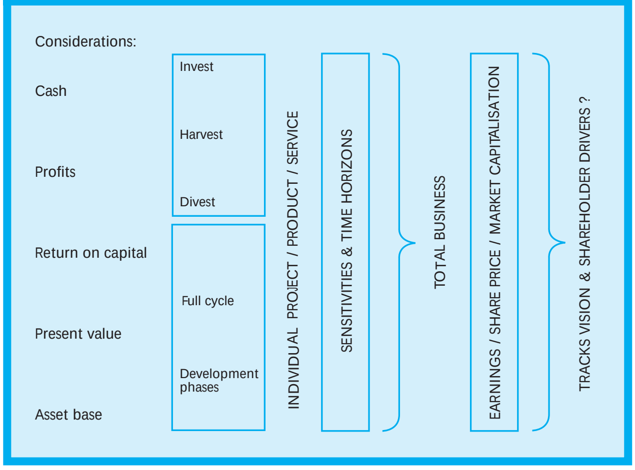
Later in the development of the strategy process, we will reinforce the credibility and realism of the vision following the comprehensive analysis of markets, competitors, organisational capability, value chain, technology, the e-world and so on together with risk analysis. It will become clear that, when moving through the development of a strategy, it is important to loop back to the vision to ensure that the strategic goals fulfil this vision. The thoroughness of the approach will also provide a sound platform to adjust the vision if needed.

Step 2 – Shareholder value

It must be understood that the drivers are from the shareholders' (or stakeholders') perspective. We cannot run a business unless we deliver the results that are required by the ultimate owners. Talking an excellent growth story is one matter but suffering zero near term earnings may be an unwelcome requirement.

Shareholder returns must be rigorously benchmarked and compare well against those of competitors. This is arguably the obvious shareholder performance measure. Beyond that, performance against non-peer organisations also needs monitoring, as any business is also competing against other market sectors for shareholder interest and investment. The key of course is to make the organisation attractive in a combination of ways and to get the right balance.

FIGURE 1 PORTFOLIO ANALYSIS



Obviously the nature of the business – whether it is a new launch or well-established, operating in stable or more dynamic markets – plays a huge part in determining what realistic performance targets are, what it takes to become an outperformer and what will attract committed shareholders. The big challenge is in trying to predict the future, relying on our analysis and assumptions of market opportunities and our winning position in them. We therefore need to predict shifting shareholder demands as markets and our competitive position change. Historic measurement is somewhat easier !

Following the vision development, the emphasis here is on understanding very clearly what the shareholder drivers are and whether they will be met by the fulfilment of the established vision. Without understanding what the owners of the organisation expect and what the value creation needs are for supporting the vision, a strategy to satisfy those needs and expectation cannot surely be built.

Step 3 – Portfolio analysis

A business is invariably a bundle of investments, product streams, product life cycles, profit/loss cycles, cash cycles and so on, and it is essential to understand what all these underlying components of the business are doing in terms of growth, profits, cash, returns on capital, internal rates of return and present values. Ultimately, all the investment cycles for various products and services can be mapped alongside each of these underlying components and the combination sum total will obviously show where the business is heading.

Each investment cycle component will have its own characteristics and shape and will depend on whether it is in 'invest', 'harvest' or 'divest' mode. We need to determine the position today for each component and extrapolate forward plotting the future curve of the business for each dimension. Typically, this data is graphically presented with these individual and combined curves clearly giving the current picture and where we will be at various time intervals.

Such graphical presentation can help in communication with the external world of analysts and internally with employees. These graphical aids will also be a very useful tool in scenario planning, making it easy to see the impact on the business direction as we experiment with each component in the projected portfolio. Again, the level of sophistication in this will vary according to the organisation.

(The next article in this series will deal with situation analysis, segmentation, time horizons and risk analysis).

Chris Hughes-Rees is an independent consultant and a director of the performance measurement and change consultancy signalsfromnoise.com limited.
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Treasury matters

Chris Mansell explains how to model a cash flow cycle

Understanding your business cash cycle is a critical element in strategic management, especially for the small firm and it is an area to which treasurers can make a real creative contribution. As with other treasury issues, the information and figures needed to support this work are simple enough, but do not drop naturally out of the conventional accounting system.

Key components of the cash cycle model include:

- terms of payment from suppliers, especially providers of substantial volumes of components and those with long-lead times or in short supply;
- supply bottlenecks and the effectiveness of just-in-time arrangements;
- production process times, especially where there is a development lead-time involved (eg software);
- terms of payment to customers (especially key accounts), overdues record (different national attitudes to debt settlement can be very important for exporters for example);
- seasonality of sales;
- breadth of product range and corresponding inventory requirements;
- other routine cash flows (payroll, establishment costs, promotional expenses etc);
- cash flow budgets and forecasts are frequently prepared and evaluated on the basis of broad brush ratios, such as debtors to sales, trade creditors to cost of sales. Statistics such as these have proved generally unreliable outside those businesses which have a very large number of transactions (eg retailing). PC power linked to diligent research can produce more complex but more reliable and flexible models, especially if the spreadsheet user is up-to-speed on their 'what-if' skills.

For many small and medium-sized businesses the year-end profit is of interest to the Inland Revenue and outside shareholders, but not as vital for management as the conservation and effective use of cash.

ABSTRACTS FROM LIBCAT

Smith K – The Chancellor is listening
Tax Journal, No.573, 20 November 2000, p19-20 (2 pages)
- *The author outlines the VAT measures in the November 2000 pre-Budget report. Covers measures for small businesses: namely the flat rate; submitting annual VAT returns; the VAT cash accounting scheme; and the increase in the VAT registration threshold. Also covers measures aimed at regenerating Britain's cities namely: reduction of VAT on conversions to create new dwellings; and reduced VAT rate for repairs to listed places of worship.*

Leech T J – The next wave in assurance thinking
Internal Auditor, Vol.57. No.4, August 2000, p66-71 (5 pages)
- *A new 'Collaborative Assurance and Risk Design' strategy works on the precept that multiple assurance approaches are better than one. Knowing which approach to use – and when – can help internal auditors to structure an enterprise assurance framework that satisfies key stakeholders and results in acceptable levels of residual risk.*

Grundy T – Strategy and the 'cunning plan'
Accounting and Business, Vol.3. No.7, July/August 2000, p36-37 (2 pages)
- *With the fast moving corporate climate of the new millennium – awash with e-commerce, mergers and global development – the accountant is in pole position to be a strategist. The author gives some advice, and in an associated article on p38-39 he looks at what went wrong with BMW and Rover.*

Bou-Raad G – Internal auditors and a value-added approach: the new business regime
Managerial Auditing Journal, Vol.15. No.4/5, 2000, p182-186 (5 pages)
- *The role of internal auditors is changing from a traditional audit approach to a more proactive value-added approach where internal auditors are taking up partnerships with management. The debate of internal auditors needing to expand their repertoire has been around for many decades, though now, the evidence of more internal auditors changing their practices has begun to emerge and examples are visible. Internal auditors are seen to be accepting change to keep up with the demands of the market place and are doing so to provide a service of value to their employers.*

Walton P – Reconciled to reconciliation
World Accounting Report, Vol.3. No.4, May 2000, p15 (1 page)
- *In the face of the political importance which is currently being attached to the need for foreign issuers to provide reconciliations between home GAAP and US GAAP calculations of earnings and equity, the author talks to Chris Dakers at SmithKline Beecham, an accountant seasoned in US/UK reporting problems.*

http://www.icaew.co.uk/library.htm

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FORTHCOMING FACULTY EVENTS – 2001

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 Jacquie Lee 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 Jacquie Lee on 020 8953 0758.

- 20 February
LECTURE
LONDON
(Chartered Accountants' Hall)

'COMPETING IN THE NEW ECONOMY' – PROFESSOR DAVID ASCH, MSC, FCA, FRSA, OPEN UNIVERSITY BUSINESS SCHOOL.

This lecture is designed to highlight some of the key issues confronting organisations with the rapid development and deployment of information and communications technologies (ICTs). The session will start by considering some fundamental aspects of customer choice and the nature of buying decisions. Data on the development of ICTs will then be presented followed by the implications for both retailers and producers. The session will conclude by considering the business opportunities available to firms. Registration & coffee 5.45pm; lecture 6.00pm and buffet 7.00pm.

***David Asch** is professor of management at the Open University Business School. He was dean of the school from 1993 to 1999 and has written eight books and over 35 articles on strategy, competition and change, including the bestseller 'Managing Strategy'.*

- 13 March
LECTURE
LONDON
(Chartered Accountants' Hall)

'DYNAMIC STRATEGY – CREATING SHAREHOLDER VALUE THROUGH STAKEHOLDER MANAGEMENT' – MARK THOMAS OF PA CONSULTING.

The lecture aims to illustrate how companies that adopt this approach can create spectacularly superior returns for their shareholders over the long term. It will show how companies can develop strategies by understanding the way complex interactions between stakeholders can alter the strategic battleground and how strategies – often, ones that are counterintuitive – can be formulated to exploit these dynamics. Registration and coffee 5.45pm; lecture 6.00pm and buffet 7.00pm.

***Mark Thomas** is a member of PA's management group. He works within PA's strategy and marketing practice, helping major organisations to resolve fundamental issues of corporate or business unit strategy and to align their management processes with the creation of long-term shareholder value.*

- 24 April
HALF DAY CONFERENCE
(Manchester Business School)

'ACCOUNTANTS AND CHANGE' – PROFESSOR TONY HOPE OF MANCHESTER BUSINESS SCHOOL AND PROFESSOR RICHARD THORPE OF MANCHESTER METROPOLITAN UNIVERSITY.

This conference will examine the ways that organisations are changing in order to become more adaptable to the fast moving business world and the impact this has on traditional budgeting procedures. Registration and coffee 9.30am; chairman's introduction 9.55am; lecture - Tony Hope 10.00am; coffee 11.00 am; lecture - Richard Thorpe 11.30am, buffet lunch 12.30pm.

DATES FOR YOUR DIARY – Full details will be sent with future issues of *Finance & Management*

25 May	Half Day Conference Great Hall, ICAEW, London	**Beyond budgeting** – Robin Fraser - CAMI, David Berkley - Bulmers, speaker from Arthur Andersen.
3 July	Evening Lecture ICAEW, London	**Intellectual capital** (includes case studies) – Goran Roos - ICS Ltd, Joe Peppard - Cranfield School of Management.

RECORDINGS OF FACULTY LECTURES

Recordings of the London lectures are available, in both **audio** and **video** format. To obtain a recording, please tick the audio and/or video box on the tear-off response form opposite. There is a charge of £5.00 for audio recordings and £10.00 for video. However, please note that the recording shown here is available **for one month only**.

THIS MONTH

VALUE BASED MANAGEMENT: THEORY AND PRACTICE

Matt Davies of Accountancy Tuition Centres provides a review of a management approach that explicitly promotes shareholder value creation within a company.

TAX UPDATE

New approach to VAT evasion

In the second of her series of Update columns about tax matters, **Francesca Lagerberg** of the ICAEW's Tax Faculty looks at the Customs and Excise's new efforts to tackle VAT evasion.

Customs and Excise have initiated a 12-month trial from 1 September 2000, involving a new approach to investigating cases of VAT civil evasion. The trial is being carried out in the North West, East Midlands and London regions, as well as using a team within the National Investigation Service. Customs are keen to point out this is a true trial and will only be rolled out nationally if the results of the test show it to be worthwhile.

There are several key elements to the trial. This new approach replaces the formal investigations and procedures currently in place. Meetings with the trader are being held rather than a formal taped interview. The £75,000 threshold above which VAT was normally investigated with a view to prosecution rather than imposing a civil penalty is being removed. Civil procedures will be used whenever possible, with criminal investigations being used only for the most serious cases of fraud.

A procedure similar to the Revenue's Hansard procedure will be implemented in the trial. This will involve four formal questions. However, this is not the same as the Hansard procedure in many respects. For example:

- the procedures will not encompass personal tax affairs;
- the intention is to have a swifter time scale within which to deal with the issues;
- the process will apply to dishonesty rather than negligence; and, most key of all
- if the trader answers 'yes' to any of the questions, the fall-back will be a full civil investigation rather than prosecution.

Customs have confirmed they will only prosecute after this procedure where there has been materially false disclosure.

The advantages of the new approach for traders will be that the process is less adversarial and more flexible, with agreement possible on arrears and a reduced penalty available. When the arrears have been agreed and accepted by Customs, the resulting penalty will not exceed 20% of the tax evaded where the trader has fully co-operated. At present the minimum penalty is 25%. Furthermore, no investigation will be undertaken during the disclosure period available under the new approach. The main pay-off for Customs is that this approach will be more cost effective and will, it hopes, avoid costly appeals.

Customs are also keen to stress that they will not be using the new procedure for 'fishing expeditions'. They also do not want to be criticised for operating inequitably. Therefore, even if a case is not within the trial regions, if the trader co-operates in the same way the new-style 20% penalty will be made available rather than the old 25%.

The trial will be evaluated throughout the year, and it remains to be seen if it proves to be a success. However, on the face of it, it may offer more advantages than disadvantages to traders. More information on the scheme can be found in Business Brief 11/2000, dated 4 September 2000 and the Statement of Practice found in VAT Information Sheet 4/00.

Francesca Lagerberg is the senior technical manager at the Tax Faculty of the ICAEW. To contact the Tax Faculty call 020 7920 8646; fax: 020 7920 8780; email: tdtf@icaew.co.uk. Or visit the Tax Faculty's web site (www.taxfac.co.uk) to find out more about its work.

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