Finance & Management

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The monthly newsletter for members, with news, views and updates on current topics.

THE INSTITUTE OF CHARTERED ACCOUNTANTS IN ENGLAND & WALES

Faculty of Finance and Management

'EVERYONE LIVES BY SELLING SOMETHING ' – Robert Louis Stevenson

FORTHCOMING EVENT ...

Behaviour

22 January – At this evening lecture, Malcolm Lewis of Strategic Value Partners will discuss 'hard' and 'soft' organisatonal issues, showing that linking value with values is the key to creating long-term success.

For further details – see page 15

BACK PAGE ...

PFI guidance

We summarise the Institute's guidance on prospective financial information (PFI).

See page 16

IN THIS MONTH'S MAILING ...

Good Practice Guideline

Issue 40

Real options techniques in capital investment
How do companies make investment decisions? Established methodologies, such as discounted cash flows, help but they ignore many uncertainties concerning future costs, revenues, technologies, markets and customer needs. This *GPG* focuses on the valuation of these options and their use in assessing investment.

Couldn't we get that done in India?

Outsourcing offers companies the opportunity to reduce costs and increase efficiency – but there are also risks. **Scott Geisinger** and **Shaun Walsh** of Proactive Business Solutions explain business process outsourcing (BPO) and, specifically, what India has to offer in this context.

Business process outsourcing (BPO) is one of the most dynamic phenomena of our modern global market. But what is it? Quite simply, BPO is when companies give their business processes to be managed by outside service providers on their behalf.

These activities represent every element of the value-chain including upstream activities such as research and design, manufacturing-related activities such as procurement and logistics, front-end activities such as marketing and sales, and staff functions such as accounting, information technology, and human-resource management (see Figure 1 on page 2).

In economic boom, the fastest moving players will consider BPO options primarily to cut down on time to market, while in the current less robust economic climate, companies look at BPO to cut costs. Regardless of the reason, BPO has become a world-wide trend.

BPO: a competitive requirement
Experts are bullish about the BPO market. For example, Gartner India (subsidiary of Gartner, the world-wide IT research and consulting firm) comment that 'the global opportunity for (BPO) is expected to be $611.4 billion and India currently has the potential to address 38% of that market.'

Two years ago, the consultants McKinsey predicted that 'by 2008, global (BPO) operations may undertake activities accounting for half a trillion dollars around the world.... Such operations could generate cost and other savings of about $400 billion, to be shared by the users and providers as profits'.

Certainly, during times of recession, when growing revenues is a challenge, the stripping out of non-core processes with potential cost savings of 50% to 60% represents a major opportunity to improve the bottom line and improve shareholder value.

Why India?
India has a large, well-qualified, hard-working, technologically proficient, English-speaking workforce eager to develop the prestigious BPO industry

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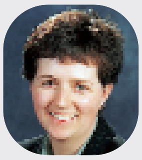

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Outsourcing – *from page 1*

(see Figure 2, opposite). The country produces two million college graduates annually who face an unemployment rate as high as 20%.

While companies in the UK struggle to hang on to the white-collar staff that perform the kind of activities usually targeted for outsourcing, such jobs are viewed as a profession in India. A single newspaper recruitment advertisement by a BPO service provider in India gets responses by graduates in the thousands and 82% of those fortunate enough to be selected will remain with the company for at least a year (vs 58% in the US).

In cost savings, India is second to none, being typically 60% less expensive than the US (which itself is significantly cheaper than the UK) for customer interaction services. Other types of BPO activities offer even greater savings. No other country can currently match India's English-speaking graduate wages (10% to 25% of the salaries of people with similar qualifications in the UK). Telecom deregulation means that the cost benefit keeps increasing while the infrastructure improves.

India's businesses are quality-focused. Most call centres within India practice 'six sigma' processes (an international quality process improvement methodology) and are ISO 9001 or Customer Outsourcing Performance Centre (COPC) certified (or are in the advanced process of being so certified). With 65% of the world's top-rated software companies based in India, quality has become an obsession. Indian service providers in the BPO segment have seen how the Indian software development sector grew at an amazing rate of 40% to 50% each year during the 1990s and have been emulating its obsession with quality.

Finally, the Indian government through its 'Software Technology Parks of India' offers world-class infrastructure along with various incentives and concessions to encourage foreign investment in this industry, including the allowance of 100% foreign direct investment (as against 49% for most other Indian industries) and a 10-year tax-free holiday on exports. Fifty years of democracy has shown that India is a politically stable environment.

Who has taken the plunge?

Financial services giants like American Express, Citibank, GE Capital, E-Funds, HSBC and Standard & Chartered have taken advantage of India's BPO offering to a significant degree. Insurance industry players such as Prudential and Conseco have also entered India. Call centre services providers such as Convergys, PRC, and Sitel have been providing their blue chip client bases service from India for some time now. In addition, UK majors British Airways and British Telecom are benefiting.

British Airways (BA Speedwing) employs about 1,400 employees in two centres while American Express's back-office operations employ more

Figure 1 **Projected capacity in BPO services by 2008**

Opportunities *(Figures in $ billion)*	1998	2008
Customer interaction services	6.5	33.0
Finance and accounting services	1.5	15.0
Animation	1.3	2.0
Translation, transcription and localisation	0.3	1.2
Engineering and design	0.4	5.0
HR services	0.2	44.0
Data search, integration and management	-	18.0
Remote education	-	15.0
Network consulting and management	-	5.0
Web site services	-	3.0
Market research	-	1.0
Total	**10.2**	**142.2**

Source: Nasscom.

than 900 people in India. Standard & Chartered's initial investment in an India-based global processing hub was of $8 million and they are currently growing their employee base from 300 (end-2001) to 1,000 (end-2002).

A large financial services organisation initially set up a data processing centre at a cost of £2.5 million vs the £7.5 million it would have cost in the UK, representing half the pay back period. The 50% savings in its cost of processing offer the potential to double group net profit. Company managers report the India operations have higher accuracy of data entry than the UK! As a result they have doubled their employee base in less than 12 months. The company started with simple low risk processes to build capabilities.

British Telecom (BT Cellnet) has been running pilot projects in Indian call centres for more than six months. Their summary of the strengths and weaknesses of Indian call centres is set out below (right).

What are the risks of sending your processes to India?
The primary risks in shifting non-core business processes to India centre around lack of experience: lack of Indian experience on the part of the Western managers responsible for moving the processes offshore and lack of experience on the part of Indian managers in the specific process area.

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The BPO industry in India is only a few years old. Many Indian service providers would be only too happy to learn how to run a process at your expense! The lack of experience tends to result in a 'text book' approach to all problems. So while Indian managers do tend to be process oriented, since many come from the highly developed Indian IT industry, they typically lack the experience required in these new business processes to know the tricks of the trade and to perform 'triage' effectively (ie quickly determine which areas of the process to prioritise, to make the greatest impact). In addition, being young and highly growth oriented, Indian BPO managers tend to overestimate how many new accounts and processes they can handle successfully, making it difficult to ensure that your account gets the attention you require.

Western managers just off the plane rarely have the culture or industry knowledge necessary to make the right choices. Working with offshore service providers on the other side of the world from a different cultural background can cause major issues.

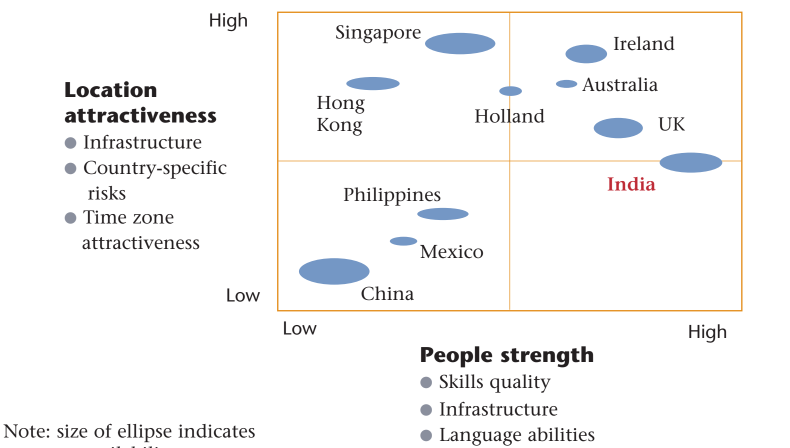
The cost in time, headache, and capital of coming to terms with the Indian BPO industry through a proper detailed request for proposal (RFP) process and due diligence also militate against a proper entry. Further complicating matters is that some Indian management teams present well yet perform poorly or have experience in a related process area but lack the breadth to succeed in others. Also, the sheer geographical and cultural distance stands in the way when trying

BT's view of Indian call centres

Strengths
- Lower cost than UK
- Performance stabilises at a higher level than UK
- State of the art call centres
- Latest technology
- Ability to attract and keep quality people is high
- Large pool of graduates
- Quality focused – standards are followed
- Security focused

Weaknesses
- Text book approach to all problems
- Lack operational experience
- Cultural alignment issues
- Telecom infrastructure not resilient
- Training focused on technique, not customer relationship
- Staff selected on age and qualification vs ability

Figure 2 **India's positioning for BPO**



Note: size of ellipse indicates resource availability

Source: Nasscom

to launch or ramp up a programme or solve a serious problem.

Infrastructure and environment are also areas of concern. The ability to guarantee back-to-back uptime is limited and interconnectivity restrictions may make data back-up or load balancing difficult. In addition, information security, intellectual property rights and knowledge management are areas that must be examined carefully.

Checklist for Indian BPO partner selection

An offshore BPO service provider must excel in several areas to qualify as a viable outsourcing partner:

✔ **Company management**
- Level of experience with call centres
- Breadth of operations
- UK presence in sales and marketing

✔ **Company performance**
- Satisfactory client references
- Employee satisfaction
- Growth trends

✔ **Company financials**
- Three-year history
- Future plans and aspirations

✔ **Call centre facilities infrastructure**
- Facilities
- Back-up power
- Commuting and transportation arrangements

✔ **Technology capabilities**
- Call centre technologies and infrastructure
- Security and control
- Expansion capabilities

✔ **Telecommunications capabilities**
- Redundancy, local-loop fibre, voice over internet protocol
- Capability to handle/complete calls
- Capability to match UK reliability

✔ **Human resources**
- Recruitment and retention programmes
- Ongoing development programmes
- Accent neutralisation and syntax skills

✔ **Quality assurance/reporting**
- Proven ability to meet/exceed service level agreement (SLA)
- Ability to meet other requirements
- Ability to provide the required metrics

In addition, a global deal with such a partner must ask tough questions along several dimensions to avoid risks and maximise benefits:

✔ **Service levels**
- How do you document service levels?
- How do you avoid micromanagement and prevent the escalation of out-of-scope work?
- How do you build a contractual relationship that is manageable and focuses on benefits?

✔ **Due diligence**
- When do you allow due diligence?
- Do you allow access to financial data?

✔ **Contract**
- Do you have to contract to a baseline price and service?
- Is it typical to provide the outsourcer with any form of exclusive right to provide the services?

✔ **Termination**
- How do we provision for termination?

✔ **Transition**
- What is the process for staff transfers?
- What's an acceptable period for transition? How much should it cost? Do we need SLAs during transition?

✔ **Global issues**
- What are the legal and tax implications of signing a global agreement?
- Can we treat every country covered by the agreement in the same way?

✔ **Liability**
- What liability should the outsourcer accept in the event of unacceptable performance?

Source: PA Knowledge Ltd

Mitigating the risks

An experienced partner seems to be the key. While Indian government and industry are making a best effort to address the areas of concern, there is no better way to mitigate risk than having the right partner. The lack of BPO experience in India means experience will have to be imported. Significant support for this contention and the impact of having experienced expatriates on the ground can be seen in the experience of American Express and Providian.

In managing the outsourcing of American Express inbound customer services programmes to India, two centres provided very different results, though the quality of the infrastructure, technology, commitment to excellence, experience and financial backing in the two was similar.

Call centre 'A' had several experienced in-house expatriate managers. In addition American Express sent three people to support the effort (two trainers and one quality assurance associate). This centre accomplished the following for Amex:

- documented all Amex processes for the offshore inbound campaign – this later became the 'book' in other offshore locations;
- cut training time in half while increasing quality of trainee and agent;
- reduced agent attrition by more than 50%;
- moved agent training to a paperless process;
- substantially cut support staff requirements; and
- handled 75% more than the expected volume of calls while taking over the lead in quality (world-wide) in less than eight months.

Contrastingly, call centre 'B', with no expatriates, required more than 60 American Express foreign staff to support its ramp-up of the same programme and was delayed by over four months. The centre required almost a one-to-one ratio of Amex staff to Indian agents for the ramp-up.

For its part, Providian has ramped-up

outbound teleservices programmes at call centre 'A' at least twice as fast as any other site in India (most other sites do not have in-house expatriate support like this call centre had for the ramp-up of that programme). Tellingly, Providian vendor managers have complained about other Indian call centres in the following areas:

- communication gaps;
- lack of understanding;
- no sense of urgency; and
- lack of experience.

The lack of operational experience of BPO Indian managers makes importing that experience in the form of on-the-ground expatriates critical. Such a move also helps overcome some of the cross-cultural risks.

Few Indian call centres have hired this kind of experience and those who do rarely have these expatriates involved in the hands-on management of operations where they can do the most good. Processes can be done in India at or above international best practice standards but there are significant risks which need to be carefully managed.

In addition to finding a partner who has experienced expatriates on the ground who will assist in managing the operations of your processes, there are specific things you should be looking for (see Checklist, left).

A value added intermediary

The benefits of moving to India are significant in terms of cost, human resource, quality focus and government support.

It is important to have the right partner to mitigate the risks of lack of experience, cultural and geographical distance, and even telecom and information security concerns. Given the difficulties associated with finding that kind of partner, those considering BPO to India should get the assistance of a value added intermediary (VAI)* with intimate understanding of the Indian market, extensive cross-culture business ability, and depth of experience. **F&M**

** Proactive Business Solutions (www.proactbiz.com) functions as a VAI providing a range of services to international companies.*

Do enterprise planning systems measure up?

Corporate enterprise systems – or enterprise resource planning (ERP), as they are collectively referred to – are a hot topic. However, as **Dennis Keeling** contended in his October lecture to Faculty members, the dream has not materialised and most corporates have to tackle deployment in a mixed-mode fashion.

At the start of his lecture, Dennis Keeling pointed out that the main scenarios which a corporate may choose for enterprise-wide deployment are:

- a single (Tier 1) enterprise-wide (ERP) system;
- a strategic (Tier 2) stand-alone system in each operation;
- a two-tier strategy, involving a mixture of ERP (Tier 1) for large industrial units and stand-alone systems (Tier 2) for local medium sized and smaller units; and
- disparate systems, such that each unit/division chooses its own solution.

In order to improve real-time reporting and simplify the tangled mess of the typical financial reporting system, many international corporates are reviewing their information systems. Unfortunately, Keeling said, choosing a replacement is not easy.

At one extreme is the hugely expensive enterprise-wide 'one system fits all' approach which can take years to implement let alone show any clear benefit. At the other is abdication, with the divisions choosing their own systems. For those with budget constraints but with a real need to get quick results and access to key information, the choice has not been easy.

A compromise

Now, though, there are developments that allow a compromise between ERP and abdication that can show real benefits in months rather than years. Traditionally companies have used a stand-alone accounting infrastructure and, where feasible, centralised processing. These accounting systems are rarely standardised, more often they are locally sourced in the country of operation. They rarely communicate with each other – relying on consolidation of management and financial information by external systems like spreadsheets or hard-copy reports. Outside the accounting infrastructure is usually an ad hoc information system to supply management with daily/weekly/monthly operating control information.

> There are few examples where the dream of linked systems has been realised

Companies wanting to improve on these traditional methods have considered implementing enterprise-wide (ERP) systems throughout the organisation. The dream was to have all the systems linked together, not only accounting but also sales, stock, purchases, manufacturing and human resource. In practice, Keeling observed, there are few examples where this dream has been realised.

The last five years have seen the evolution of packages from vendors like Baan, JD Edwards, Oracle, PeopleSoft and SAP. In the boom IT period in the late 1990s these solutions replaced legacy systems with Year 2000 problems. Over the last few years other players have started to move into this enterprise-wide market: manufacturing specialists like IFS, mid-range suppliers like Scala and Microsoft (see 'Types of business application' table on page 6).

The key selling points between the early entrants and the current players are becoming less distinct but total cost of ownership (TCO) is becoming key.

The debate continues between the ERP, enterprise-wide solutions and the best-of-breed stand-alone solutions which they replaced. Both sides still claim successes. The fact that one such stand-alone customer relationship management (CRM) system from Siebel has grown to be third largest software developer in the world proves, said Keeling, that best-of-breed cannot be discounted. However, he pointed out, its immediate peers are all ERP solutions. The leading financial best-of-breed solutions are Agresso, Coda and Systems Union.

The significant developers
While there are several significant ERP developers for the Tier 1 market, the Tier 2 market is more fragmented. Few developers have the resources to develop truly international systems that can be deployed in most countries around the world. The leading international players are Microsoft Business Solutions, Sage and Scala.

The mid-range system architecture has been developed for stand-alone client-server solutions. Many have 'fat' clients resulting in heavy network loading which is not ideal for wide-area deployment. Whilst many have launched web-client interfaces few have been taken up due to security and performance considerations.

Keeling pointed out that although there are nearly 300 members of the Business Application Software Developers' Association (BASDA) – of which he is chief executive – less than 20% develop Tier 1 or Tier 2 solutions. The vast majority of the software developers provide specialist solutions which are, in the main, country-based.

> Most software developers provide solutions which are country-based

A local specialist solution may meet the functional requirements when the product is purchased. But as the business changes these solutions rarely have the capability to adapt to those changes. In the main, specialist solutions have a simple generic core that is adapted to specific customer requirements. This bespoke tailoring provides a very tight fit but makes it difficult and expensive to upgrade or modify the system later. Specialist developers derive their income stream from these modifications.

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A recent survey on ERP systems commissioned by Scala shows that most corporates have a mixture of all these systems. Many have started to implement ERP systems only to find they are not meeting their expectations. They still have some centralised processing and see no alternative to having stand-alone locally sourced systems in developing markets and third world countries. In many cases they prefer to use Tier 2 systems for their smaller subsidiaries irrespective of location (see 'Business software issues' table, below).

Enterprise-wide systems can cope with the huge numbers of users involved. But whilst they are capable of handling the complex needs of central finance or manufacturing, they are not ideally suited to handling the less complex needs of branches or sales offices in remote countries. They are inept at handling the needs of smaller

Types of business application

- **Tier 1 – Enterprise-wide**
  J D Edwards, Oracle, PeopleSoft, SAP
  Full suite, workflow, self-service portals, 4GL environment for specialist systems
- **Tier 2 – Best-of-breed**
  Agresso, Coda, SquareSum, OpenAccounts
  Financials + MIS, definable interfaces to other systems
- **Tier 3 – Mid-range**
  Exchequer, Exact, MS Great Plains, Navision, Sage ES, Scala, SunAccount
  Financials, order processing, assembly
- **Tier 4 – Entry-level**
  Sage Line 50, TAS Books, Quick Books
  Financials, invoicing
- **Tier 5 – Home /office**
  Microsoft Money, Money Manager, Quicken
  Cash books
- **Specialist**
  Alphameric, IFS, Intentia, Misys
  Banking, hairdresser, hotels, complex manufacturing, plant hire, retail

Source: Dennis Keeling

Business software issues

- Network/web-centric computing
- Relational database
- Desktop integration
- Information retrieval
- Flexibility
- International design
- Workflow – best practice processes
- EMU/euro compliant
- Self service portals
- object oriented/component design
- Electronic commerce
- Electronic reporting – XBRL

Source: Dennis Keeling

subsidiaries who need some but not all of the complexity.

Most organisations are a diverse mixture of large and small operations, covering sales and distribution and in some cases manufacturing. Whilst most mid-range system developers claim that their systems are scaleable, in reality they are only used in operations of up to 100 concurrent users at a single site.

Huge ERP investment rarely justified

The huge investment in rolling out complex ERP systems is rarely justified, Keeling said. The computer press, over the last two years, has been full of stories of failed projects, cost overruns and customer dissatisfaction with their ERP implementations. Few of the main vendors managed to achieve that truly global roll-out. Some tried to use partners with limited success. Others, that had developed their software to be multi-currency, multi-language and adaptable for individual country fiscal and legal requirements, expected the corporate customer to take the responsibility for the international deployment and configuration.

The total cost of ownership (TCO) of deploying enterprise-wide systems has become a major concern. Even though licence fees may look similar in this heavily discounted market, there is a huge disparity between the excessive cost of deploying and maintaining a Tier 1 system and the low costs of a Tier 2 system.

In many cases the financial reporting and management information systems supplied in mid range systems are rarely up to the same standard as Tier 1 solutions. Frequently third party reporting tools are supplied which are never as well integrated to the underlying data as custom developed tools. Few Tier 2 solutions have advanced workflow capabilities and very rarely have the complete enterprise-wide suite of applications. Usually customer relationship management (CRM) and human resources (HR) are missing; manufacturing and logistic modules tend to have basic or patchy functionality (specialist functionality developed for a specific customer).

With the move to international accounting standards (IAS), and spurred on by the recent outbreak of US corporate failures, companies are under closer scrutiny from both auditors and shareholders. They are concerned about getting financial information that meets local accounting standards, as well as US GAAP (generally accepted accounting principles) and emerging international standards.

These emerging standards will affect the way assets are depreciated, and the way profits are calculated and reported. The underlying systems will not change but the data may need to be converted from one format to another. One thing is sure, he added; following the corporate scandals over the last few months, auditors will be scrutinising accounts in a lot more detail in future.

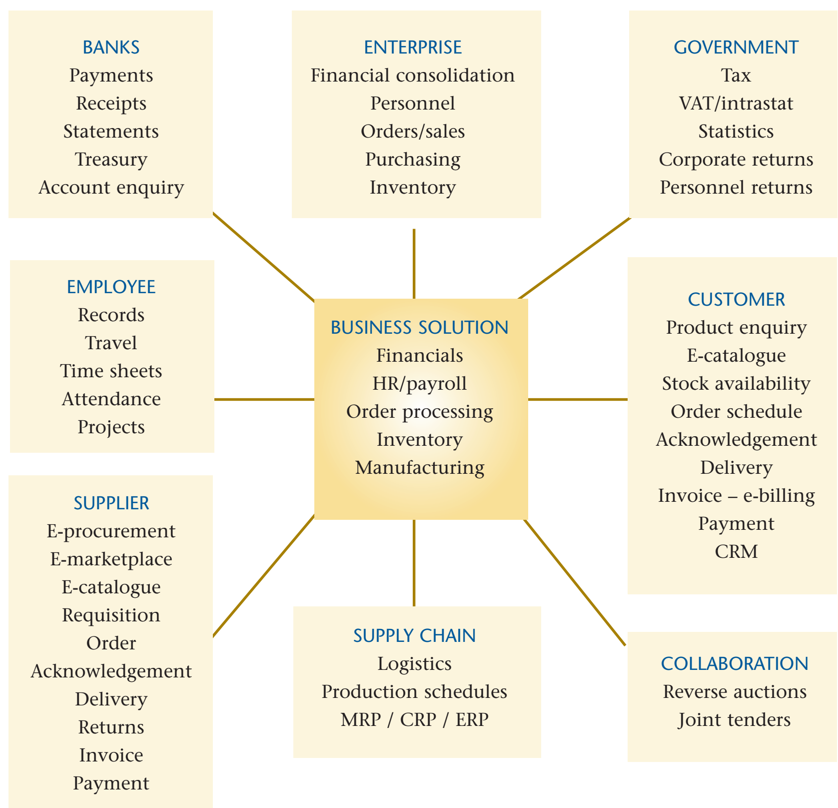
The best way forward

In summary, Keeling suggested that the best way forward is to adopt a strategic solution based on a two-tier strategy. By selecting a Tier 1 system and a truly international mid-range Tier 2 system, significant savings can be achieved.

This approach can keep implementation and support costs firmly under control, he said, by using local implementation partners and a realistically priced mid-range systems architecture.

Information flows allow near-live operational data to be made available to all levels within the corporate organisation. These systems can also link to those big industrial sites using Tier 1 manufacturing systems – but of course they are designed for ease of use and adaptability by all the other units and offices, comprising the corporate structure. (For a general overview of e-commerce patterns today, see Figure 1, below.) **F&M**

Figure 1 **E-commerce today**



Source: Dennis Keeling

FRS 17 – a major worry for SMEs

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Although the implementation timetable for FRS 17 has been amended whilst the International Standard is reviewed, its implications cannot be ignored. In the following article **John Tranter** details just how serious the impact of adopting FRS 17 could be for SMEs.

In recent months, financial markets have taken a battering. There was a time when those of us who are financial managers, with involvement in managing the financial effects of the company's pension scheme on the company, could view such issues from the sidelines. We were comfortable with the received wisdom that defined benefit pension schemes take the long view and that any changes to rates of return could be gently smoothed through the company's operations and financial results.

If there was any complacency it must now be shaken off. FRS 17 has major implications for the sound financial management of SME businesses. By impacting on net asset values FRS 17 will raise serious issues for shareholders, bankers and those receiving normal trade credit.

The implementation timetable for FRS 17 has been amended whilst the International Standard is reviewed, which provides a little breathing space to consider the implications. However, if implemented as proposed, the effects of FRS 17 on the balance sheets of SMEs could be dramatic.

Volatility

The background to FRS 17 has been well covered in the financial press and the full details of the accounting methodology are better dealt with elsewhere. Suffice to say that the effect of FRS 17 is to reflect the volatility of the markets in the provision you may need to make on the balance sheet for your pension scheme if it is of the defined benefits type (defined benefits pensions are those that are typically linked to final salary). FRS 17 lays down a specific methodology for matching the long-term pension liability of the scheme against the assets of the scheme. The projected liability is discounted back using the 'AA' bond rate to give a present value for the exposure. This is then matched to the market value of the pension fund assets, normally a mixture of equities, bonds, property etc.

> The performance of the markets is of much more immediate relevance today

The important point to grasp is that there are two elements that drive the volatility in the assessment of the FRS 17 valuation – the AA bond rate, which affects the liability calculation, and the market value of the assets which are held against the liability. Hence the day-to-day performance of the markets is of far more immediate relevance today than it was seen to be in the past. Market changes have to be reflected immediately and not smoothed as before.

In just a few months after May 2002, the FTSE 100 fell by over 20%. At the time of the Asian crisis in 1998 it fell by the same amount. The AA bond rate has fluctuated between 5.5% and 6.25% which can make a difference of 20% on the liability side of the equation. And the hit on one side of the equation is not necessarily balanced by a benefit on the other. In fact a 'double whammy' of reduced asset and increased liability is possible. The impact of this volatility can be material – pension scheme assets can be vast compared with the company's net assets.

Well-established

What does this mean in practical terms? Take a fictitious company 'SME Ltd', with turnover of £15 million, earnings before interest and tax (EBIT) of £1.5 million and £1.5 million of shareholders funds. Like many companies it has a well-established pension scheme with assets of £7 million, which the actuary has declared to be fully funded. The trustees of the scheme have not pressed for a rise in cash contributions by the company.

The finance director, being proactive, has asked for an FRS 17 valuation for the company for the last balance sheet date. This tells her that there is a provision to be made of £1.5 million caused by the volatilities described above. Having recovered from her shock what are the implications she needs to consider?

The main issue is the effect of the provision on shareholders funds. SME's net assets are £1.5 million. The effect of FRS 17 is to wipe them out completely. SME now has no shareholders funds and can pay no dividends, as there are no longer any distributable reserves.

In addition, SME has a bank loan, which has a covenant that SME must maintain shareholders funds in excess of £1 million. SME is potentially in breach of this covenant and the bank could require immediate repayment of the loan.

SME, in common with all businesses, relies on trade credit. Many of SME's suppliers take out credit references from the major credit assessment organisations. These use net assets as one of the measures of credit worthiness. SME's credit rating might fall thus forcing SME to look for additional funding.

Finally, SME Ltd is backed by venture capitalists who will not be interested in increasing their investment in order to recapitalise the business unless there are significantly enhanced earnings as a result. SME will not be in a position to pay them their annual dividend. (SME Ltd until recently was owner-managed and the previous owner's pockets were certainly not deep enough to recapitalise the business.)

Challenges
What are the options for our finance director? She understands the numbers. The next step is to start talking to people. Many of those third parties, the banks, investors etc, are still unaware of the challenges which FRS 17 is putting on the table for SMEs.

From a broader perspective the credit rating agencies, banks, venture capitalists, and other creditors need to design new approaches to assessing a company's stability which take into account the volatility recognised by FRS 17. A key indicator of risk is the size of the pension fund relative to the company's net assets.

The example above may be a little exaggerated from the 'average' position that will be experienced by SMEs when they look to implement FRS 17. However this scenario is far from unthinkable. It is therefore imperative that financial managers recognise the impact of FRS 17 on their companies, take advice and talk to the relevant stakeholders. Company advisors need to ensure that their clients are looking at these issues now.

In the meantime let us hope that the bear market is nearing its end and that normal service and returns will be resumed shortly. **F&M**

Retail shrinkage – not just a fact of life

Attention to detail is a key ingredient of commercial success. Here **Stuart Lodge** looks at 'shrinkage' in the retail industry and argues that it is not an inevitable part of the business, but can be controlled with a sensible strategy – to the benefit of the bottom line.

Shrinkage – the erosion of stock levels through petty pilfering (internal and external) or genuine error – is currently at unprecedented levels. Yet it appears to be a common view among retailers that these levels of 'shrinkage' represent an inevitable and unalterable fact of life. Indeed, even the financial controllers and operations managers of some of our major high street retail organisations seem to accept objectively unacceptable percentages of shrinkage as just 'part of the retail business'.

This shrinkage is what used to be known as stock loss, whether made up of missing stock, cash or errors caused by inefficiency. And, contrary to the passive view many retailers seem to take of the problem, retail security specialists who have spent many decades in the field maintain that it need not exist at the prevailing high levels

To gain some insight into the extent of the problem represented by this uninsurable loss to retailers, consider the British Retail Consortium's last estimate – based only on the large high street retailers – that in 2001 some £1.8 billion of stock went missing in this way.

That estimated figure excludes the many retail businesses in the UK lacking sufficiently sophisticated systems to be able to calculate, with any meaningful degree of accuracy, what they are actually losing. Yet – the high street giants apart – retailing in this country is based on thousands of these small businesses, usually working on a gross profit percentage basis. In such circumstances, the retailer can only estimate that a loss has been suffered through a reduction in its margin, but this fails to tell it what has been lost.

The cost
Today the euphemistically named 'shrinkage' is very much the norm, for a variety of reasons. Shoplifting, for instance, is hardly treated as a criminal offence these days by the courts – it has almost become 'acceptable'. Similarly, the shop assistant who pilfers some of his/her employer's cash from the till or takes home some goods, hardly merits the interest of the Crown Prosecution Service, certainly not in our larger cities. But such shoplifting and pilferage – further euphemisms for theft – are crimes for which the consumer ultimately pays. Everything we buy nowadays contains a small mark-up to cover the uninsured losses caused by retail dishonesty. If all retailers saved the 2% (or more) that is actually being lost through dishonesty and error, their shrinkage problem would disappear.

> Funds are often wasted on inappropriate solutions

Also, what must not be overlooked is the huge amount spent on security measures. Often senior management has fixed views on the causes. Unfortunately, these views are frequently erroneous and funds are often wasted on quite inappropriate solutions, instead of being directed at the real causes of loss.

A recent study by the University of Florida described current efforts to deal with the situation as follows: "an imprecise science based on perception. It is widely agreed that present day retail loss prevention is not even close to being an exact science. Nevertheless, loss prevention professionals every day are forced to make significant and costly policy decisions based on very limited and sometimes inaccurate information about the problems which they confront."

Security staff (guards, store detectives, management) and hardware (CCTV, EAS tagging, etc) are all expensive ongoing costs which, again, are added to the prices that customers end up paying. The Retail Consortium estimates this amount as £0.6 billion per annum – making a total annual cost to the retailer, (and, ultimately consumers) of £2.4 billion.

However, the established view that shrinkage and its associated added security costs are an unavoidable part of the retail business, for which the consumer will pay, is changing. In the current economic climate consumer spending is not buoyant, margins are low and competition is fierce. In this situation, pro-active retailers are always looking to increase margins, not through price increases – a non-starter for most – but by reducing unnecessary and uninsurable losses. And the method for doing so is increasingly through outsourcing.

Seeking a solution

In-house efforts at shrinkage control have not been very effective. It is not unusual to have a security manager in a retail business, even today, measuring his success by the numbers of shoplifters detained and dishonest staff dismissed. An increase in either figure is viewed as an improved performance, but it obviously is not. It merely emphasises that prevention and deterrent controls have failed, and certainly nothing has been achieved in reducing losses.

An in-house team of security and audit personnel, with all the added costs, creates a major overhead for retailers of all sizes.

However, outsourcing these functions is cost-effective, due to the on-call availability of security personnel to react at short notice and the opportunity to have compliance audit operatives working at arm's length and not subject to internal company policies. Thus, the modern approach is to use loss control or loss prevention programmes.

Identifying causes

How do these programmes work? They start by accepting that every retailer is an individual business with its own unique problems. What benefit can there be in deciding that shoplifting is the retailer's major cause of loss, and then making a substantial investment in store detective coverage when the area that should be addressed is that of internal staff dishonesty? Why add large labour costs to a perceived problem that may not be the cause of any loss?

In some cases, the business may have grown so quickly that procedures have not kept pace with expansion. In others, the existing system is now out-dated and does not match the needs of modern trading and current labour laws. In each instance the experienced retail security specialist will view every potential client as a 'green field site' and then establish which are the most vulnerable areas in the business and define where the root of any shrinkage problem may lie.

> The modern approach is to use loss control or loss prevention programmes

Procedures – the key

Perhaps the procedures need updating – in which case an in-depth review of the system would disclose where these need enhancement. The one basic cause of shrinkage is broken rules, by staff, customers, delivery services or human error. Many in the retail security industry believe that staff dishonesty is at least equal to customer theft, so it is essential to put in place control procedures.

Additionally, establishing the information derived from branch reports (using the benefits of modern technology) and how management evaluates such returns, should highlight exception branches or departments warranting remedial attention. Physically visiting and assessing the sharp end – where the money is taken – provides the facts which determine the difference between reality and what head office may wish to believe. Combined with additional covert monitoring, this enables a detailed review to be produced, with recommendations for improvement and a programme for ongoing prevention and control.

From such a sound and professionally established base, a programme of this kind should have an immediate effect on shrinkage, both existing and future. Compliance auditing and covert monitoring to ensure that the established system is being adhered to will establish a large degree of deterrent and control.

This will also raise the profile of security in any business, and demonstrate to the branch management, and the staff, that their head office and senior management are committed to an ongoing policy of loss control and prevention. The ability to respond at short notice to a request to investigate any security problem also enhances such a policy.

Specialists, with long experience in the field of retail security, have for many years provided these loss control and prevention programmes. By outsourcing this function, those retailers who have an accurate system of stock control can make substantial reductions in shrinkage, and those working on a gross profit basis can improve margins.

All should show highly beneficial reductions against their own in-house costs of dealing with shrinkage, and thus bring about an improvement to the bottom line. **F&M**

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Why the New ACA is relevant to business

The New ACA Professional Stage came into operation in 2000, the Advanced Stage in 2001, and the new work based learning requirements were implemented during 2002. The Institute's **Anna Coen** explains how the new approach to learning and assessment creates a powerful financially based business qualification.

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If someone is needed to prepare a company's statutory accounts, manage its auditors, ensure that adequate financial controls and systems exist, and manage the funding and capital structure of the business, then the answer is probably to recruit a qualified chartered accountant. These are the traditional areas which newly qualified chartered accountants might take on.

However they can also expand far beyond these traditional areas. In fact more than half the Institute's membership works in business and the majority of FTSE 100 finance directors are chartered accountants. The objective of the New ACA qualification is still to capitalise on the traditional strengths but at the same time recognise that the current demands of business require a greater flexibility and responsiveness. Businesses want individuals who can:

- maintain objectivity whilst also taking personal responsibility;
- demonstrate technical excellence but understand the big picture;
- consider all options and then make a recommendation or take a decision;
- be reliable whilst taking appropriate risks; and
- show loyalty to the business whilst maintaining ethical standards.

Where does the New ACA fit in?
The New ACA is intended to develop individuals capable of technical excellence in a business context.

The 'technical excellence' element of the ACA qualification has been strengthened by:

- requiring students to understand concepts and principles as well as rules; and
- asking students to consider the relevance of technical knowledge to the real world.

The 'business context' part is strengthened by:

- introducing new subjects relevant to business (eg the new Advanced Stage specifically includes large sections on corporate transformation and change management); and
- looking at technical applications from the business perspective rather than business from the technical perspective.

These improvements are achieved in three ways: by delivering an integrated approach to professional development; through the focus of the new assessments; and by asking students to link their studies with what they are doing in the workplace.

Integrated approach
The three-year training contract ensures the student undertakes a structured training process that links real experience with studies and assessments on an ongoing basis. The Institute also believes that the demands and pressures of modern business make it more important than ever that its historic and traditional insistence on the highest standards of ethical behaviour and practice, backed by a strong disciplinary and supervisory machinery, is active and vigorous. Therefore students will be expected to consider ethical issues

Institute forum on IAS issues

The pace of development in financial reporting is hotting up. The European Union (EU) requirement for all listed companies to use international standards (IFRS) by 2005 could be extended to all other entities that currently use UK accounting standards, including small and medium-sized enterprises (SMEs), according to a recent DTI consultation paper.

Before the end of this year, the International Accounting Standards Board is expected to issue new and controversial draft standards dealing with share-based payments and business combinations. The Institute is to host an open discussion forum on the business combinations in London in early 2003. To register an interest in attending, contact: cara.billen@icaew.co.uk.

For information on these and other IAS developments, members should visit the Institute's web site at www.icaew.co.uk/library and a brand new site, www.iasknowledge.com, a joint venture between ICAEW and CCH Croner.

arising from real events on a regular basis as well as undertaking a structured ethics training programme.

Assessments

The six Professional Stage examinations form the technical foundation and include business management, business finance, financial reporting, audit, tax and finance. There are also two devolved assessments in company law and commercial law.

Next, the Advanced Stage comprises three examinations. Its two Tests of Advanced Technical Competence (TATC1&2) assess the application of technical knowledge through addressing business problems. TATC1 is framed around the business environment and TATC2 is framed around the business lifecycle. This contrasts with questions that in past years asked students to address problems by technical area eg a tax question or a financial reporting question. Now, students will be expected to know which technical areas they need to draw on and how to apply them.

Examples of TATC requirements set in the context of specific scenarios might be:

- to help an organisation understand the steps it needs to take and risks it needs to address when considering an acquisition, merger, demerger, new investment, overseas expansion;.
- to consider options and put forward a recommendation given the reduction in a company's share value; or
- to comment on the financial strategy of an organisation given changing circumstances.

The third examination in this section, the Advanced Case Study, extends this approach to a larger business scenario and the focus forces students to think about how to apply their professional skills in a complex, changing and often conflicting environment.

> The New ACA gives responsibility beyond the professional role

Work based learning

The new work-based learning requirements mean that on a regular basis students have to answer staged questions that link what they are doing in the workplace to their professional development. Examples of these questions might be:

- *communication stage 3*: what recommendations have you made after a recent piece of work? Were your recommendations accepted or rejected? Assess why in either case and whether communication played a part.
- *business awareness stage 2*: what do you consider to be the main threats to your organisation? How does your work help you identify them?
- *professional judgement stage 2*: for one key issue you dealt with, what factors influenced it? What impact did the issue you were dealing with have on other areas of the business? and
- *application of technical knowledge stage 3*: how has the work you have undertaken added value to the organisation? What technical skills have been most useful in this process?

Finally, there is a service for students called 'links with the real world', which selects key articles from the Financial Times and ask students to consider topics that enable them to link real events with their own professional development and study.

Conclusion

We believe that the New ACA enables newly qualified chartered accountants to make the transition from training in practice to fit within a particular business organisation and take responsibility beyond the professional role.

At the same time we are collaborating with business organisations to encourage their employment of students training to be ACAs.

In summary the New ACA delivers chartered accountants who both demonstrate technical excellence and can see – and respond to – the bigger picture. **F&M**

TOPICS FOR 2003

Next year, as a result of member feedback, the Faculty publications will feature various in-depth articles on professional and technical issues such as:

- risk management;
- benchmarking;
- growth strategies;
- best practice;
- corporate governance; and
- budgeting.

Articles will seek to provide insight into these relevant topics, focusing on practical issues as well as reporting on new developments in terms of strategy and methodolgy.

In addition we will report on lesser-known and developmental areas such as:

- XBRL;
- professional image management;
- cycle time reduction; and
- supply chain integration.

Through focusing on this mix of issues we aim to provide both practical advice on the core day-to-day aspects of practice, as well as keeping members informed of innovative developments within the professional and technical arena.

Comments to: chris.jackson@icaew.co.uk

LEGAL

A fair-minded look at avoiding discrimination

Eleanor Freeman is an assistant solicitor for the employment, pensions and benefits department at Stephenson Harwood. E-mail: eleanor.freeman@shlegal.com

As more discrimination cases are brought, and frequently upheld, how does a company avoid becoming the target of such accusations? Here **Eleanor Freeman** of law firm Stephenson Harwood outlines the various forms of potential discrimination.

There are currently three types of discrimination – sex, race and disability. Not only employees but also prospective employees are protected under the relevant legislation and employers should ensure that from recruitment through to termination of employment – including issues such as training and promotion – they treat all employees with an even hand.

Sex and race discrimination
Sex and race discrimination legislation is very similar and covers both direct and indirect discrimination.

Direct discrimination occurs when an employee is treated less favourably on gender (including transsexualism) or racial grounds. In November 2001, Neil Walkingshaw won his claim when his employer gave little consideration to his request to work part-time following the birth of his son. Four female workers had reduced their working hours after having children.

Indirect discrimination arises when a policy or criterion is applied which statistically disadvantages a particular group of employees because of their sex or race without justification. This can sometimes lead to surprising results: an employment tribunal recently held that the statutory upper age limit of 65 on an employee's ability to bring an unfair dismissal claim or receive a statutory redundancy payment was discriminatory against men and unlawful.

Disability discrimination
The Disability Discrimination Act defines a disability as 'a physical or mental impairment which has a substantial and long-term adverse effect on (a person's) ability to carry out normal day-to-day activities'. Asthma, epilepsy and depression being treated by Prozac have all been held to be conditions capable of amounting to a disability, although this does not mean that such conditions will always amount to a disability: each case will be decided on its own facts by reference to the definition in the Act. Employers can be reassured that terms such as 'anxiety', 'stress' or 'depression', even when used by medical professionals, will not necessarily be sufficient to establish a disability, unless resulting from or consisting of a clinically well-recognised mental illness and having a substantial effect on the employee's ability to carry out day-to-day tasks.

> The potential financial liability is unlimited

An employer will discriminate against an employee if it unjustifiably subjects him/her to a detriment for a reason relating to his/her disability.

An employer who fails to make reasonable adjustments to prevent a disabled employee being disadvantaged will also risk a claim. What is 'reasonable' will always depend on the nature and resources of the employer's business, but may include altering an employee's hours, adjusting premises, allowing absences for treatment and reallocating duties.

How much could it cost?
The poor industrial relations and bad publicity which can result from discrimination claims should not be underestimated.

The potential financial liability is unlimited. Damages for discrimination are based on loss of earnings and benefits – both past and future – and can also include sums for injury to feelings, personal injury and aggravated damages. Julie Bowers received a 'lousy' bonus of £25,000 from her employer Schroders in 1999 (compared with male colleagues who received £440,000 and £650,000 respectively), and following her constructive dismissal was awarded around £1.4 million by a tribunal in June this year.

Good practice
To reduce the likelihood of claims, employers should:

- formulate a written 'equal opportunities policy' (EOP) including appropriate penalties;
- give responsibility for implementation to a member of management at the highest possible level;
- publicise the EOP throughout the organisation;
- train employees in the application of the EOP; and
- examine existing practices, policies and procedures to ensure they do not fall foul of the discrimination legislation.

The future
This area of the law is expanding all the time. European legislation outlawing discrimination on the grounds of sexual orientation and religious belief is due to be implemented in the UK by 2003, with age discrimination becoming unlawful by 2006. **F&M**

HUMAN FACTORS

Can accountants be good with people?

In her latest Update column, **Miranda Kennett** investigates the myth that accountants are, by definition, 'not good with people' – and explains how to disprove it.

Miranda Kennett is managing coach at The Coaching House and founding partner of The Management Due Diligence Co.
E-mail: Miranda@coachinghouse.com

"You know, he's great at the figures, but not very good with people – after all, he's an accountant." So runs the briefing I've been given on more than one occasion in relation to a prospective client and his/her development needs.

This is always somewhat mystifying because, in my experience, there are plenty of accountants who confound the stereotype by being very good with people. For example, a chief financial officer I coached was the member of the management team who, in their recent downsizing, made sure that both the outplaced and the survivors were treated humanely. This approach saved the company money and avoided serious trauma.

Another good example is (accountant) Andy Taylor, who is now chief executive of the successful music company Sanctuary plc, which he has built up over 25 years. He is financially shrewd but, more importantly, he has developed a strong team, all of whom have exceptionally strong relationships with the artists they manage and represent, relationships worth many millions of pounds in royalties, record and ticket sales.

> Stereotypes can contain a grain of truth

Yet it is usual for stereotypes to contain a grain of truth. So how, then, has this perception arisen that accountants are people who prefer the clinical purity of numbers to relating to their fellow men and women? Could it be the expectations others have of the profession (or the profession has of itself) as 'arbiters of truth', influenced only by the facts and not by sentiment? The less you are expected to show your human side, the harder it becomes to reveal the likeable aspects of your personality, not just your professionalism.

Perhaps it is the high degree of technical competence required by the tasks accountants have to perform in their early years which encourages concentration on accomplishing the project in hand, sometimes at the expense of the niceties of the process.

Address the problem now

For whatever reason, any reader feeling that the stereotype could be applied to him or her, should start to address the problem now, because without the ability to work effectively with people, the prospects of future success are limited.

However good you are personally at your job, the next step up the ladder inevitably leads to working with others to achieve results outside your individual capabilities.

And, although in theory a senior job role allows you to tell people what to do, in practice issuing orders proves to be a pretty ineffective way of eliciting good performance in others.

However, if you're someone who has spent more time pursuing a task than considering the people embedded in it, do not despair. The great news is that emotional intelligence (what this ability boils down to) can be increased. Emotional intelligence, the factor which research shows is significantly present in those who are consistently successful, is defined as the ability to understand and manage our own emotions and those of others.

A good starting point is to tune in to your own feelings and name them. Work out what tends to trigger your emotions – positive and negative – and how you handle yourself when your emotions are aroused. You may have become so good at hiding your feelings, others may think you don't have any and you yourself may have suppressed your awareness of them. You can extend your skills by spotting emotions in others, at home and at work. Try listening carefully for meaning – after all only 10% of communication is carried by the words we use, the rest by tone of voice and body language.

> Tune in to your own feelings and name them

In effect I am suggesting you start to exercise an under-used muscle and, just as when you first try this in the gym, it will seem like hard work. However, it will get easier and you will become fitter, in this case for being an effective professional.

The truth is that, if you can extend your competence in this way you will find yourself in great demand. After all some of the best 'people people' aren't very good at the numbers.

Question: what do you call an accountant with great people skills? A CEO! **F&M**

FORTHCOMING FACULTY EVENTS

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

2003

22 January
EVENING LECTURE (Chartered Accountants' Hall, London)

'LINKING VALUE WITH VALUES – THE BEHAVIOURAL ASPECTS OF FINANCE' – MALCOLM LEWIS, STRATEGIC VALUE PARTNERS

With people and organisations moving ever faster, Malcolm Lewis of Strategic Value Partners will discuss 'hard' and 'soft' organisatonal issues, showing that linking value with values is the key to creating long-term success. Registration is at 5.45pm; the lecture is at 6.00pm; the buffet and networking start at 7.00pm.

19 February
EVENING LECTURE (Chartered Accountants' Hall, London)

'FINANCE OF THE FUTURE' – SCOTT PARKER, PARSON CONSULTING

Scott Parker, managing director of Parson Consulting, will discuss the pressures on the finance function, including reliability of information, speed, efficiency, complexity and increasing demands from the business. Registration is at 5.45pm; the lecture is at 6.00pm; the wine, buffet and networking start at 7.00pm.

RECORDINGS OF FACULTY LECTURES

The following lectures and conferences held by the Faculty in 2002 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.

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

28 MAY PAY FOR PERFORMANCE – DIRECTORS' REMUNERATION
Ruth Bender of Cranfield School of Management discusses the structure of directors' remuneration in the context of creating value for shareholders.

18 SEP HUMAN CAPITAL – MEASURING PEOPLE AS ASSETS
Andrew Mayo, a consultant on international human resource management, discusses how to balance people's cost with a quantitative measure of their value.

18 FEB ENTERPRISE PLANNING (ERP) SYSTEMS – DO THEY MEASURE UP?
Dennis Keeling of BASDA, the international software standards body, explores the pros and cons of these systems and looks at software industry trends.

Guidance on prospective financial information (PFI)

Publication of the Institute's guidance paper for UK directors on PFI is due in mid-2003, following the end of the consultation period this month. Here we summarise the main points to be covered in the document.

The guidance emphasises that markets and investors need PFI that is relevant, reliable, comparable and understandable. The promptness and clarity of profit warnings, for instance, are areas of recent interest that fall within its scope.

The guidance is based on a framework of principles derived from the Accounting Standards Board's Statement of Principles. It encourages directors to adhere to the concepts of business analysis, subsequent validation and reasonable disclosure, when preparing PFI for publication.

The consultation draft is in three parts. It builds up to Part C which guides directors through the rules that require and regulate common types of PFI published in the UK. Part A comprises principles for making PFI useful in helping investors make decisions. Part B summarises the legal and regulatory framework that UK directors need to bear in mind when they provide PFI to investors. The principles and the regulatory framework reinforce each other and both are used to support the specific guidance in Part C.

Although the guidance is designed to set a 'gold standard' for reporting PFI disclosure, it also provides a framework for other kinds of forward-looking information about strategy, future plans and risk.

Benefits
If this approach is adopted as best practice, it will:

- help to underpin investor confidence in the reliability and quality of PFI disclosure as a sound basis for their investment decisions;
- provide a set of benchmarks that directors, investors, analysts and commentators can use to assess the quality of PFI and promote improvement;
- help directors to address legal risks in the current liability environment as well as risks of reputational damage; and
- reinforce directors' efforts to prevent or correct unrealistic market expectations and thereby reduce the pressures such expectations create for aggressive earnings management. **F&M**

For further information, contact Desmond Wright at the ICAEW. E-mail: tdwright@icaew.co.uk

PFI – THE SCOPE

Published financial information comprising primary financial statements and elements, extracts and summaries of such statements and related disclosures drawn up to a date, or for a period, in the future. PFI includes the forward looking equivalent of any information that might subsequently be prepared as historical financial information:

- announcements of changes in expectations;
- working capital statements;
- estimates of funding requirements;
- profit forecasts;
- merger benefits statements;
- illustrative financial projections issued by OFEX companies; and
- other voluntary disclosures, eg in the OFR.

IN JANUARY'S MAILING...

Finance & Management, Issue 95

- Corporate governance issues for finance directors
- Leadership – a report on the recent Faculty workshop
- Sustainability and stakeholder reporting
- Measuring intangibles – selecting the right tools
- Updates on tax and treasury developments

(Please note – F&M contents may change)

Management Quarterly, Issue 18

This issue looks at 'risk' from a number of angles.

- An overview of risk management issues
- Practical advice for operations and systems
- The special factors in managing marketing risk
- Financial and treasury risk management
- Business continuity and crisis management

Finance & Management

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