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MANAGING PEOPLE

WHAT CAN GO WRONG IN TEAMS – AND WHAT TO DO

VALUATIONS

BRAND AND REPUTATION FOR PRACTITIONERS

STRATEGY

REASSESSING EUROPE'S ECONOMY

CORPORATE FINANCE

THE IMPACT OF STRUCTURED FINANCE

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This publication is produced in parallel with the Braybrooke Press publication of the same name and published quarterly. It is compiled and edited by Roger Mills, professor of accounting and finance at Henley Management College.

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

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The articles contained in this and previous issues of this publication are available (to faculty members only) on the faculty website at www.icaew.com/managerupdate.

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FOREWORD

PRACTICAL MANAGEMENT

Chris Jackson
Head of faculty

Emma Riddell
Technical manager

The faculty has always supported the need for softer skills for members in business, and this is one of the reasons we have 'management' as part of our title. But some trainers at the touchy-feely end of the soft skills spectrum can see the world through rose-tinted spectacles and make unsubstantiated generalisations which we are expected to accept. Even if you are an analytical accountant. It is therefore refreshing to read academic articles on practical topics. Academic articles require greater effort from the reader but they can also be more rewarding. Statements are substantiated and references are provided for those that wish to dig deeper.

The article on managing teams by Richard McBain is such a piece and it usefully complements the faculty's special report, *Managing Teams*, which you will have received in June. Working as part of a team or leading one is a fundamental skill for the accountant in business and the faculty has a wealth of material on the website if you want to develop this competence. There are also references to related articles on page 19 of this issue. It counts as continuing professional development, as long as it's relevant to your needs.

Another faculty belief is the importance of finance working with colleagues in other functions. The article on brand and reputation highlights how important it is for finance to work with marketers to tease out what drives sales in an open dialogue and non-technical forum.

By the time you read this you will know all about sub-prime, not least because of Northern Rock. It is important to note that Roger Mills's article was written before the Northern Rock crisis came to a head. It provides an interesting and timely overview of the issues faced by structured finance.

CHRIS JACKSON and EMMA RIDDELL

CONTENTS and EXECUTIVE SUMMARY

WHAT CAN GO WRONG IN TEAMS – AND WHAT TO DO ABOUT IT

Richard McBain, director of specialist masters and doctoral programmes at Henley Management College.

Recent research on effectively using teams includes issues such as:

- barriers to helping behaviour within teams;
- social 'loafing' and perceived unfairness in team processes; and
- workplace deviance, undermining behaviour and the formation of subgroups.

This article examines the findings in this range of research and also looks at approaches to reducing the risk of using teams, such as what is the potential impact of leadership on workplace deviance? Clearly teams do not always function as they ought to, despite their significance to success in modern organisational structures.

BRAND AND REPUTATION VALUATION FOR PRACTITIONERS

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

The accounting treatment of intangible assets is problematic, yet businesses have attempted to evaluate them as key drivers of performance. However, their ultimate value lies in the minds of stakeholders and a good reputation seems to enhance an organisation's 'licence to operate' in a society increasingly concerned with corporate responsibility.

This article looks at the evaluation of brand and reputation through both financial assessments and social perceptions, and why, after 20 years, there is no agreed methodology or definitions.

THE IMPACT OF STRUCTURED FINANCE

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

How much evidence is there for the so-called subprime lending 'implosion'? How much 'toxic' debt exists, and who owns it? This kind of financing should be cause for concern as at some point it will have to be accounted for. It comprises part of 'structured finance', a term widely used yet inconsistently defined, and this article explores its uses and management, including collateralised debt obligations, securitisation and intellectual property.

The growth and appeal of structured finance is likely to continue yet it is essential to be aware of its regulatory challenges.

THE EUROPEAN ECONOMY – AN UPDATED ASSESSMENT

Bill Weinstein, professor of international business and director, the Henley Centre for Value Improvement.

While the European Union (EU) is an impressive example of uncoerced linkage of different nations, its economic performance is less grandiose. With many new members of the EU and the euro currency zone (ECZ), the situation seems to be becoming more complicated and an overall assessment is due.

This article provides an overview, exploring the Scandinavian 'myth', ECZ policies that threaten to widen differences and the diverse destinies of the 'marginals'. China and India may have demanded more attention recently, but changes inside Europe command a renewed interest.

WHAT CAN GO WRONG IN TEAMS – AND WHAT TO DO ABOUT IT

There is enormous emphasis placed in today's business world on the importance of teamwork. What is it that makes teamwork so important to us? What are the weaknesses of the team approach to work and how can we overcome them? Here, **Richard McBain** provides an overview.

Teamwork, it seems, is now a fact of working life. Whether as a member of a project team set up to achieve a specific task – or a permanent unit such as a customer service or executive team, and whether co-located or virtual – it is likely that everyone has experienced membership of one or more teams. Indeed, for some the greater emphasis given to teamwork has changed the nature of their jobs. As Jackson et al[1] contend "... the very conceptualization of job performance has changed, as the concept of 'doing a good job' has become more dependent on the concept of 'being a good group member.'" Why, though, has teamwork become so popular?

Clearly, the range of knowledge, skills and abilities provided by a team-based approach can deliver more effective task completion, creativity and learning. Effectively using teams, though, means minimising or avoiding a range of potential problems. This article will examine recent research that considers a number of important issues such as barriers to helping behaviour within teams, withholding behaviours or 'social loafing', perceived unfairness in team processes, workplace deviance, undermining behaviour and the formation of subgroups as well as the impact of acute stress on teams. In addition, it considers approaches to reduce the risk of using teams, including selection procedures, the structuring of work, training and development, and also leadership characteristics.

Managers should be proactive and deliberate in promoting team learning

Richard McBain, director of specialist masters and doctoral programmes at Henley Management College.

Maximising the benefits of diversity in levels of expertise

One of the key potential benefits of working in a team is the learning that may take place between members of the group that have different types or levels of knowledge and expertise. This learning, of course, requires that members are willing to share their knowledge and expertise, and where this is the case diversity can be a positive benefit rather than a source of complexity or conflict. But what are the factors that contribute to helping behaviours within teams?

Van der Vegt[2] and his fellow researchers set out to examine the factors that may hinder the goal of increasing the overall expertness and effectiveness of a group through the passage of knowledge from the more expert to less expert. Their focus was on intra-team helping and the commitment, or attachment, to other team members as well as on team effectiveness. Some of their conclusions in a study of 24 small teams were that:

- members of groups were more committed to – and more likely to help – those members who were perceived to be more expert – particularly if they themselves were perceived to be more expert;
- the less expert members were forced to rely on help from other less expert members or hoped that more expert members would reciprocate the commitment, or help, that they were giving them; and
- groups that had diversity in levels of expertness that did achieve intragroup learning were more effective.

Their study suggests powerful dynamics can impede team learning. Managers should not, therefore, automatically expect learning to take place, but be proactive and deliberate in promoting team learning and helping behaviours in teams where there is a diversity in levels of expertness.

Mentoring relationships may encourage more expert members to offer help and advice to the less expert, but other incentives may also be required. In addition, actions that develop a sense of team commitment – through shared goal development and rewards – may assist, as may keeping teams together over time, since the more expert members may eventually be induced to extend to those that are less expert the commitment and helping that they themselves have received!

'Social loafing' – the problem of withholding inputs

Effective teams also require that all members contribute sufficient effort, skills and abilities to achieve collective tasks. So-called 'social loafing' occurs when team members withhold these efforts or contribution. Price[3] and his colleagues – in a study of more than 140 project teams – developed and tested a model to explain why members withhold effort in teams. They considered factors including:

- member composition in terms of demographic dissimilarity and differences in member knowledge, skills and abilities;
- the extent to which members perceive that their contributions are dispensable, and the extent to which they perceive team processes to be fair; and
- the extent to which a specific individual's contributions are identifiable.

They found, unexpectedly, that social loafing did not seem to be linked to whether there was a team process that identified and evaluated an individual's own separate contribution. In contrast, perceived fairness in team processes was linked to loafing behaviour – especially when an individual thought that their contribution was dispensable. This feeling was less likely amongst those who had task-relevant knowledge, skills and abilities. Indeed, there was some evidence that the more team members are dissimilar from each other, the more they perceived their contributions to be dispensable and team processes to be less fair.

Overall, this research indicates that perceptions of dispensability and, in particular, the perceived fairness in decision-making procedures, are the keys to minimising social loafing behaviour. Accordingly, managers should structure tasks so that they provide individuals with a sense of autonomy and responsibility to reduce perceptions of dispensability. They must also scrutinise decision processes so they are seen to be fair. Finally, they should seek to integrate team members who are dissimilar from others.

Geographical fault lines in teams

The theme of member differences or diversity is also pursued by Polzer[4] et al, who have examined the 'fault lines' that may split a group into various subgroups. These are dividing lines based on team members' perceptions of different social categories, such as demographic differences, which are shared within subgroups but differ across subgroups. They cause people to categorise members of their subgroup as an 'in-group' and other subgroups as 'out-groups'. Fault lines and subgroups may create problems for teams in developing trust and managing conflict – both characteristics are required to enhance team effectiveness.

The research focuses on whether differences in geographic location may be a source of fault lines. This is a practical question as organisations increasingly rely on work teams across varying locations to perform core work activities. In a study of 45 teams engaged in a short-term project, the

Members reported better relations with close peers than with distant colleagues

authors found differences in location could become incorporated into work structures, such as through shaping communication patterns. In addition, members typically reported better relations with close peers than with distant colleagues and differences in location became a basis for social categorisation, or differentiation, especially when the dispersed teams had subgroups based at the same site.

Interestingly, the main source of potential problems arose where a team had just two co-located subgroups. Such teams had more conflict and less trust than teams which were more fully dispersed. The issues were especially pronounced where the subgroups were equally sized and had a homogeneous membership, for example, in terms of nationality. The relevance of this research is that the division of work within teams is often made on the basis of co-location. While this may be an advantage for task performance it may reduce communication between subgroups leading to an 'us versus them' mentality which leads to reduced performance. To address this risk, managers should:

- avoid creating teams with strong fault lines, for example by adding members from a third location or adding members with similarities that cut across particular locations;
- emphasise joint team performance and identification with the whole group rather than just a subgroup. This can be done, for example, by training and collective rewards; and
- focus on full team communication, for example using email or intranet communication that is available to all members.

How acute stress breaks teams down

Research indicates that teams are unable to function properly under acutely stressful conditions. The mechanisms through which stress impacts performance, though, have not been made clear. Under conditions of acute stress team interaction may decline but, it seems, it isn't the frequency of communication which impacts team performance. Rather, the answer is likely to lie with the quality of communication. To try and answer some of these questions, Ellis[5] examines the role of mental models and transactive memory on team performance. Mental models and transactive memory have different functions but they both enable a team to process information by collectively encoding, storing and retrieving it.

- Mental models are the psychological maps of knowledge that members of a team have relating to other members: their characteristics, duties and needs and how they fit together. Team members need to hold similar mental maps for the team to be efficient. In this

way mental models perform an integrating function; and
- Transactive memory refers to the co-operative division of labour teams have for learning, remembering and communicating relevant team knowledge. It is represented by behaviours such as sharing, sending and requesting information based on team members specialism or expertise. In effect, it is a system for storing, retrieving and distributing knowledge. It helps team members to know who knows what, what information to pass to each other and when to request information from appropriate people. In this way it has a differentiation function by focusing on differences in team members' roles and responsibilities.

In a study of 97 teams, Ellis found that acute stress did in fact reduce team performance: he manipulated stress by applying time pressure and by the threat of video taping and public displays of the worst performers! He also found that the impact of team mental models and transactive memory could together fully explain how stress impacts performance. Under acute stress, team members narrow their breadth of attention and become more self-focused. A sense of common identity weakens, as does the perception that a task requires an interdependent team effort. Mental models and transactive memory therefore represent the cognitive and behavioural mechanisms through which acute stress affects team performance.

To counter the negative effects of stress, managers could restructure teams so that members do not need to allocate attention to their team, by broadening roles. This would negate the importance of team interaction mental models and transactive memory. In unstable and unpredictable environments divisional structures – in which team members have broad and independent roles – may outperform function structures where team members have narrow specialised roles. Another quite different option would be to enhance team interaction mental models and transactive memory through team training – eg cross-training where each team member is trained in the duties of other team-mates.

High self-esteem can produce antisocial behaviour

People engage in socially undermining behaviour when they act in ways that seek to hide or harm another person's ability to establish and maintain positive interpersonal relationships, to achieve work-related success and to maintain a favourable reputation. Examples include publicly criticising, belittling or not listening to people. Such behaviour can lead to negative job-related attitudes and behaviours as well as to diminished well-being. Why, though, do individuals engage in such socially undermining behaviour? One factor could be the amount of such behaviour in the social context, which influences an individual's own behaviour. Another factor may be the personal characteristics of an individual. Duffy[6] and her fellow researchers in two studies of about 200 groups considered whether a person's levels of self-esteem or neuroticism could explain their response to the levels of antisocial or aggressive behaviour in the environment.

Self-esteem refers to the overall evaluation that people make of themselves, while neurotic individuals are prone to negative emotional states including nervousness, anxiety, moodiness and worry. The research found that high levels of undermining behaviour in a group was associated with high levels of individual undermining behaviour, but only among individuals who had both high levels of self-esteem and of neuroticism.

Individuals who have low self-esteem may be more susceptible to influence from external and social cues but may view environmental negativity as self-diagnostic and not yield to group undermining influences. By contrast, individuals with high self-esteem may be more likely to engage in antisocial behaviours where they perceive their prestige or esteem to be threatened and because they are typically more confident in their opinions and less likely to fear reprisals. A high level of neuroticism also makes individuals strongly sensitive to potential punishment signals in the environment, which may build upon concerns regarding potentially threatening environmental conditions.

Undermining behaviours are, therefore, not just acts of revenge against other group members – they are likely to be responses, directed by transferred norms and values, intended to achieve an individual's goals such as retaining relative status. Managers seeking to avoid or minimise such behaviour should bear this in mind, and the key practical implications of this research are that:

- undermining behaviour has its origins in both personality and contextual factors and therefore situational interventions alone, such as punishment for offenders, may not be sufficient to eliminate social undermining in work groups; and
- organisations could use selection processes to filter out aggression-prone individuals, but they should also consider designing team training around ways to manage conflict and also highlight the impact of individual differences.

Under acute stress, team members narrow their breadth of attention

Looking for collectivism in team members

Another approach that seeks to maximise individuals' contributions to teams is to identify those employees with the potential to be effective group members. Individuals who are highly 'collective' have just such a propensity. Jackson[7] and her colleagues have sought to develop a new measure of collectivism and to link scores on the measure to aspects of group member performance.

In terms of their measure, collectivism has five different aspects:

- preference – to be working in a group rather than alone;
- reliance – a sense of collective responsibility that makes members comfortable relying on other members of the in-group;
- concern – being motivated by a concern for the well-being of the in-group and its members;
- norm acceptance – compliance with norms and rules of the in-group in order to foster harmony with the collective; and
- goal priority – group goals take priority over individual goals.

In a study of 186 employees of a computer software firm they explored collectivism's linkage with four dimensions of job performance:

- task performance;
- citizenship behaviours – discretionary behaviours that lie outside an employee's job description;
- counterproductive behaviours – intentional behaviours contrary to group's interests (these are similar to deviant behaviours considered in the next section); and
- withdrawal behaviours – psychological and physical avoidance of group and its work (these are similar to social loafing behaviours).

They found significant relationships between psychological collectivism and job performance, with the links to task performance and counter-productive behaviour being the strongest. Higher levels of collectivism led to higher task performance and greater citizenship behaviour and to lower levels of counterproductive and withdrawal behaviours. This research suggests that for jobs where co-operation is vital, organisations may wish to maximise collectivism through selection procedures or through employee development programmes and should seek to incorporate collective strategies and approaches in team-building programmes.

Leadership's role in reducing workplace deviance

Finally, we consider the potential impact of leadership on workplace deviance, which involves behaviour that intentionally violates organisational or social norms and harms the organisation or its members. Examples include stealing, work avoidance, social loafing, disregarding instructions, lateness and alcohol abuse. Brown and Trevino[8] considered whether 'socialised charismatic leaders' have an influence on levels of workplace deviance. Such people are a role model of ethical conduct and help their followers transcend self-interest for the good of the group. They may influence deviant behaviour in the workgroup through developing a sense of shared mission and through a process of shared values. In a study of 150 work groups they found that:

- higher levels of charismatic leadership were associated with lower levels of interpersonal and organisational deviance and higher levels of perceived values congruence between leaders and workgroups; and
- this congruence of values between leaders and workgroups seems to explain the link between socialised charismatic leadership and lower levels of deviant behaviour directed towards other individuals, but it was unrelated to organisational deviance ie, aimed at the organisation.

This study is important for linking ethics, leadership and workplace deviance and demonstrates socialised charismatic leadership may reduce workgroup transgressions. It suggests that values congruence is the social influence mechanism for interpersonal deviance but not organisational deviance. This may be because trust in senior management may be more important than trust in people's immediate supervisor. The research suggests that another reason why an organisation may benefit from developing transformational leaders, and also why there is a need to focus also on ethics and to bring leadership and ethics training and development together.

Conclusion

Teams are widely used because they can help organisations achieve their goals, and their prominence in modern organisational structures is a key success factor. Clearly, though, teams do not always function as expected. ■

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BRAND AND REPUTATION VALUATION FOR PRACTITIONERS

Reputation is a slippery phenomenon resistant to quantification, but for any business to function successfully, reputation needs to be accounted for. Below, **Nuno da Camara** claims it is increasingly necessary for financial practitioners to engage with the more subjective and non-enumerative approximations of social perceptions and organisational relationships in order to put a fair price on brand and reputation.

Widespread media coverage of brand studies such as the *Business Superbrands* survey have highlighted the importance of brand equity and organisational reputation to corporate earnings.[1] Whilst the accounting treatment of intangible assets is problematic – and only strictly required for mergers or acquisitions at present – businesses have resorted to various methods in the attempt to evaluate brand and reputation as key drivers of business performance.[2]

This article discusses the valuation of brand and reputation as understood by marketing and communications academics and practitioners. Such a discussion intends to improve the dialogue between practitioners concerned with what might be termed the externally-driven value of corporations and other managers, especially those in finance, who may focus on more traditional metrics when evaluating performance.

Brand and reputation as performance drivers

The key role of brand and reputation in business performance is today generally undisputed since differentiation of product and corporate associations are crucial to successful stakeholder relationships. Such factors as, for example, name awareness; customer loyalty and perceived quality are vital to current and future earnings. Brand and reputation are highly intangible factors that organisations can manafge, rather than control. Their ultimate value lies in the minds of stakeholders, and is only realised through the latter's relationships with the organisation.[3] Brand equity, or the value of a brand in consumers' minds, is "a reservoir of future earnings."[4]

Clearly, branding is focused on the marketing and consumer behaviour realm. Reputation, though, can be defined as "a perceptual representation of a company's past actions and future prospects that describes the firm's overall appeal to all its key constituents when compared with other leading rivals".[5] Reputation, therefore, represents a wider concern with all stakeholder groups including the organisation's impact on and influence with investors, regulatory authorities, employees and communities. A good reputation, it seems, enhances an organisation's so-called 'license to operate' in a society increasingly concerned with corporate responsibility.

Brand valuation

The attempt to calculate the value on the balance sheet of such intangible assets as a brand has spawned an entire industry.[6] Such valuation is also important for internal management decisions around brand investment and management. Despite its potential financial and strategic importance, a clear way to value brands remains elusive and a variety of methods are in use.[7]

Different brand valuation methods include historic cost-based analyses of brand expenditure and replacement, which are fairly easy to use due to the ready availability of such data. In reality, however, the accumulation of costs rarely relates to the market value of the brand.[8] Imagine, for example, how a well-known corporate brand ultimately reduces the expenditure necessary for the development of new products and how advertising costs may decrease comparatively over time as a brand establishes itself. A more realistic reflection of brand value might involve the direct valuation of brands according to their potential market price. This approach is subject to the variability of market conditions, however, and assumes the

The accumulation of costs rarely relates to the market value of the brand

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

availability of easily comparable transactions that may not necessarily be obtainable.

Perhaps the most productive methods are economic use or revenue-based approaches. These project future cash flow associated directly with the brand to value the incremental income that a brand can generate over an unbranded equivalent and discount backwards to a present-day value.[9] The premium pricing method, for example, ascertains the price premium of a branded product against a generic business to assess the contribution of the brand. Such generic alternatives, though, are becoming rarer in today's heavily branded environment and an alternative approach may be an earnings split or royalty relief approach. In the former, earnings above a break-even economic return are attributed to various classes of intangible assets, one of which is the trademark or the brand. A market-based royalty rate (ie percentage of sales) takes a certain trademark or licence and seeks to calculate the brand's contribution to overall sales in a comparable business.[10]

Again, however, both the subjectivity of the earnings split and the relevance of a royalty rate based on market prices for other businesses can be questioned. Such approaches – and their potential disadvantages – are not simply questions for academic debate. Both economic use and revenue type approaches have, for example, been popular ever since Interbrand conducted its first discounted cashflow valuation for Rank Hovis McDougall in 1988,[11] when the company believed its brands were undervalued during a hostile takeover bid.[12]

All approaches raise key questions around brand valuation. First, it is important to distinguish whether it is the brand itself – in terms of trademarks and patents and the brand name – or the branded business as a whole which is being valued.[13] Second, all approaches face the critical issue of 'separability' – or how to distinguish and identify which factors make up brand from the other intangibles and tangibles in a business. It is always difficult to identify, let alone separate and value, intangible assets such as brand name, business processes, management quality and so on, from each other.[14] Thus, a large degree of subjectivity exists whatever the valuation method, and new ways of evaluating are constantly being developed.

Reputation valuation

In theory, the same issues that apply to brand valuation also apply to estimations of reputation value. The picture is further complicated by the fact that reputation-building activities – such as public relations and corporate communications – are always difficult to identify and separate from each other. Unlike licences and trademarks, for example, there are no clearly established and tradeable reputation assets to give some indication of real market value. Reputation also differs in other ways. It is more obviously an outcome of business activity rather than a managed input, and relates to all stakeholder groups rather than the customer-based focus inherent in marketing-focused estimations of brand value.

> The evaluation of reputation tends to involve a personal assessment of organisational relationships, rather than a strict financial calculation

Most practitioners and academics agree that reputation is crucial to organisational success. A good reputation can help attract and retain employees, attract suitable investors, reduce transactional costs and increase leverage with suppliers and regulators, as well as affect a company's strategic marketing options, such as premium pricing.[15] Corporate reputations have "bottom line effects" and a good reputation "enhances profitability".[16] Yet the nature of reputation as an amalgam of external perceptions amongst a range of stakeholders has meant its evaluation tends to involve a personal assessment of organisational relationships, rather than a strict financial calculation.

Fombrun is one of the few in the reputation literature to define reputation in financial terms, stating that reputation capital is the excess market value of a company's shares – or the amount by which the company's market value exceeds the liquidation value of its assets.[17] Reputation, he insists, can be calculated as a financial asset. Yet his definition is synonymous with the more common interpretation of intangible assets as a whole – including other factors such as brand, management quality, customer relationships and employee motivation that all impact on productivity and income generation.[18] One might ask if Fombrun is indeed suggesting that reputation should be equated with intangible assets as a whole and that it is indeed inextricable from those other factors as a reflection of intangible rather than a business input? A clear answer, though, is not apparent.

A more obvious question may be how to estimate the role reputation plays as an individual intangible asset. Bowd and Bowd[19] use Fombrun's Reputation Quotient (RQ) – a percentage based evaluation of external perceptions – and his definition of reputation capital to suggest a way of approximating the elusive role of reputation and its impact on market value. Under the assumption that reputation is what differentiates companies from their immediate competitors – which is a generally accepted notion – they compare the relative differences between a company's proportion of intangible assets to market value with the industry average and, similarly, between a company's RQ for the industry average, using both differences to estimate a percentage value of intangible assets that is related to reputation. The assumption here is that other intangible factors, such as management quality, brand recognition and business processes, can be held relatively constant across the sector and the remaining difference is attributable to reputation.

This is of course highly contestable, although it is a more refined attempt at understanding reputation as one factor within intangible value rather than the equivalent of all intangible factors as Fombrun does, and comes closest to attributing an evaluative figure to reputation. Using this method, Bowd and Bowd[20] estimated the reputation value of Microsoft, for example, to be 21.5% of its market value at the time of measurement. Despite many public relations practitioners' desire to adopt an acceptable valuation method to report on company accounts, most companies do not use such calculations or brand type valuations,[21] ie premium pricing or market-based valuations, in the realm of reputation management.[22] Instead, they tend to opt for simpler perceptual analysis surveys, using criteria for evaluation like Fombrun's Reputation Quotient or Fortune's America's Most Admired Companies,[23] which are cheaper to produce and less likely to be questioned by financial practitioners. Further work remains to be done in this field.

Non-financial valuation methods

In fact, the growing view amongst both marketers and accountants is that understanding the real drivers of brand performance and revenue – or what might be termed the actual story behind the brand – is what really matters.[24] As we've already shown, brand or reputation value is subjective, as it resides in people's perceptions and emotions. Attempting to relate that to economic value may be little better than structured guessing[25] and – useful as it may be to have a financial evaluation that can be capitalised on the balance sheet – knowing that brand represents a certain value or percentage of assets may not be that informative. Managers in a variety of business functions beyond marketing and communications appreciate that while brand value starts with perceptions, it eventually leads to a payoff in hard cash. It is therefore unsurprising that marketers instinctively focus on the evaluation of stakeholder perceptions through a range of activities from conducting quantitative customer surveys to "finger-in-the-wind" methods.[26]

Qualitative research techniques are also used to identify possible brand association and sources of brand equity. Consumer-based brand equity measures are generally attitudinally-based and various models (such as Young & Rubicam's Brand Asset Model, Total Research's Equitrend and Interbrand's Top Brands) or approaches have been developed over the last 20 years to gauge stakeholders' views.

In academic circles, the consumer-based brand equity view has been championed by academics such as David Aaker and include mostly qualitative and subjective factors such as loyalty, name awareness, perceived quality, associations, brand personality and brand salience, with no absolute score existing for each.[27] When considered together they provide some description and partly measure a brand's value to consumers though, just like IQ tests, no one can quite agree which is the most suitable method.[28]

Marketers and communications people often have a good understanding of what drives sales and client relationships at the coalface of a business

Financial reporting of brand and reputation

The complexity of evaluating brand and reputation – either financially or through the assessment of social perceptions – should not detract from the larger aim of improving corporate information on so-called intangible assets. Clearly, financial evaluations of brand and reputation need to be developed further. Financial practitioners, though, must increasingly learn the language of marketing and encourage marketers to think about the ways value can be attributed to brands and perceptions amongst clients, employees, suppliers and secondary stakeholders.

Marketers and communications people often have a good understanding of what drives sales and client relationships at the coalface of a business. Such information needs to be teased out and nurtured by accountants in an open dialogue and a non-technical forum.[29] The inherent difficulties of attempting to evaluate brand and reputation should not stop companies from reporting on stakeholder relationships through more attitudinally-based surveys and qualitative methods. Such measures would help to inform managers and investors of the value-creating properties of brand and reputation, even if their exact role in generating income can be difficult to identify and separate from other intangible factors.

In effect, such information would help to fill in the gaps in the accounting framework and provide further comfort to stakeholders on the crucial role of intangible assets in organisational value.[30]

Conclusion

Serious attempts to financially evaluate brands over the last 20 years have failed to lead to an agreed methodology. Brands may therefore be more usefully understood through the study of consumer perceptions. Any link to hard financial data raises questions about both subjectivity and concepts. The importance of reputation is undeniable. Yet this is even more difficult to ascribe to discrete revenue-generating activities in companies. Brand equity as a value generator is a component of reputation, relating as it is to the outcome of brand activities amongst consumer audiences.

We have to conclude that a suitable valuation of reputation as a value-enhancing activity for organisations is not well developed, and definitions equating it with the totality of intangible assets are severely lacking.

Some progress has been made with approaches that combine perception-based surveys with financial data on intangible assets, but it remains to be seen whether these will be acceptable to the accounting institutions and economists whose role it must be to develop such attempts at quantification.

Meanwhile, the reporting of corporate information should, as far as possible, include non-financial estimations of brand and reputational value as indicators of likely future revenues for organisations. Clearly, it is increasingly necessary for financial practitioners to engage with the more subjective and non-enumerative approximations of social perceptions and organisational relationships, if they are to fully appreciate the complex but all too real factors that drive revenue generation and stakeholder trust and motivation towards businesses. ■

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23 Fortune asks 13,000 senior executives, outside directors and financial analysts to rate competitor on eight attributes: quality of management, quality of products and services, innovativeness, long-term investment value, financial soundness, ability to attract, develop and keep talented people, responsibility to the community and the environment, and wise use of corporate assets.

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ROGER MILLS

THE IMPACT OF STRUCTURED FINANCE

A relatively new breed of loan based on highly complex terms that take into account unusual factors and offer a high-risk source of funding is a growing source of finance for many businesses. Such financing may be of concern to us all, as millions lost on the backs of such deals still have to be accounted for and borne by the financial world collectively. **Roger Mills** explores the appeal and growth of this type of investment.

Many readers will have heard about problems in the US 'subprime' market.* Subprime lending, which is also sometimes called 'B-Paper', 'near-prime' or 'second chance' lending, refers to the practice of making loans to borrowers with credit history problems who do not qualify for market interest rates. Such loans or mortgages are risky for both parties due to the combination of high-interest rates, bad credit history, and murky financial situations of many subprime applicants. Subprime loans, because of the increased risk, are offered at a higher rate than A-paper loans. Subprime lending encompasses a variety of credit instruments, including subprime mortgages, subprime car loans, and subprime credit cards.

If you think the subprime problem has little or nothing to do with you, you may need to reconsider. So far, some argue, there has been muted evidence of what some speculators referred to as a 'subprime implosion'. One key issue that's not altogether clear, though, is exactly how much really 'toxic' debt is out there and who owns it?** Rathbone of www.breakingviews.com suggests that there is about $500bn in low-rated subprime debt, which might be held by hedge funds, commercial banks (mainly in Europe), investment banks and possibly insurers.[1] At some point, it will have to be shown at market values, written off or somehow accounted for. The danger clearly hasn't passed, but perhaps the ultimate wind-down will be orderly. Equally importantly, as will be illustrated later, subprime debt has been attracting attention in the UK.

Although structured finance is something undertaken between financial institutions and companies, it may have an impact on many of us

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

Subprime lending and structured finance

Subprime lending is part of what has come to be referred to as 'structured finance'. This is a broad term, used to describe a sector of finance that was created to help transfer risk using complex legal and corporate entities. Unfortunately structured finance, while widely used, is rarely and inconsistently defined. The Global Financial System[2] states:

"Structured finance instruments can be defined through three key characteristics:

1 pooling of assets (either cash-based or synthetically created);
2 tranching of liabilities that are backed by the asset pool (this differentiates structured finance from traditional 'pass-through' securitisations); and
3 de-linking of the credit risk of the collateral asset pool from the credit risk of the originator, usually through use of a finite-lived, standalone special purpose vehicle (SPV)."

Structured finance has, in fact, now become a service offered by many large financial institutions for companies with very unique financing needs. These financing needs usually do not match conventional financial products such as a loan and structured finance is often highly complex. Yet, although structured finance is something undertaken between financial institutions

* Many will now be aware of the impact of US subprime problems on the Northern Rock crisis in the UK, which emerged recently.

** It is referred to as 'toxic' debt because if borrowers default on loans, these investments would be the first to take losses.

and companies, it may have a significant impact on many of us. For example, there has been phenomenal growth in tried-and-tested asset-backed securities such as commercial and residential mortgages, but one of the most significant developments has been the growth of derivative and structured credit products, such as certificates of deposits (CDs) and collateralised debt obligations (CDOs).

CDs and CDOs[3]

CDs are a form of insurance contract linked to underlying debt that protects the buyer in case of default and CDOs are a type of asset-backed security and structured credit product. CDOs are exposed to the credit risk of a portfolio of fixed income assets and divide this credit risk among different tranches: senior tranches (rated AAA), mezzanine tranches (AA to BB) and equity tranches (unrated). Losses are applied in reverse order of seniority, and so junior tranches offer higher coupons to compensate for the added risk. The bottom sections of a CDO are the ones most vulnerable to losses from bad debt, and are referred to as equity tranches, but they are also referred to as 'toxic waste' because if borrowers default on loans, these investments would be the first to take losses.

CDOs serve as an important funding vehicle for portfolio investments in credit-risky fixed income assets and grew out of the market for asset-backed securities which took off in the 1970s and encompassed mortgages, credit card receivables, car loans and even recording royalties. According to the Securities Industry and Financial Markets Association, aggregate global CDO issuance totalled USD $157bn in 2004, USD $273bn in 2005, USD $550bn in 2006, and was $158m in the first quarter of 2007, more than 50% higher than its previous first quarter high in 2006.[4]

Investment bankers have used structured products to offer their clients ways to manage risks. More ambitious products involve risk-transfer instruments that deal with weather, freight, emissions, mortality and longevity. The most immediate opportunities are probably in asset classes – such as property derivatives – that have already proven successful in America but are still emerging in Europe and barely exist in developing countries.

Structured financial innovation, according to its boosters, not only spreads the risk for investment banks' clients, but also makes the banks themselves more diversified in the quest for unrelated portfolios that do not suffer problems at the same time. However, CDs and CDOs generate some real concerns, not least because of the leverage embedded in them, which does not appear on banks' balance sheets.

The second concern is the possible need to pay out on CDs in the event of a wave of defaults. The attraction for the CDs seller, as with any insurance contract, is receiving a steady stream of payments for a risk it hopes will not occur. If its calculations are wrong, the result can be devastating.

Securitisation often involves the packaging of pools of loans or receivables and their redistribution to investors

A third and major concern highlighted earlier is that US banks have been selling the riskiest CDO portions to public pensions and state trust funds.[5] Bear Stearns, the fifth-largest US securities firm, has promoted the riskiest portions of collateralised debt obligations to public pension funds.

Securitisation, structured finance and intellectual property

Clearly, structured finance is not necessarily a bad thing – it's just that there are some clear issues associated with its use and management. One well-established use of structured finance is securitisation. This has evolved from tentative beginnings in the late 1970s to a vital funding source with an estimated total aggregate outstanding of $8.06 trillion (as of the end of 2005, by the Bond Market Association) and new issuance of $3.07 trillion in 2005 in the US markets alone.

Securitisation often involves the packaging of designated pools of loans or receivables and the redistribution of these packages to investors. Investors buy the repackaged assets in the form of securities or loans which are collateralised (secured) on the underlying pool and its associated income stream. As such, securitisation converts illiquid assets into liquid assets. For example, a collection of similar commercial loans could be packaged together, and sold on to investors. The originator of the loan will still continue to collect repayments on the investors' behalf, but can now use the cash originally tied up in the loans for other purposes.

Another way of viewing securitisation is as a financing process in which a corporate entity moves assets to an ostensibly bankruptcy-remote vehicle to obtain lower interest rates from potential lenders because the assets cannot be seized in a bankruptcy proceeding. Thus, the risk is less for lenders and they are willing to offer a lower rate. The technique comes under the umbrella of structured finance as it applies to assets that typically are illiquid contracts (ie assets that cannot easily be sold).

Are there limits, though, to what can be securitised? You might have heard of Bowie Bonds, which in 1997 securitised the future royalties of David Bowie's 287-song catalogue and pioneered the use of intangible assets as collateral in the securitisation of intellectual property (IP). Although similar IP deals were rolled out after the 1997 Bowie transaction, the original excitement surrounding the 'new trend' quickly slowed. Despite the variety of the transactions, ranging from music and jeans to comic-book superheroes and pharmaceuticals, pessimists viewed this type of financing as a freak transaction reserved for a select few risk takers – essentially, investors who could understand the esoteric components of this type of deal.

More recently, though, there has been a resurgence of IP securitisation – not because of music or movies – but because of donuts, pizzas, sandwiches and, most recently, pancakes.[6] The deal that triggered the IP comeback occurred in May 2006 when Dunkin' Brands, which runs the Dunkin' Donuts and Baskin Robbins franchises, closed a $1.7bn IP securitisation, the largest then to date. Many market observers viewed the trademark-backed transaction as a landmark deal in various ways, chiefly because of its size.

With the marketplace shifting to a more knowledge-based or 'IP-centric' economy, major investment banks have been testing the waters. Several factors are important in helping drive IP securitisations: hedge-fund driven liquidity in the market; an appetite for non-traditional assets; and a willingness to undertake more sophisticated modelling and analysis. More recent examples of IP securitisations include the US pancake chain IHOP in March 2007. Goldman Sachs closed a $200m IP securitisation backed by IHOP's intellectual property and franchising assets. Domino's Pizza also announced plans to issue $1.85bn in asset-backed securities, funded by franchise fees from its stores in a deal underwritten by Lehman Brothers. The deal will allow Domino's to refinance debt and buy back stock.

The pros and cons of IP securitisation

IP deals are more complicated to structure, but have become more than just a novelty because of interest from issuers and investors alike. Securitisations provide a cheaper source of financing for borrowers – especially below-investment-grade companies – and a higher yield for lenders. Furthermore, the traditional investor base such as hedge funds and private equity firms is also slowly expanding. Insurance companies, for example, are realising that although IP investments are more complex, ultimately they can help drive a company's success.

IP deals still have some way to go before they are adopted more generally. However, many argue problems in the subprime market will ultimately support IP securitisations. The perception that IP securitisations are riskier than asset-backed deals is dismissed by those who argue that they are not correlated with equity market returns. In other words, the stock market may go down, but people will still go to the movies! Yet there are caveats. One misconception is that these transactions can apply to most businesses and are relatively straightforward. The reality is that the legal work is complex, requiring substantial due diligence.

The most active areas this year may be restaurant franchises and films because, with a few successful transactions completed, some other chains will want to pursue the same route. The financial rationale is very simple; IP securitisation is a lower cost of funding than straightforward bank loans. For some, the potential for IP is endless, and there has been speculation about IP securitisations of books, photography catalogues, sports broadcasting rights, sponsorship and advertising, as well as TV shows and video games.

Conclusion

Clearly, the appeal and growth of structured finance is considerable and it will continue to affect our lives. Certainly, as Jobst has made quite clear, though, there are some real regulatory challenges.[7] Furthermore, in the UK in July, the Financial Services Authority (FSA) published a review of the behaviour of intermediaries and lenders within the subprime mortgage market, which services consumers with impaired credit histories.[8] It found weaknesses in responsible lending practices and in firms' assessments of a consumer's ability to afford a mortgage. As a result the regulator has started enforcement action against five firms. ■

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BILL WEINSTEIN

THE EUROPEAN ECONOMY – AN UPDATED ASSESSMENT

In this article, **Bill Weinstein** takes a broad glance at the impact of the European Union and the euro currency zone from the point of view of different member and non-member states. The European economy is becoming increasingly complex, and thus it warrants our close attention.

One oft-heard comment is that those countries furthest away from Brussels are registering the highest growth rates.[1] The citation highlights several broad-ranging concerns about the European economy, including:

- stagnation in structural reforms since the European Union's formal resolve in 2000 to promote a decade of growth through increased spending on infrastructure, R&D and education;[2]
- the disparity in growth among members of the euro currency zone (ECZ) such as Ireland or Spain, compared with Italy or France, and the significance of differences between high performers outside the ECZ like Sweden – and low ones inside it such as Italy;
- the impact on foreign or locally sourced investment of national taxation;
- the impact of European Central Bank monetary policy on economic performance, productivity and competitiveness; and
- the recurrence of nationalism – such as attempts to block or encourage cross-national acquisitions and mergers or to confer favours upon so-called national champions.

The European Union is, perhaps, the grandest un-coerced linkage of different peoples in human history. Less grandiose, though, may be the bloc's economic performance which is at the core of the 50-year old treaty intended to form a 'common market'.

General assessment – EU, ECZ, EEA

The composition of Europe is, it seems, becoming more complex. The situation is becoming more complicated with the expansion of 15 newer members (2004) of the European Union (EU), 12 members of the euro currency zone (ECZ), the exceptional relations of Denmark and Finland with the European Central Bank (ECB) interest rate policy without membership of the ECZ; and then there is the non-EU group of the European Economic Area (EEA: Norway, Lichtenstein, Switzerland, Iceland). And in the offing for the EU: 27 + 2 to enter.

What does seem clear, though, is that European economies were in the doldrums in the 2001-05 period, growing at a mere 1.4% per year in the ECZ.[3] By mid-2006, the strongest pace of expansion since the second quarter of 2000 was experienced, though that was probably driven more by a rise in consumer spending than by private or public investment.[4] One key element of any such discussion is the controversial subject of interest rate policies. Some say they constrained demand growth excessively,[5] while others argue that to alleviate slow growth the ECB adopted an expansionary monetary policy. The major economies, Germany, France and Italy, crawled whilst the USA and Asiatic worlds passed them by. The appreciation of the euro has held back exports, especially for those countries such as Italy that were unable to compensate with productivity increases.

With only slight loosening, such as small gains in productivity but even more in wages, consumption led the way towards growth, such that 2007 and 2008 growth is expected to be around 2.5% for both ECZ and EU, with the latter higher due to some faster growth areas among the new 15.[6] However, the EC itself already foresees a slowing down in 2008,[7] with domestic demand remaining the vital factor. OECD

The appreciation of the euro has held back exports, especially for those countries such as Italy that were unable to compensate with productivity increases

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

optimists, though, cite 'pent up investment demand.'[8] The workings of the EU and ECZ are far from uniform, although the Commission claims that divergences are diminishing – albeit not with regard to inflation.[9] The ECZ stimulated a continuing debate with regard to Country Risk analysis as to whether the influence of national differences upon a company would cease to be important even if a common currency diminished foreign exchange risk.[10] For businesses the differences remain significant even within a common currency area. For starters, differences run to inflation rates, taxes, and government debt. Disaggregating 'Europe' is therefore essential to this update.

Differences among members

For Jean-Claude Trichet, president of the ECB, Ireland is a 'shining example' after its GDP per capita rose from 61% of the EU average when it joined in 1973 to 125% by 2004.[11] Among the 'new 15' Slovenia has achieved ECZ status. Disparities in economic growth suggest that under a common monetary regime, different national regulatory, fiscal and labour market policies mean that countries move at different speeds and in different directions. The EU Commission, though, concedes little, stating in its November 2006 report that governments responded incorrectly to the euro's introduction and made it difficult to set a single interest rate.[12] Italy's example also illustrates how a member of the ECZ, were it free, would choose devaluation; just as others might prefer revaluation.

The one size fits all ECB interest rate is reviewed in the EEAG Report which focuses on 'stress' – this is defined as the difference between the actual short-term interest rate and the interest rate that would prevail if that country was able to follow an 'optimal' monetary policy.[13] However, this attempt to measure the single monetary policy's impact may ignore whether there would be downsides to a country's 'freedom' to use exchange rates as a mechanism of adjustment after a period of exceptional non-alignment with its trading partners, eg constraints or roller-coaster effects of critical importance for business planning. Nonetheless, EEAG suggests that over the eight years of ECZ there has not been a steady increase in the degree of business convergence. This fact rebuts the argument that monetary union would automatically reduce differences in cyclical development.[14] It also implies that the existence of collective institutions of the EU or within it, the ECZ, as well as aggregated economic data, do not excuse those engaged in trade and investment, national or across borders, from the task of analysing country-specific and market/competitive performance and risk factors of both a short and long-term nature. In this important respect, nothing has changed.

Low employment protection is not demonstrably a cause of low employment, yet high unemployment benefits do contribute to high unemployment

A Scandinavian model - myths and realities

Although burdened by myth, the delivery of high growth, high employment and macroeconomic stability combined with a generous welfare state is often perceived as the Scandinavian 'miracle'. The region's productivity has advanced at a high rate and is linked to a stronger focus on information and communication technologies than in the major EU economies.[15] This policy is supported by a well-educated workforce and skilled use of capital.[16] Releasing such advantages has, though, depended on extensive market deregulation. Furthermore, Denmark and Sweden rank among the top industrialised (OECD) nations for the percentage of their working-age population that is in employment.

Employment-generating factors involve childcare, the benefit of household income division among earners, and absence of dependent spouse deductions and the resulting high female employment. Denmark has been successful in reducing unemployment, where policy combines low employment protection with generous unemployment benefits. This combination has been prescribed for Continental European countries – but the reputation of this policy mix is largely a myth because low employment protection is not demonstrably a cause of low unemployment, yet there is evidence that high unemployment benefits do contribute to high unemployment. Denmark has significantly reduced unemployment benefits and tightened benefit qualifying conditions. Employment protection, though, has changed little from the late 1970s and the 1980s when unemployment in the country was very high.[17]

The lesson from such examples, it seems, is that market restrictions should be reduced and work incentives strengthened – such as through cuts in unemployment benefit and qualifying conditions. Interestingly, in late 2006 the elected Swedish right-of-centre government chose to promote employment through tax credits to the low paid and lower social security taxes by employers for 19-24 year olds or the unemployed. Comparisons had been drawn with German and French policies.[18] France's 35-hours working week has added €100bn (£67bn) to the national debt. According to the OECD, the average French employee works 1,459 hours a year, compared with 1,724 for the average US worker.[19]

Deepening concerns

As this year has advanced, two developments have attracted concern about the future.[20] The first is that the ECZ policies still threaten to widen differences. Spain may now be heading for a crisis, while Germany may be readying for a more robust performance. The ECB, some argue, may have induced a Spanish property bubble and a corporate financing gap of 10% of GDP. The risk, according to a Dresdner Bank economist, "is that Spain will tip over the interest rates rise, and it will be very difficult to claw its way back out again."[21] According to another economist, large areas of economic policy remain in national hands, leading to divergent trends and a vicious circle in which each country tries to recover its competitive position by wage cuts. These then cause a deflationary spiral. More empowered euro government can deal with unruly economic diversity, but that implies that divergences in the ECZ are economically harmful or even politically dangerous for some countries.[22] One alternative outcome, in theory, is a profound rupture within the ECZ, including its abandonment, if only temporarily. It is, though, unclear if we are witnessing the gradual erosion of the ECZ or simply more bumps on the road to greater integration.

A second concern arises from the election of Nicolas Sarkozy as French President in mid-year. His budget proposals, intended to stimulate growth, are likely to breach the 3% of GDP government deficit limit. This would challenge ECZ rules, but not be the first occasion either France or other members have failed to comply with the 3% rule. Sarkozy also seeks EU support for what is arguably his nation-first, free-trade second approach. This is intended to shield France from foreign competition through blocking foreign takeovers, creating national champions – such as the merger of Gaz de France and Suez – and supporting companies such as Airbus. Divergence over interest rate policy and responses to the rising euro against the US$ is causing serious tension between France and Germany over ECB policy, though this may be less important that it looks at first blush.

The diverse destinies of the 'marginals'

Staying out, or partly out of the EU, or having only a qualified connection to the euro and ECB interest rates, can be conducive to economic wellbeing is the argument of some eurosceptics. The UK experience since the ending of its relation to the ERM in 1991, and subsequent Central Bank and budget policies are key to above-EU or ECZ growth. Norway's people have twice rejected proposals to join the EU; and Switzerland has negotiated its relationship to the EU on a case-by-case

It is unclear if we are witnessing the gradual erosion of the ECZ or simply more bumps on the road to greater integration

basis, whilst maintaining as a key motivation the maintenance of its political independence from Europe. Clearly, though, the performance of new members from Eastern and Central Europe is a focus.

According to one recent study, there is an upswing in mood, with the main factor being the perceived improvement in Germany.[23] Whilst drawing special attention to Germany's labour market rigidities and lack of skilled personnel as major constraints, the report regards economic prospects as relatively robust but expresses serious concern about Hungary, with a negative 2007 probable on most measurements. Yet the general picture is positive for both ECZ and non-ECZ enterprises. There is a division within the expanded EU: in investment activity the accession countries of 2004 such as Cyprus, Estonia, Poland and Latvia (although Hungary is well below the EU average) are in the lead, whilst the laggards in forecasting investment in 2007 are the 'older' member states, Germany, France, Italy and the Netherlands. Well above the EU average, however, are the 'stand-asides' from the ECZ: the UK, Sweden and Denmark.[24]

Conclusion

In recent years economists have given more attention to China and India, the new engines of global economic growth, and to the question of whether the post-peak performance of the US economy would involve a soft or a hard landing, especially for the dollar exchange rate, and the consequences for world economic growth.[25] New European developments, recent monitoring and analyses of ongoing changes, the surfacing of new issues and revamped proposals, and changes in the position of Europe both internally and externally, command renewed attention. ■

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