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

'REAL KNOWLEDGE IS TO KNOW THE EXTENT OF ONE'S IGNORANCE' – Confucius

FORTHCOMING EVENT ...

Planning systems

8 October – In a Faculty evening lecture, Dennis Keeling, chief executive of BASDA, the international software standards body, outlines the pros and cons of enterprise planning systems.
For further details and booking form – see page 15

BACK PAGE ...

Back to basics

What the latest Hackett benchmarking survey reveals about trends in best practice.
See page 16

IN THIS MONTH'S MAILING ...

Management Quarterly

Issue 17

Marketing
From product-based to relationship pricing

Management
Developing corporate social responsibility

Optimising your shared services strategy

Finance
Financing acquisitions

FACULTY BRIEFING PAPER

Risk management for SMEs

Managing risk is at the heart of current business concerns, particularly for small and medium-sized enterprises (SMEs). This month the Faculty publishes a keynote briefing paper on risk management – and here we provide a summary of the main points.

A string of large and highly public corporate failures over the past 10 to 15 years has focused investors' and regulators' attention worldwide on the way in which company directors and managers are managing risk.

Many companies have focused on value creation as a key goal. But without adequate procedures in place to manage both the upside and downside of risk, many of them have been unable to create real sustainable value. As a result, many countries are now issuing tighter guidelines on the way in which risk is monitored and publicly reported. There is a new appreciation of the wider scope of risks facing businesses, requiring them to look at risk in a more structured way.

It is clear that risk management is now a core business process and should be planned accordingly and on a continuing basis so as to reduce risk and volatility and improve returns.

Our research

The Institute of Chartered Accountants in England and Wales has been, and continues to be, a major contributor to the debate on managing business risk. This briefing summarises recent work by the Faculty of Finance and Management looking at current practice in risk management.

> The full version of the Faculty's new 'Risk management' paper can be seen at: **www.icaew.co.uk/risk**

The Faculty first published a comprehensive guide, 'Business risk management', in 1996 when the topic was in its infancy. This was one of the first documents to view business risk as a cross-organisational technique rather than a narrow, mainly financial discipline.

Since then, risk management has become established as a core business activity. However there is still little guidance on how companies should best manage risk, who should be responsible and where to turn to for advice. This paper fills that gap.

continued on page 2

Tel: 020 7929 8486 Fax: 020 7920 8784

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Chartered Accountants' Hall, PO Box 433, Moorgate Place, London EC2P 2BJ

Main contact numbers
Tel: 020 7920 8486
Fax: 020 7920 8784
Web site: www.icaew.co.uk/fmfac

Comments and suggestions should be addressed to Chris Jackson (see below).

Chris Jackson
Head of Faculty
Tel: 020 7920 8525
Chris.Jackson@icaew.co.uk

Kirsten Fairhurst
Services manager
Tel: 020 7920 8508
Kirsten.Fairhurst@icaew.co.uk

Judith Shackleton
Technical manager
Judith.Shackleton@icaew.co.uk

Debbie Came
Administrator
Tel: 020 7920 8486
Debbie.Came@icaew.co.uk

THE FACULTY COMMITTEE

Risk paper *– from page 1*

Development of risk management

Whilst the profile of risk management has undoubtedly risen in the last decade, there has been no huge breakthrough or development of a high profile 'must have' management technique. In the 1990s the idea of managing risk throughout an organisation was relatively novel and most companies still focused on specific, mainly financial and insurable risks. The development of risk management has been characterised by a gradual acceptance that a good risk management process is an essential part of being in business.

The role of the risk manager has developed and has been refined, although it is still relatively new and appointments of board-level risk directors are only just starting to be made.

Products for managing risk have developed too. Financial and insurance markets are no longer so clearly delineated and products cross into both areas. Insurance is no longer seen as the automatic solution to deal with a risk.

There is more discussion of companies choosing their 'risk appetite' and a greater understanding that companies need to look at their own risk culture. There is a better appreciation that good communication and a learning culture, with openness, lack of blame and analysis of mistakes, is the key to effective risk management.

Enterprise risk management (ERM) as a term has attracted a lot of coverage. This coverage is welcome as it helps to increase the profile of risk management. However, ERM in itself is not a new technique as the ideas of an integrated risk management across the organisation and of risk management being embedded in the culture are central to all risk management processes.

Management of risk

Enterprises in the same industry, facing similar risks, will often choose different risk management strategies.

Any company needs to ensure that it has a proper continuous risk management process. Each company will organise differently, but the process will generally involve the following steps:

- identifying and ranking the risks inherent in the company's strategy (including its overall goals and appetite for risk);
- selecting the appropriate risk management approaches and transferring or avoiding those risks that the business is not competent or willing to manage;

Risk and the Institute

The Institute is taking a leading role in promoting the discipline that companies should report on their major business risks and on how management deals with them.

In June this year, the Institute published 'No surprises: Working for better risk reporting'. This summarised the thinking behind the Institute's stance on risk reporting and explained why companies, shareholders and other stakeholders would be better served by the provision of risk-related information.

Other relevant Institute publications have included: 'Business risk management' (1996); 'Financial reporting of risk – proposals for a statement of business risk' (1997); 'No surprises – the case for better risk reporting' (1999); 'Internal control: Guidance for directors on the Combined Code' (1999); and 'Implementing Turnbull – a boardroom briefing' (1999).

This new Faculty paper, summarised here, aims to establish good practice for the management of risk, particularly among SMEs. As previous papers have acknowledged, the dual objectives of good risk management and good risk reporting reinforce each other. An integrated risk management process should lead to better risk reporting without additional procedures.

- implementing controls to manage the remaining risks;
- monitoring the effectiveness of risk management approaches and controls; and
- learning from experience and making improvements.

Establishing overall goals and appetite for risk

Many companies are now aware of their overall goals and they usually have a formal or informal process both for recording them and (most importantly) for communicating them to shareholders and other stakeholders (in this context, 'stakeholder' includes anyone with an interest in the company).

What is not so common is the formal identification of the company's appetite for risk. There are no standard benchmarks for identifying what level of risk a company chooses to take. In certain sectors a company needs to accept a certain level of risk to operate in that environment. In other situations a company may choose a high level of risk as part of a deliberate strategy. Companies should be aware of the relative risk tolerance of others in the same sector and highlight any differences.

The risk management process

Major companies, together with academics and professional consultants, have produced risk control systems which, although varying in shape and detail between different industries, generally involve grouping and assessing risks under these headings:

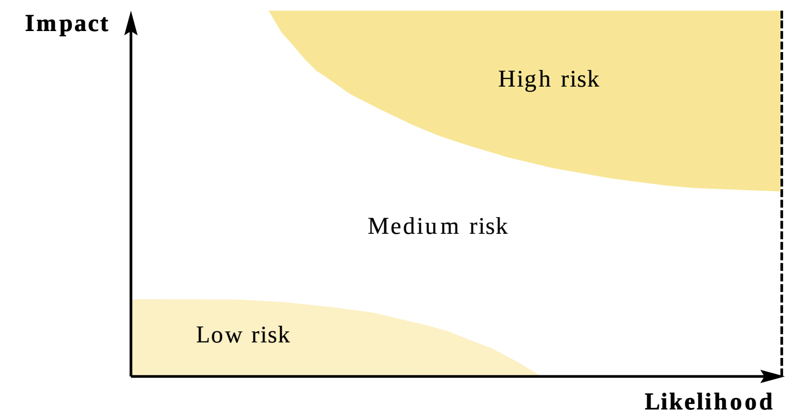
- strategic;
- operational;
- financial;
- compliance (including health and safety); and
- environmental.

Strategic risks arise from being in a particular industry and geographical area.

Operational risks arise from the various operational and administrative procedures that the business uses to implement its strategy.

Financial risks arise from the financial structure of the business, from transactions with third parties and from the financial systems in place.

Figure 1 Plotting the impact and likelihood of risks



Compliance risks derive from the necessity to ensure compliance with laws, regulations and other less formal societal expectations which, if infringed, can damage a company. Health and safety risks are sometimes straightforward and can be considered as a subset of compliance or operational risk but in many industries (eg transport) health and safety are key areas which require major resources and concentration.

> Companies should be aware of the relative risks of others in the same sector

Environmental risks can be relatively routine and covered under compliance but in many businesses (and in an increasingly large number) they are a major area requiring separate consideration.

Identifying and ranking the risks

The first and most important step is to identify the risks. This is usually done internally by management through self-assessment exercises, although, in larger companies, consultants are often brought in to assist.

The risks must then be evaluated in terms of their likelihood of occurrence and their severity if they do occur. There are a number of ways of doing this, including 'risk mapping' (*see Figure 1, above*), which plots the likelihood of the risk occurring on one axis and the severity or impact of the risk on the other.

Impact can be measured in many ways – ultimately there will be a financial effect but as this is often extremely difficult to calculate with any certainty, businesses often use a series of levels (measuring the overall effect on the business or selected business unit in a larger organisation). Whatever method is chosen it must be clear and easily understood by everyone in the organisation.

Measuring likelihood is a similar exercise. Usually a series of categories is chosen, for example linking each one to a frequency such as every day, every month, or every 10 years.

Once each risk is plotted, the chart can be divided into categories of risk, usually high (top right corner), medium and low (bottom left corner). The concentration should then be on reducing the higher risk items lying in the top right corner of the chart.

Defining appropriate actions for managing these risks

Appropriate responses must then be prepared to all the risks that would significantly affect the strategy or returns of the company if they were to occur.

Various methods are used to deal with risks, ranging from avoidance and diversification through monitoring with appropriate corrective action to hedging and insurance. Complete elimination of a risk or reduction to an acceptable level may not always be possible and sometimes the risks may be so high in a particular business or process that it is not sensible to proceed. In other businesses there may be risks (eg volatility or economic or weather) that are inherent to the business but which, so long as they are explained, investors are willing to accept if the likely return is also commensurately high. Investors, can, of course, reduce their own risks through diversification.

Generally the four main ways of dealing with risks are grouped as follows:

- accept;
- transfer (usually via insurance);
- reduce/manage; and
- eliminate.

These are sometimes referred to as the four Ts (tolerate, transfer, treat or terminate).

Taking action

Having evaluated and agreed appropriate actions and procedures to reduce the risks, these measures then need to be put in place. It is also necessary to introduce reporting and monitoring mechanisms so that senior management, directors and eventually shareholders can see that the risks are being properly considered both initially and on a continuing basis. It is important not to rely solely or even mainly on self-assessment and to include effective third party monitoring – normally through internal and/or external auditors.

Risk management is not a one-off exercise. Risks need to be monitored on a regular basis – the business environment changes rapidly, as do the ways of managing risks. It is particularly important to be alert to new risks that a business may face and to have early warning systems in place to monitor for changing risk levels.

Who should manage risk?

In small organisations, the finance director or chief executive tends to add the role of risk management to his/her other responsibilities. In larger organisations this role is likely to be undertaken by a risk management committee, led by senior executives, or board directors. The increasing prominence of risk has resulted in the new role of a board-level chief risk officer being created in some companies.

Although the finance director should undoubtedly be involved in most aspects of risk management, it is not ideal that he/she is solely responsible for risk throughout the company.

Following the Turnbull report, risk related self-assessment workshops were often led by internal audit staff. As the process has developed and with the greater general understanding that risk is a company-wide responsibility, much of the leadership has been passed on to the line management. There is a greater understanding that risk management must be led from the top of the company and needs to involve all employees in some capacity to be truly effective.

The risk management process – an overview

The key requirements of the process are to:

- identify responsibility and reporting lines for risk;
- determine your risk appetite;
- list risks within the five suggested categories (strategic, operational, financial, compliance, environmental);
- rank risks by, for example, using a matrix diagram;
- define appropriate action for risks according to the four Ts;
- take action;
- monitor regularly through better risk reporting; and
- learn the lessons and feed back into the process.

Conclusions

Although managing risk has always been considered important, it has generally been managed as a separate function. It is now important to have a company-wide, integrated procedure in place to monitor and control risks.

The overriding objectives are to reduce the downside risks and to minimise lost opportunities, and not simply to come up with processes that appear to do this in order to comply with corporate governance requirements. Good, genuine risk management processes will comply with requirements but, more importantly, will also improve the quality and returns of the business. F&M

Useful web sites

Fraud Risk Management – A Guide to Good Practice (CIMA): full text publication from CIMA's Fraud and Risk Management Working Group which provides an overview of risk management cycles and the steps towards developing and implementing a risk management strategy.
www.cima.org.uk/downloads/fraudriskmanagement.pdf

Enhancing Shareholder Wealth by Better Managing Business Risk (IFAC): study produced by the Financial and Management Accounting Committee at IFAC looking at identification of an organisation's risk profile and the response of management. Available in full text following free registration.
www.ifac.org/store/details.tmpl?SID=9559541062771

Global Association of Risk Professionals: official web site of GARP, who are a 'not-for-profit independent association of risk management practitioners and researchers'. The GARP web site includes the full text of the GARP newsletter and an archive of issue summaries for the bi-monthly journal 'GARP Risk Review'.
www.garp.com

e-gov online: useful collection of guidance material and further reading on risk management in government as part of the e-government web site.
www.egov-online.co.uk/management/risk/guidance/index.php

Risk Management: position papers, guidance and articles on risk management from the Institute of Internal Auditors in the UK. This dedicated section of the site includes the text of a sample 'terms of reference' for a risk management committee.
www.iia.org.uk/knowledgecentre/keyissues/riskandcontrol.cfm

The Institute has set up a web site collecting together all its risk resources and providing links – www.icaew.co.uk/risk.

Benedictines and business – improving the workplace

Father Dermot Tredget is a Benedictine monk at Douai Abbey. Previously he held senior management positions in the hotel and catering industry, and has an MBA and a masters degree in applied theology.

Tel: 0118 971 5325; e-mail: dermot@douaiabbey.org.uk;

(for more on Douai Abbey, see page 8).

There is more to work than just perspiration and remuneration – or at least there should be, according to **Father Dermot Tredget** of Douai Abbey, who recently spoke to a business audience, including Faculty members, about 'Spirituality in the workplace'. Helen Fearnley reports.

Monks and management might seem unlikely bedfellows, but as Father Dermot Tredget pointed out to members of both the Association of MBAs and the Faculty in his lecture on spirituality in the workplace, modern Benedictine monasteries, as registered charities, have to produce annual audited accounts. They also have at least to break even, financially, if they are to survive.

Nor are the monks themselves necessarily business 'innocents'. Father Dermot, before becoming a monk aged 36, had a career in the hotel and catering industry – including teaching catering management at the University of Surrey. He has an MBA from Bath University, and an MA from the Graduate Theological Union, Berkeley, California.

Also, the Benedictines are very long-standing pioneers of quite radical strategic planning, having survived crises and repeatedly reinvented themselves for 15 centuries.

However, most pertinent of all, in the business context, are the order's guiding principles, as set out in the 20,000 word Rule of St Benedict, their founder's 'manual of monastic life'. Written over 15 centuries ago, some of these rules, said Father Dermot, can equally well be applied to the business environment And part of Douai Abbey's pastoral programme involves exploring how a spiritual content can improve working life.

The 'working wounded'

To begin with, Father Dermot described those who might be in need of increased spirituality at work – a group he collectively dubbed the 'working wounded' (*see below, far left*).

As he observed, the load-lightening promise of new technology seems to have been replaced, in reality, by even more pressure on employees. This in turn has soured relationships at work and at home, leading to burn out and sometimes physical illness. In addition there are some workers – often close to retirement – who lack the competence to contribute in this stressful environment, and are merely clinging on until their time is served.

The extent of the problem was revealed by the 1998 *Management Today* magazine survey of 6,000 members of the British Institute of Management (BIM), resulting in league tables both of what respondents considered the top 10 personal sacrifices made for their careers (*left*), and also of the 10 things that would most improve their working lives (*below*). The latter, 'wish list' showed 'earn more money' as a fairly low

The working wounded

Who are they? Some of the problems are that:

- they are over-worked;
- relationships at work and/or home are deteriorating or have broken;
- they are bullied, harassed or discriminated against;
- they are stressed, burned-out or physically ill; and
- they are lacking the necessary competence.

Top 10 personal sacrifices

- Missed children growing up.
- Work put before home and family.
- Moving home for employer.
- Missed out on leisure and hobby time.
- Had to be away from home short-term.
- Strain on relationship often leading to divorce.
- Had to be away from home long-term.
- Time spent on work-related education and training.
- Not having or postponing children.
- Unable to form relationships.

Management Today June 1998

Top 10 wish list

- Work fewer hours.
- Change company culture.
- Work flexible hours.
- Reduce or avoid commuting.
- Work from home.
- Change jobs or relocate.
- Get more staff.
- Earn more money.
- Retire.
- Reduce stress.

Management Today June 1998

priority (eighth), compared with the desire for improved working conditions and work/life balance.

An update of that survey in 2000 showed – encouragingly – that companies were starting to initiate more family and home-friendly policies. However, it also revealed that more than half those questioned would change jobs for more time with the family; that 46% would change jobs for a better quality of life and 30% would take a salary drop for 'more time'; and that more than a third expected to have changed organisation in two years.

Perhaps most significantly, 55% were too exhausted to do anything else at the working day's end, 29% felt their lives were not under control, and women were 70% more likely than men (34% and 20% respectively of their single sex samples) to feel uncomfortable about asking for time off to tend a sick child.

So things were still far from ideal.

The spiritual dimension
Over recent years, Father Dermot explained, four elements of 'intelligence' have been identified, and can be represented on an 'intelligence compass' (*Figure 1, below*). Eysenck's original 'intelligence quotient' measure of job suitability (IQ) was joined around a decade ago by Daniel Goleman's notion of 'emotional intelligence', (EQ). There is also now the acceptance of 'physical intelligence' (PQ). Finally, a couple of years ago, Danah Zohar and Ian Marshall suggested the existence of a spiritual dimension (SQ).

The elements shown in Figure 1 (*below*) as contributing to each of the four types of intelligence need to be in harmonious balance for optimum performance in any area of life.

> The religious connotations of spirituality may be a stumbling block

However, he cautioned, introducing the notion of 'spirituality' into the workplace is not easy. Many people feel that their spirituality is personal, unique and not open for discussion. Also, spirituality is not fixed but evolves with time.

Again, it is 'experiential', in that an individual seeking spirituality might investigate several philosophies or practices before settling on one. The 'unseen' or 'transcendental' nature of spirituality is also difficult to define. Cultural influences may come into play.

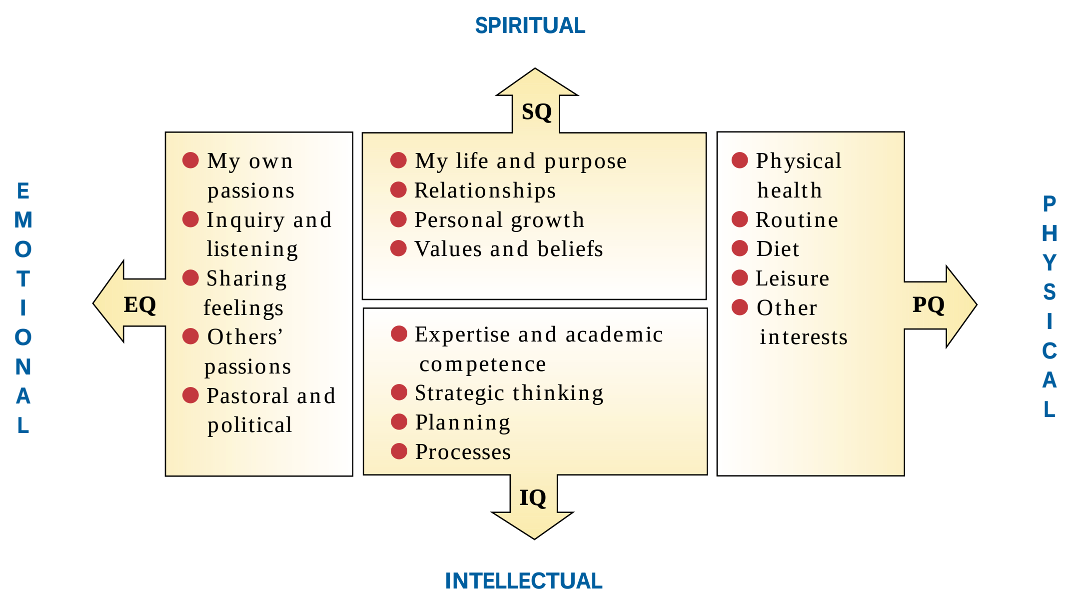
The religious connotations of spirituality may be a stumbling block (a study of the CEOs of the US's top companies indicated that, though becoming more spirituality-friendly, they were largely unhappy with any religious content). And, of course, 'spirituality', like all intangibles, is difficult to measure.

In practice, spirituality is most easily explained in terms of a relationship, which can be defined both vertically and horizontally. Vertically, the relationship is both internal (with one's mind, body, soul, spirit) and external (with a higher power). Horizontally, the relationship is with other people (especially family and the community, but also customers, colleagues, suppliers) and with nature and the environment.

Superimposing this horizontal 'sphere of influence' affects one's spiritual development ie the vertical relationship with oneself and a higher power. Similarly one's spiritual development affects one's horizontal relationship with the rest of the world. (*Figure 2, opposite*).

That horizontal component of the spiritual relationship can be very

Figure 1 Compass of four intelligences



important. It is not unusual for someone to believe they need to change jobs in search of a more spiritual environment, only to discover that they need to change themselves and their work relationships. A commitment to personal transformation is an essential part of finding spirituality, Father Dermot emphasised.

Another factor in spirituality is the right physical environment. Architect Francis Duffy in 'The new office' identified four necessary work 'spaces':

- *the hive* – open plan, humming with activity;
- *the club* – a replica of the 18th century coffee house, where deals are done, ideas are exchanged, and bonding occurs:
- *the den* – for intense communication within small groups; and
- *the cell* – a contemplative and reflective place.

The 'cell', indeed, is essential to all human beings, to a greater or lesser extent. This need not be a conventional 'cell'. For some it can be time alone in the car, a lunch-time solitary walk or 20 minutes of private meditation before work.

Monastic origins

There are significant rewards from cultivating the spiritual dimension in one's life, Father Dermot continued. These range from life long learning, improved self-knowledge, enhanced emotional and spiritual intelligence to better relationships with others (including in the workplace) and better understanding and handling of stress.

Ultimately, the goal is personal transformation. The monk is a universal archetype. For 25 centuries such an alternative way of life has existed – whether as a hermit, a nomadic truth-seeker, or a member of a religious community. The kernel is always the offering of an alternative way of life, and encouragement in the personal search for truth and meaning. It is a philosophy transcending religious, social and political boundaries. It is multinational and multicultural.

The Benedictine monks are an example of the resilience of this way of life. Formed in the sixth century, they evolved through Henry VIII's Reformation of the Monasteries by retreating to France, re-establishing themselves, and flourishing.

When they returned to Britain, they founded and ran leading public schools such as Ampleforth, Downside and, until recently, Douai. They were the main centres of learning (and repositories of written knowledge, until the invention of the printing press), they had agricultural interests (even going so far as to use an early form of commodity futures involving their sheep's wool), and were practitioners of herbal and homeopathic medicine.

The 'cell' is essential to all human beings, to a greater or lesser extent

Nowadays the rules of St Benedict can still have universal applications – including in the workplace. His teachings, for example, relate to:

- leadership;
- personal development and self-knowledge;
- organisational structures;
- the creation of 'nurturing' communities and relationships;
- decision-making and discernment;
- coping with failure and success;
- life-work balance; and
- ethical behaviour.

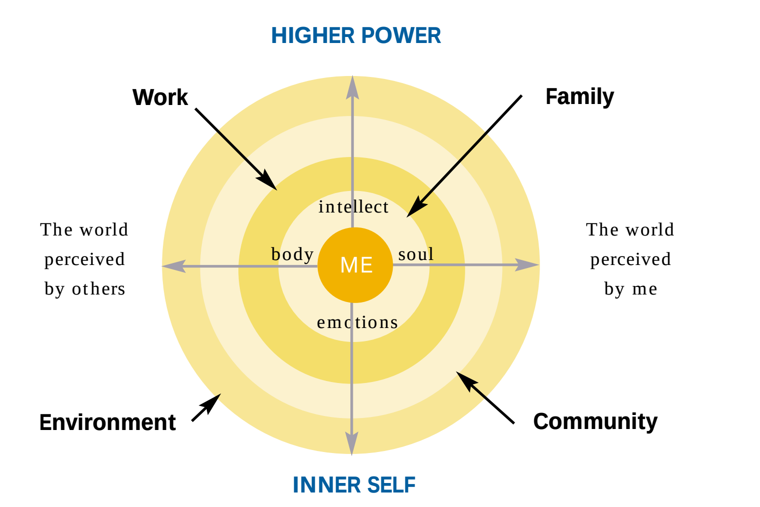
Hence, St Benedict's view on the ideal Abbot – equally applicable to a leader in business – was that:

"Excitable, anxious, extreme, obstinate, jealous or oversuspicious the Abbot must not be. Such a man is never at rest. Instead he must show forethought and consideration in his orders, and whether the task he assigns concerns God or the world, he should be discerning and moderate."

Similarly, he envisaged the ideal Benedictine organisation as being caring, with a 'servant leadership' style. Consultative and participative, socially inclusive and hospitable, with shared morals and spiritual objectives, the monastery would provide a stable learning environment through mentoring. It would also show concern for the weak and marginalised, treating all members according to their need.

Seniority within the monastery was based simply on the time of joining – a revolutionary idea at the time, when in the prevailing social culture one's status was based on the wealth and standing of one's family. The Benedictine system produced the anomaly of recruits from the servant

Figure 2 Spirituality as relationship



classes having seniority over those from the ruling classes, purely through having joined the monks earlier.

Equally revolutionary – even today – is the idea of members being treated according to their need rather than solely according to their hard work and effort. In modern day working life, this translates into recognising that those who are older, and perhaps have other calls on their time or emotions than younger, more 'hungry' colleagues, have a valuable contribution to make. This is being shown, said Father Dermot, in the number of start-up companies now recognising that they need people in their fifties on board, to provide the longer perspective, and the more mature opinion.

Present-day application of St Benedict's Rules

The participants in Douai Abbey 'Spirituality in the workplace' workshops have produced interesting feedback into the qualities necessary to lead a better balanced working life.

Humility, they suggested, could be achieved through self-motivation, respect for consensus, deep listening, integrity, open communication, team work, recognition of diversity, a sense of shared values, economy of words, laughing with (not at) colleagues, moderation, and 'authentic holism'.

> Coping with failure and success would depend on developing humility

Discernment and decision-making were deemed to be more experiential and deductive rather than scientific, based on figuring out 'what is going on?', the use of accumulated wisdom, collaborative effort, an ability to separate and distinguish, a grasp of the obscure, and the ability to recognise where small signs and indices are pointing to a larger form.

Coping with failure and success would depend on developing humility rather than pride, avoiding the 'blame culture' and the associated betrayal (of fellow workers), learning to accept failure as an integral part of learning, and understanding the effect – not always negative – of crisis and stress on personal growth.

The workshop participants had defined 'success' as a state of feeling happy, recognised, affirmed, connected, in touch, inspired by others, energised, in harmony, creative, powerful, strong, having clarity of purpose and a feeling of worth.

Failure, on the other hand, they associated with feeling a lack of trust, stressed, disorganised, confused, shocked, isolated, silenced, powerless, invisible, tired, angry and aggressive, blinkered and being 'in the desert'.

However, failure can also be beneficial, Father Dermot pointed out. The 'in the desert' experience of both physical and spiritual isolation is something most people encounter at some time – often when trying to cope with a crisis. It is important to enter into this willingly – even though things will get harder before they improve – because it is actually the opportunity for a new start. Although it is a place of powerlessness, this is also a purifying experience, said Father Dermot.

Life-work balance

Father Dermot went on to consider the contributory factors to a spiritual element in the workplace. These included having the right life-work balance – such that individuals are supported, there is a recognised boundary where 'enough is enough' in terms of effort expected of employees, but employees in turn do not try to 'short change' the organisation. Other stakeholders' needs are also considered, the structures and patterns of work may be adjusted. And the general work culture is of a nurturing community.

Ethical behaviour

Similarly, all areas involving individuals' relationships with others should be subject to ethical behaviour – be it in marketing, advertising, professional codes and conduct, sales techniques, e-commerce, legal or criminal sanctions. Such ethical behaviour, of course, precluding discrimination, harassment, and fraud.

Some concerns and hopes

Changing behaviour is almost inevitably accompanied by fears, and one of the major concerns for businesses in this case is 'will it make the organisation more profitable?'. Father Dermot admitted that there is little evidence of research into the area of workplace spirituality and the bottom line. His view, though, was that improved morale and working relationships would surely bring better productivity. Also, he ventured, the perception of a business as 'ethically clean' was likely to have the effect of drawing new clients in.

> Spirituality could become a recognised element of leadership development

He also touched on some other areas that currently give cause for concern. These included that the research into the whole area of spirituality and work is fragmented, and that there is evidence that many business leaders, though happy with the notion of EQ and workplace spirituality, draw the line at any religious content, fearing it may be seen as over-prescriptive.

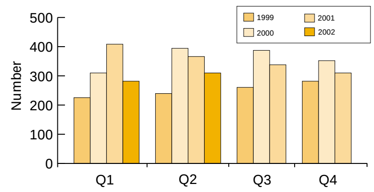
Ending on a more positive note, Father Dermot expressed his own belief that in the future spirituality will become a recognised element of leadership development (business schools and MBA courses already generally including some study of ethics). He also suggested that there was scope even for some business-sponsored research into the benefits. F&M

Douai Abbey has a pastoral programme focusing on Spirituality in the Workplace. The short residential courses cover spirituality-related issues such as workplace relationships, tools of the workplace, taking responsibility for oneself and others, coping with success and failure, and developing a spiritual practice. For further information, contact Father Dermot (see contact details on page 5).

Raising finance in the current economic climate

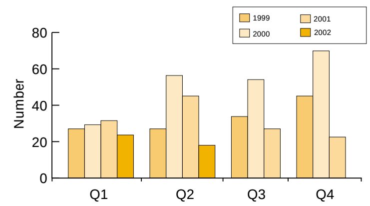
Current conditions make it particularly tough for companies trying to raise finance. Tough, but not impossible. Grant Thornton's **Michael Thornton** and **Naomi Sharma** look at the possibilities, and explain how best to make your case.

Figure 1 Deals involving venture capital



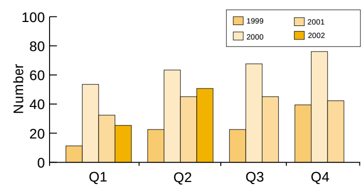
Figures only include deals reported to corpfin
Source: corpfin worldwide

Figure 2 Admissions to the Official List



Figures include companies moving from AIM
Source: UK Listing Authority fact sheets

Figure 3 Admissions to AIM



Figures include companies moving from the Official List
Source: UK Listing Authority fact sheets

Following a period of strong economic growth when most business propositions could raise finance, times are now more difficult. Providers of finance, whether banks, equity funds or private investors have many reasons to be more cautious in advancing funds and this has been reinforced by the turmoil that the world's stock markets have experienced in recent months.

Nevertheless, there is still a market for raising finance and substantial amounts continue to be invested by banks and equity funders. However, funders are now more critical and more selective about the businesses in which they will invest.

Here we summarise the current state of the economy and the market for raising finance in the UK, before setting out some practical ways in which a business can maximise its chances of raising finance. The focus is on raising finance for growth rather than in a rescue situation – the latter having its own, different, characteristics and issues.

The overall economic climate

The current economic climate is a difficult one for many businesses. After recent years of sustained economic growth (GDP increased by over 3% in 2000 and around 2% in 2001) predicted growth is now reduced. The trough in output came at the turn of the year with only 0.1% growth in Q4 2001 and Q1 2002 while the preliminary estimate for Q2 2002 indicates 0.9% growth in that quarter and a forecast annual growth in GDP of 1.5%. However, the Bank of England expects growth to recover gradually as we head into 2003 based on strengthening global demand and higher public spending.

The current market for raising finance

In each of the main categories of funding the patterns have been as follows:

- *equity funding* (*see Figure 1*) – equity funds have raised considerable sums over the last few years and, whilst the market for raising new funds is much tougher, there is still a substantial amount of cash available for investment. However, concerns about business growth prospects and the opportunity for profitable exits have meant that equity funders are being far more cautious about their choice of investment. As demonstrated by the chart, the number of deals completed in 2002 is lower than previous years but it is clear that equity funders are still investing in deals;
- *bank lending* – given that interest rates are at their lowest for decades and at present there is no immediate prospect of an increase, bank lending is a highly cost-effective form of funding. Banks will look carefully at the asset base and especially the cash flow of a business, but there is no sign that they are not willing to fund transactions, indeed banks have sought to extend that range of banking products available by developing more innovative funding products, such as mezzanine finance packages; and
- *flotations (Figures 2 and 3)* – stock market turmoil, compounded by the well-reported recent concern over the validity of corporate reported results, has added to the difficulties of achieving a flotation or a rights issue. Admissions to both the Official List and AIM (the Alternative Investment Market) are well down on the heyday of 2000 but companies are still being admitted to trading and a flotation, although difficult, is not totally out of the question. The chief concern is the price that can be achieved on float given the current depressed value of the stock market.

Essentials for raising finance in the current economic climate

The most important point is that the underlying argument must be realistic. There is no point putting together a business proposal that is more ambition than reality. Funders have experienced the fall-out of investing in over-ambitious plans and will be sceptical of all business proposals. Hence an unrealistic proposal will fall at the first hurdle.

Fundamentals
There are certain fundamentals of fund raising that apply at all times but when the climate is difficult they are more important than ever. These fundamentals are:

- having a quality business opportunity;
- presenting a robust strategy; and
- fielding a credible management team.

All three are interlinked. In the case of the first two fundamentals, the management team must have a quality business opportunity backed up by a robust and clearly thought out strategy. A good strategy will not be sufficient if the business opportunity is not there and similarly a business opportunity may be wasted if management does not have a strategy to maximise it.

Funders will be looking for a business opportunity where there is demonstrable profit potential. In the current economic climate where most growth forecasts are modest the management team has to demonstrate why its business is the one that the funders should support.

The third fundamental is the management team. Funders are essentially placing their trust in the management team to deliver a financial return and will not back a team that does not inspire confidence. So the credibility of the management team is crucial.

Communication and presentation
The proposition needs to be clearly communicated to funders. Funders are naturally sceptical and are even more so in a difficult economic climate. Although it is the substance of the proposition that matters, good presentation will help ensure that funders pay attention to it.

A good business plan is essential in enabling the management team to communicate effectively its business proposition and its ability to deliver that proposition. Funders are inundated with business plans and will be selective as to the ones in which they will invest time and effort. Consequently, developing a high quality business plan that conveys the key messages in a succinct fashion is time well spent. A business plan that can stand out from the myriad of competing opportunities is more likely to receive a favourable audience.

However, the business plan is only the first stage in the process. The management team will need to be well prepared for meeting with funders, who will ask probing questions to challenge the management team on the merits of its proposal.

> There is money out there looking for a home

Managing the fund raising process
The fund raising process is time consuming and lengthy and it is vital that management teams remain focused on the need to manage the business. The financial results will be under scrutiny throughout the process and must stay on plan and budget throughout.

Underperformance will lead to renegotiation of the funder's terms and the fund-raising process can be aborted at a late stage because business performance has declined.

Understanding the different requirements of funders
It is important to understand where the requirements of funders differ. Banks are concerned with the ability of the business to service and repay its debt and will be focused on available security and the quality of future cash flows. Equity funders are concerned with the growth potential of the business and whether an exit can be achieved in a reasonable period.

The business proposition should be directed at raising the right type of finance for that business. For some businesses specialist forms of lending such as asset based lending may be more appropriate.

Selling assets/divisions
Selling non-core business assets, divisions or companies is another means of raising finance. There are still buyers looking for acquisitions but matching sellers' price aspirations with the prices that buyers are willing to pay, in what is currently essentially a buyers' market, can be difficult.

Conclusion
The market for raising finance is tougher now and funders are highly conscious of the risks of under-performing businesses. However, there is money out there looking for the right home – and a business looking to fund a robust and credible strategy, with a high calibre management team will find that funders are still keen to back the proposition. F&M

Michael Thornton is client service director in Grant Thornton's corporate finance department. Tel: 0870 324 2644, E-mail: michael.j.thornton@gtuk.com

Naomi Sharma is a senior manager in Grant Thornton's London corporate finance department. Tel: 0870 324 2386, E-mail: naomi.l.sharma@gtuk.com*

** Naomi Sharma is a member of the technical committee of the ICAEW Corporate Finance Faculty (www.icaew.co.uk/corpfinfac – or e-mail jonathan.levy@icaew.co.uk for further information or a free trial).*

Managing design with finance in mind

Rick Keyton is industrial designer for the Flymo brand, working within the research and development department of Electrolux Outdoor Products.

Design and finance often seem to have diametrically opposed priorities; yet the relationship does not have to be antagonistic. To find out more, *Finance & Management* asked Jan Dekker of the Design Council to interview lawnmower brand Flymo's industrial designer **Rick Keyton** about the way these two important corporate activities deal with each other.

DEKKER: **What is your competitiveness based on?**
KEYTON: First and foremost, the brand, which is incredibly strong and well known to consumers. We have roughly 50% of the UK lawnmower market and Flymo is the UK's favourite gardening brand overall. The products are innovative and friendly and people latch on to that.

It is not about price. We are neither the cheapest nor the most expensive, but we give value for money.

DEKKER: **How does that value manifest itself?**
KEYTON: We sell two key benefits – our products are both light and easy to use. The hover mower established those two perceived selling points, and we have built on that reputation with every product since. You can go on forever tinkering with the aesthetics of new designs. As for working on producing something completely new and different... we're always doing that.

DEKKER: **Some people reading this will think that design is perhaps an airy-fairy discipline that needs tight control because designers don't know about financial issues. Have you come across that attitude?**
KEYTON: Of course I've heard it all before – to some, I'm 'the fibretip fairy'. We're all different and we all have our skills in certain areas, but if you are professional in what you do you also make the effort to understand the issues that other people have. It's a team thing. If there are financial reasons for a design being rejected, you don't spit your dummy out but instead you try to understand what has to be done to get it right. It's wrong to think we're all in compartments – this is the arty guy and this is the one who pays for it – we all work as a team.

DEKKER: **If all design was done externally, would your current success be threatened?**
KEYTON: We do have outside consultancies that we use occasionally. Indeed, apart from a period of a couple of years we have never completely stopped using outside help. However, often they act as the 'hands', while it is you who has given them the tools to do the job.

DEKKER: **When a decision is made to green-light a product, how early is design involved?**
KEYTON: Very early, though each product is different and so is its development cycle, its introduction and the origination of the concept. The idea can come from anywhere. It most often comes from the research and development department, but it could also come from marketing or from outside the business.

Generally, the culture has always been one of encouraging innovation, and the ideas can start anywhere. The group sees innovation as being an investment for the future.

If the process of developing a product were very regimented, it might stifle innovation. There is a lot of tacit knowledge in the company. We all take the products home to use – that's part of the job! They say that, if you've been here long enough, when you cut yourself you bleed orange.

And there is a freedom here for individuals to get on and do things, which, although scary at first, allows you to really run with

Lawn technology in action: keeping the finance-design link in good trim

an idea – it gives the individual the chance to make a difference.

DEKKER: **In a manufacturing environment, the pressure of competition acts against that kind of culture, doesn't it?**
KEYTON: We are highly pressured – recently more than ever. I'm juggling nine projects currently. But it is up to the individual how to handle that. Here, there is no one looking over my shoulder pushing me in a certain direction, which is refreshing.

> 'Increasingly, things are becoming more cost-sensitive'

DEKKER: **What role does finance play in producing that environment for you to create in?**
KEYTON: The department wouldn't hinder us in any way in getting on with the innovation and doing the job. If you're asking if money influences decision-making on design then yes, it does. Increasingly things are becoming more cost sensitive. Competition from the Far East is trying to undercut our margins and large DIY retailers are squeezing everyone on price, so it's never been more important to get the cost right. Working with engineers a lot means that, while I'm trying to push boundaries, I don't really design anything without the final cost in mind.

DEKKER: **Is creativity reined in by the 'pinstripe suits' of finance?**
KEYTON: A number of us have been working here for long enough to know what not to do. Not that we get the same result every time, but we know that while we could create something that looked absolutely fantastic it might be difficult to manufacture and so would cost more to buy. I just wouldn't go down that route. The bottom line assumption is that every product we design now will be designed to be as cost effective as possible. It is part of your brief, part of your makeup.

An engineer may be working on a product at the same time as I am and he or she may call for very simple moulding that means it can only be designed one way. Your hands are tied. I have daily battles pushing the limits and looking at different ways of doing things. There are always two sides to everything. I don't tend to design 'expensively', though there have been times when I've defended a pricier concept if I feel it has added value.

DEKKER: **Have there been designs on your drawing board or in your mind that answer a need and look right but are impossible to make?**
KEYTON: There are plenty of things you can make but which still haven't been put into production. It may be a financial reason, for instance that the factory doesn't want to spend hundreds of thousands of pounds on tooling because the money would be better spent on another product. We try to be flexible and look at the bigger picture. If we can generate a range of products at a reasonable cost by creating an adaptable basic design we will do that.

DEKKER: **How do you stay in touch with customers?**
KEYTON: We get feedback from research done by marketing. Also, we're all customers – we use the products and judge them.

As an industrial designer, you're sometimes designing things four or five years in advance, and showing people things that are so new and modern can be dangerous. You can say 'ask the consumer what they want', but they tend not to know what they want. It's a hard one to judge.

DEKKER: **Are you often working that far in advance?**
KEYTON: Increasingly it's as little as a year or 18 months. Our Revolution trimmer and edger, where the innovation lay in the product's shape, which allowed you to switch from trim to edge in one movement, actually started as a much more complicated design. It was a specification from marketing that called for lots of features, like hedge trimming combined with telescopic extensions that did all manner of things. But it wasn't going anywhere – it looked a bit of a 'dog' and it was clearly going to be expensive. We were trying to reinvent something that didn't need to be done. The Revolution turned out to be an incredibly simple one-piece product with no moving parts as such.

DEKKER: **So if the Revolution's 'sell' wasn't multi-functionality, what was it?**
KEYTON: The shape was very different. It almost didn't go ahead. When I presented it, the sales director didn't think it would sell. But the MD of the time, to his credit, said 'we'll go with it – we'll take the risk'. It was easy and relatively cheap to make, so financially it worked too. It became the number one seller in the UK and has been for many years.

> 'As an industrial designer, you're sometimes designing things four or five years in advance'

DEKKER: **How important is design in areas other than the shape of the product?**
KEYTON: It's not just about that. It can be the whole thing. Dyson is a good example of design doing everything, influencing the whole business process. James Dyson is an industrial designer by training and, as a breed, they tend to be much broader than the arty people everyone imagines. They have a mixture of quite a few skills – manufacturing and marketing as well as design, drawing, and modelling. Ideas generation is really about managing a synthesis, subjecting many different ideas to a 'reverse explosion' so as to work out the best solution to a problem.

I tend not to get briefs from marketing. The Easi-Trim range of hedgecutters, which incorporate a steering wheel handle design making them easier to use, came from an idea I had to make hedgecutters more ergonomic. I had no brief beyond 'we need a hedge trimmer'. I've since designed something even better but I can't tell you about it, as it hasn't been launched yet... F&M

TAX

Companies – all change?

Frank Haskew is senior technical manager of the Institute's Faculty of Taxation.

In his latest Update column, **Frank Haskew** looks at the business implications of recent developments in both corporation tax and company law.

Consultation on a possible reform of corporation tax

On 5 August 2002, HM Treasury and the Inland Revenue published a consultation document outlining possible further reforms of the corporation tax system. This seeks the views of business and other interested parties on three potential areas for further reform:

- assimilation of capital profits into income;
- rationalisation of the schedular system; and
- differences in tax treatment of trading and investment companies.

The implications of these changes are far-reaching. Some of the proposals outlined will be welcomed by business but others are far more controversial. Perhaps the biggest worry is that the government's proposals may be a tax raising measure rather than revenue neutral. The truth is that the government itself probably does not know what the full impact would be, and the devil is in the detail.

One controversial proposal is that a company's capital gains should be taxed as income. This would mean that companies would lose the benefit of indexation allowance and the full profit would be taxed. However, the real revenue raiser would be in respect of UK multinationals, because this change would result in capital gains realised by a foreign subsidiary coming (for the first time) within the controlled foreign companies (CFC) rules.

The CFC rules are designed to reduce the ability of UK companies to use overseas subsidiaries to shelter profits from UK tax. The rules work by (currently) apportioning income to the UK parent company.

Conversely, the proposal to rationalise the schedular system (the system whereby different types of income are taxed under different rules – schedules) could be costly for the government. The biggest problem is to what extent losses would be allowed to be offset against other income. Currently, the loss relief rules in respect of income and profits other than trading profits are quite restrictive. If unrestricted loss relief is allowed, this could be very expensive for the government. What looks more likely is some tinkering and renaming.

> A move to international norms would be sensible

Some of the other suggested reforms would be welcome – for example the removal of the distinction (not followed in other countries) between trading and investment companies. One suggestion is to adopt an approach based upon 'passive' and 'active' income. A move to international norms would be sensible.

One issue of the proposals that needs to be considered is the further divergence between the tax treatment of companies as against unincorporated businesses. The Tax Faculty and many others have objected to this divergence ever since the introduction of taper relief for individuals in 1998. However, the differences have steadily grown, creating many anomalies, and also opening up many opportunities for tax avoidance.

The document also appears to envisage a further alignment of tax with the accounting treatment. This is a welcome development, but much will depend on whether the government still wants to retain many of the current mismatches, for example the disallowance of entertaining. If it does, then any benefits of closer alignment appear illusory.

Company law changes

On 16 July 2002, the Department of Trade and Industry published the white paper 'Modernising company law', following the long-running review of company law. The government believes that many of the existing company law provisions need to be modernised and made 'fit for the 21st century', which appears to signal relaxations in the formalities of running a company, but a tightening of reporting requirements. The changes proposed include:

- removing the requirement for smaller companies to hold annual general meetings;
- increasing the 'small company' thresholds to the European Union maximum (£4.8 million turnover, £2.4 million balance sheet total, 50 employees): these small companies not being required to provide a cash flow statement or consolidated financial statements (if a parent of a small group), instead producing a simpler supplementary statement;
- abolishing the option for small and medium-sized companies to file abbreviated accounts; and
- reducing the time allowed to private companies to file accounts from 10 months to seven months.

It is proposed to assess the impact of the July 2000 increase in the audit threshold for small firms to £1 million before deciding whether to propose a further increase. At the same time, the paper rejects the idea of an independent professional review as an alternative to audit for some small company accounts. F&M

TREASURY

Too much information!

Chris Mansell is a former treasurer and is now a director of several companies.

Treasurers are suffering from information overload, according to a recent survey. **Chris Mansell** looks at the implications – and also at ways of improving payment advice arrangements.

A small survey of one bank's largest multinational corporate treasuries suggests that the function is afflicted by too much of the wrong sort of information.

Paper-based reports received a sharp thumbs-down. Two out of three respondents read less than 20% of the paper information, while the quality of that information was deemed average at best. E-mail bulletins did slightly better, with about half reading less than 20% received. However the quality of the information was deemed worse than for paper-based media.

If there was a clear-cut 'don't' it was attending treasury conferences. Nearly 90% of the practitioners polled rated them as average or worse and only a third rated the content highly.
The best regarded sources were premium on-line providers (such as Reuters) and the general financial internet (FT.com for example). In both cases two out of three respondents rated them the best.

Slicker remittance advice

Modern electronic payment mechanisms seems to have made the apparently simple act of advising the payee that money will be or has been paid into his account much more complicated. To put this to the test, try paying a batch of BT phone bills with one BACS payment.

The problem is that the banks are interested mainly in the payment data. Humble remittance advice detail has virtually no impact on the payment processing systems so the banks seldom have an interest in handling remittance advices.

With the pressure on businesses to streamline payment processes, timely receipt of remittance information is critical. For payers, the production of remittance advices is often as labour and resource intensive as the original is expensive to deliver. Add to that the cost of dealing with queries and electronic delivery generates unexpected and unwanted inefficiencies.

Banks also are finding themselves at the sharp end of an EU Directive on pricing. By 2006 domestic and international payments (including those affecting non-euro countries) should cost the same.

This will bring pressure to generate additional revenue through remittance advice delivery. One proposal is that bank payment processing should incorporate a facility to enable the payer to generate an e-mail setting out in conventional form all the remittance data. The advice is sent directly to the lenders at the same time as the payment instruction is issued to the bank.

This approach should appeal to the smaller organisation that is pressed to make all its financial procedures as efficient as possible, while not being of the scale to use one of the third party remittance advice handlers that are available. Once again the banks are invited to give more consideration to the needs of their customers.

The survey also looked at which data were considered the most valuable. Not surprisingly cash balance information stood out, but economic data and industry-specific reports also fared well. One half of the respondents declared themselves highly satisfied with the reporting information flow provided by their electronic banking systems.

Improvements sought not surprisingly covered (i) same day reporting from third-party banks and (ii) closer integration of banking systems with corporate ones.

Although treasurers are amongst the main beneficiaries of ERP, even the largest ones remain heavily dependent on manual methods when it comes to collating internal data. Nearly 90% were using spreadsheets and half the fax and telephone to gather information. Typically a treasury department's ability to collect data depends on corporate structure and the degree of centralised control.

The final set of questions included an assessment of long-term forecasting, presumably a strength within the largest organisations. Apparently not. All expressed dissatisfaction with their ability to undertake long-term projections, and indeed short-term forecasting fared little better. With organisations depending on this information for developing hedging programmes, the incapacity to forecast effectively introduces another dimension of risk.

As with the small corporate fry, 'when in doubt, guess' is apparently common currency amongst even the largest firms. F&M

FORTHCOMING FACULTY EVENTS

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8 October
EVENING LECTURE (Chartered Accountants' Hall, London)

'ENTERPRISE PLANNING (ERP) SYSTEMS – DO THEY MEASURE UP?' – DENNIS KEELING, BASDA

How does one measure the return on investment in enterprise planning systems? Dennis Keeling, business software analyst and chief executive of BASDA, the international software standards body, outlines the pros and cons of these systems, and looks at software industry trends, including those which improve productivity and reduce costs. Registration is at 5.45pm; the lecture begins at 6.00pm; followed by drinks and networking at 7.00pm.

7 November
EVENING LECTURE (Chartered Accountants' Hall, London)

'LEADERSHIP UNPLUGGED – A NEW ROLE FOR THE FINANCE DIRECTOR' – STEVEN SONSINO, LONDON BUSINESS SCHOOL

How can finance directors, who are usually the most knowledgeable individuals, become more persuasive and even more influential within an organisation? Steven Sonsino, a fellow of the Centre for Management Development at London Business School, provides some ideas. Registration is at 5.45pm; the lecture is at 6.00pm; the buffet and networking start at 7.00pm.

3 December
EVENING LECTURE (Chartered Accountants' Hall, London)

'REALITY CHECK – THE KEY ROLE OF STRATEGY IN CREATING WEALTH' – BOB GORZYNSKI, BRISTOL UNIVERSITY

After the collapse of several 'new economy' companies, this lecture looks at what went wrong and also examines the key role of strategy in creating long-term wealth in today's rapidly changing markets. Bob Gorzynski of Bristol University also discusses the role of financial professionals. Registration is at 5.45pm; the lecture is at 6.00pm; the buffet and networking start at 7.00pm.

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

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

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

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.

When the going gets tough, go back to basics

Richard T Roth is managing director of Hackett Benchmarking & Research, a division of Answerthink Inc.

Richard T Roth, managing director of US-based Hackett Benchmarking, reviews the findings from the 2002 edition of his organisation's ongoing world-wide best practice benchmarking programme.

Hackett Benchmarking, now part of Answerthink Inc, is engaged in a multi-year study tracking how market leaders in all industries use best practice to trim costs and drive greater return on investment (ROI) from technology in key corporate functions. The 2002 edition of this ongoing study of best practice in finance, information technology, strategic decision-making, human resources, procurement, customer contact centres and related areas, looked at nearly 2,000 complex global organisations and identified key differentiators between world-class and average companies across a range of industries.

The companies making up the study sample represented 80% of the Dow Jones Industrials, two-thirds of the Fortune 100 and 60% of the Dow Jones Global Titans Index. The best practice trend data was compiled by evaluating participating companies' effectiveness (quality and value) and efficiency (cost and productivity) across five performance dimensions:

- strategic alignment with the business;
- ability to partner with internal and external customers;
- use of technology;
- organisation; and
- processes.

Significant best practice findings and trends included the following:

1 *A comprehensive approach to cost reduction beats 'spot' solutions every time.* Focusing on reducing system complexity and on implementing data standards delivers greater improvements than enterprise resource planning (ERP) and centralisation – alone or together. Companies combining best practices in application rationalisation, data standards and centralisation have driven down the total cost of finance by 44%.

2 *Average performance is no longer good enough.* Companies of all sizes with average performance are at risk of falling further behind, especially in areas that have benefited from a combination of automation and process improvements. With the cost of common processes such as travel and expenses being five times higher at average versus world-class companies (.010% and .002% of revenue respectively) and something as basic as accounts receivable costing over four times more (.032% of revenue versus .007%), clearly 'average' performance is no longer good enough.

3 *Increasing value and service levels do not automatically increase costs.* World-class procurement organisations, for example, employ more professionals with analytical skills, utilise cross-functional teams more extensively and provide a greater amount of training. None of these techniques is traditionally associated with efficiency, yet these companies manage to operate their procurement organisations with 36% lower costs while delivering more value.

4 *In uncertain times, a back-to-basics focus on best practices is crucial.* When revenues are on the upswing, it is substantially easier to ignore excessive costs generated by paper-based, duplicative support functions. Lately, however, such costs weigh heavily on the balance sheet. For top companies, automating routine back-office processes isn't just a cost play, though the savings are substantial. It also frees up resources for identification and control of factors that can adversely affect operational and financial performance.

Conclusion

In today's recessionary economic climate, the continued success of world-class participants is empirically traceable, as shown in this study, to their focus on simplifying and automating processes from end to end – thus leveraging maximum business value from technology investments. F&M

Finance & Management

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The Faculty of Finance and Management,
The Institute of Chartered Accountants
in England and Wales,
Chartered Accountants' Hall,
PO Box 433,
Moorgate Place,
London EC2P 2BJ

Telephone: 020 7920 8486
Fax: 020 7920 8784

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The Faculty of Finance and Management
The Institute of Chartered Accountants
in England and Wales
Chartered Accountants' Hall
PO Box 433, Moorgate Place
London EC2P 2BJ

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