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

'INVENTORIES CAN BE MANAGED BUT PEOPLE MUST BE LED' H Ross Perot

FORTHCOMING EVENT ...

Measuring and managing intangibles

18 September – A half-day Faculty conference will be held at Chartered Accountants' Hall, London, on the measurement and management of intangibles. Speakers include David Phillips of PricewaterhouseCoopers; Dr Robert Shaw of Marketing Best Practice Ltd; consultant Andrew Mayo; and Keith McMillan, professor at Henley Management College. Chairman of the conference is Tony Powell, director of Intellectual Capital Services.

For further details and booking form – see page 11

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FINANCE

Adopting IAS – a challenge for finance directors

The adoption of International Accounting Standards (IAS) in 2005 presents considerable challenges for finance directors, as **Allister Wilson**, head of financial reporting at Ernst & Young**,** explains.

For many UK companies, the impact of IAS will be considerable. Not only will it challenge a company's existing business model, but finance directors will also have to rethink how they measure performance and communicate with the markets.

To accelerate the completion of the European internal market for financial services, the European Commission (EC) has prioritised the adoption of a single financial reporting framework for listed European Union (EU) companies. This policy will require all EU companies, with either debt or equity securities listed on a regulated market, to prepare their consolidated accounts in accordance with IAS.

The policy is aimed directly at the removal of barriers to cross-border trading in securities, by ensuring that company financial statements throughout the EU are transparent and comparable. The deadline for adoption of IAS is 1 January 2005 for most companies, although EU member states have the option of extending this to 2007 in the case of companies with listed debt securities only.

See also David Chopping's 'Financial reporting' Update column on page 10
Be prepared – the IAS changeover clock is ticking!

IAS, like GAAP, are based on principles

There are many similarities between IAS (or International Financial Reporting Standards – IFRS – as they are to become known) and UK Generally Accepted Accounting Principles (GAAP). Like UK accounting standards, IAS are principles-based and require the exercise of judgement rather than adherence to a set of rules. Both systems share a similar conceptual underpinning, and a number of specific IAS are either based on, or were developed in parallel with, their counterparts in the UK.

Transition not necessarily easy

However, these similarities do not necessarily mean that the transition to IAS will be easy for all UK companies. There remain some significant differences between IAS and UK GAAP

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Adopting IAS *– from page 1*

(particularly where IAS have been influenced by US GAAP), which need to be understood by preparers, users and auditors of accounts.

Moreover, there are some important philosophical differences between IAS and UK GAAP that are now becoming apparent as the International Accounting Standards Board (IASB) attempts to establish itself as the global standard setter. For example, IAS have been developed in the main for application in the consolidated financial statements of listed companies. This implies that IAS financial statements are prepared primarily for the capital markets, which in turn means that IAS have not been designed with single entities in mind, nor are they particularly suited to unlisted companies and small and medium-sized entities (SMEs).

Most importantly, though, finance directors need to be aware of the substantial changes that the IASB is planning to make to the existing body of IAS over the next few years. It is now clear that the IASB has a vision of the future of IAS which is very different from the IAS of today. It is a future where fair value measurement is paramount, and historical costs, accruals and the realisation principle are all considered to be of less relevance. It is also a future where the determination of taxable income and distributable profits are considered to be purely legal issues that are not relevant to financial reporting.

It is a future based also on a balance sheet oriented, fair value model, where the emphasis is on measuring the fair values of companies' assets and liabilities. This means that the accounting process will in future be focused extensively on the recognition, derecognition and measurement at fair value of companies' assets and liabilities. The measurement of income will rely heavily on changes in the fair value of net assets. Both the 'profit and loss account' and 'statement of total recognised gains and losses' will disappear, and company performance will instead be reported in a single statement of financial performance that aggregates all accrual-based income with all value changes, whether realised or unrealised.

The implications of this 'total performance' approach for reported earnings, and the decisions and payments based on them, are enormous.

> The implications of this 'total performance' approach are enormous

For example, adopting an inherently volatile fair value system will make existing management and staff incentive structures obsolete. Traditional measures such as earnings per share (EPS) and earnings before interest, tax, depreciation and amortisation (EBITDA) will become increasingly unstable, and possibly even meaningless as a measure of financial performance. Investors will be reluctant to sanction 'performance' bonuses based on 'profits' that are the product of fair value estimates that may be of questionable reliability. Therefore effective new employee incentives, based upon sensible criteria, will be required. Given the increasing use of fair values in financial reporting, with the inherent volatility implied by the resultant recognition of unrealised gains and losses, this will not necessarily be easy.

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Do you know what the impact of IAS will be on your company?

The impact of IAS will vary from industry to industry and from company to company. The most important issue for finance directors is to establish as soon as possible what the impact will be on their particular companies. The precise mechanics of how companies will make the change to IAS will be set out in a new IASB standard entitled 'First-time application of International Financial Reporting Standards'. This standard was due to be exposed for public comment at the end of last month, and issued as a final standard towards the end of 2002 or in the first quarter of 2003.

The basic principle underlying this standard is that an entity will have to prepare an opening IAS balance sheet at the date of transition to IAS, which is the beginning of the earliest period presented in an entity's first IAS financial statements. This means, for example, that a company adopting IAS for the first time in its accounts for the year ended 31 December 2005 will have to restate both its balance sheet at 31 December 2003 under IAS with full retrospective application, and all its 2004 comparative information.

In a nutshell, this means that UK companies presenting one year's com-

Library launches IAS web page

The ICAEW's Library and Information Service has launched a new 'Sources for IAS and IFRS' page that includes a reading list and selection of links for each international accounting standard in turn.

This page includes an easy-to-use feature which allows you to check out an update bulletin (reading list) of all the books and articles published on the IAS of your choice. Each bulletin is automatically updated every night and includes abstracts with more details about the books and articles listed. You can access the page at:

www.icaew.co.uk/library/index.cfm?AUB=TB2I_32612

parative figures will continue to report as usual under UK GAAP until the end of 2004, and then in 2005 adopt IAS under the IASB's first-time application regime by retrospectively adopting IAS with effect from 1 January 2004.

A company's first set of published IAS financial statements will have to include a reconciliation of its 31 December 2003 UK GAAP balance sheet and its 1 January 2004 IAS balance sheet, and a reconciliation of the net profit or loss for 2004 reported under UK GAAP to its net profit or loss for 2004 restated under IAS.

It therefore seems obvious that finance directors should establish as early as possible the impact that IAS will have on their companies, so that they can plan the critical path to conversion. Conversion to IAS will often challenge fundamentally a company's existing business model.

It will also provide a unique opportunity for the company to re-examine and re-engineer the way it looks at itself through its internal management reporting. It will affect the way the company presents itself to investors and other users of its financial statements.

Higher levels of transparency

The adoption of IAS is therefore not about different accounting policies; it is the adoption of an entirely different system of performance measurement and communication with the markets. In addition, there will be substantially higher levels of transparency for many companies – eg through expanded segmental disclosures and the increasing use of fair values in reporting financial performance.

Most importantly, finance directors will have to learn how to deal with volatility in reported performance. Whether fair value accounting uncovers volatility that is currently masked by existing reporting practices, or creates false volatility not present in economic data is a moot point. However, the real issue is that the financial reporting future for companies reporting under IAS will mean fair value-driven income statement volatility that even the best managed business will be unable to control.

This increases substantially the challenge for a company's management in providing to the markets a coherent articulation of its company's performance.

It means that managements will have to consider carefully whether their management reporting systems need to be re-aligned with this entirely new external financial reporting model, where the emphasis is on short-term changes in fair value, rather than longer-term maintainable earnings.

This challenge will be compounded if the current proposal by the EC to require quarterly financial reporting is adopted. At the same time, though, managements need to consider now the impact that IAS will have on their existing business model. IAS will bring change both internally and to the perceptions of investors and the markets.

Finance directors need to ensure that business strategy and market perception remain aligned, and to re-examine and re-engineer their internal management reporting so as to ensure that the business model – however changed – continues to be supported. F&M

IAS – a checklist

The issues arising from the change to IAS will vary in number and seriousness according to the type of business in question. However, organisations with heavy involvement in property assets or those making extensive use of financial instruments and/or hedging mechanisms, may find the switch extremely challenging. The following are important issues:

- ✔ **Systems** – there may be systems functions implications in the move to IAS. Are your current systems capable of gathering the rather different sort of data IAS requires?
- ✔ **Collection and control** – in turn, the different data required may present management problems in collection and control – eg in the case of segmental information and designating and recording the effectiveness of hedges.
- ✔ **Tax** – the future relationship between the fair value-based performance statement and the tax computation is at present uncharted territory. The basis of the corporation tax charge has recently been moving closer to the financial accounting treatment of incomes and expenses. However the IAS fair value-based model for reporting financial performance will make an unsuitable basis for calculating tax, as it does not distinguish between realised and unrealised gains and losses.
- ✔ **Structured financial products** – companies which have structured financial products may find they are no longer effective under IAS.
- ✔ **KPI** – key performance indicators for measuring and managing the business may become less meaningful, as fair value reporting superimposes temporary fluctuations on the underlying trading performance.
- ✔ **Incentive payments** – employee reward systems may also become difficult to manage and need redesigning. Managements will not necessarily want to pay large sums in bonuses for 'performance' unrelated to the underlying trading reality.
- ✔ **Investor relations** – it will become increasingly important, and challenging, to communicate the nuances of this new method of financial reporting, if analysts and the media are not to misinterpret the new volatility engendered by the move to IAS.

Why Linux is having an impact on business

Steve Smith is an independent IT consultant. Email: steve@bites.co.uk or visit www.bites.co.uk.

The Linux open source software model (with penguin logo) is attracting increasing business interest. It is even mooted, by some, as a threat to Microsoft's commercial software. Independent IT consultant **Steve Smith** discusses what it means to business users.

Business interest in the Linux open-source operating system has increased steadily in recent years. Although the Windows v Linux debate hasn't quite reached the ferocity of the Windows v Mac debate of the 1990s, it is becoming more interesting and, in cases, quite heated. Even some accounting software vendors appear to have embraced Linux enthusiastically. What does this all mean for business users?

A brief history

Linux was originally created as a hobby by Linus Torvalds, a student at the University of Helsinki in Finland. He produced the first version between 1991 and 1994 with the help of many other developers around the world. Eventually individuals and companies began distributing Linux with their own choice of packages built around the original 'kernel'. This is where the concept of the 'distribution' was born.

The source code of Linux is freely available. However, creating and selling Linux distributions is big business. You can buy a boxed version of Linux from companies such as Red Hat, SuSE, and Caldera. Companies and developers may charge for their 'distributions' of Linux (and support thereof) providing the source code remains available.

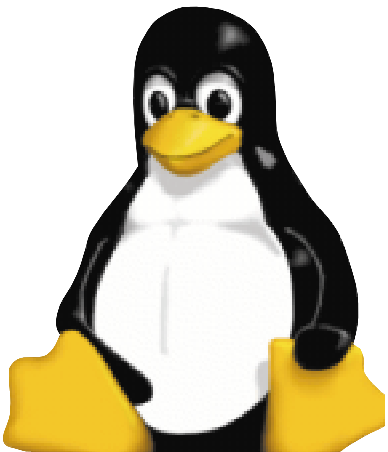
Linux may be used for a wide variety of purposes including networking, software development, and as an end-user platform. Versions of Linux exist for televisions, MP3 players and PDAs.

Let battle commence

Inevitably the above mentioned battle has all the hallmarks of a 'Microsoft v rest of the world' contest with Microsoft understandably defending its commercial software model. Supporters of the open-source software (OSS) model, in turn claim that the competitive practices of Microsoft have been harmful to the progress of IT and will no longer work in a future of open internet based infrastructures.

There have been claims and counter-claims about which model leads to more secure systems. In a recent development, the Alexis de Tocqueville Institution released a white paper 'Opening the open-source debate' that claimed that open-source software is inherently less secure than proprietary software. The report suggests that open-source might facilitate efforts to disrupt or sabotage electronic commerce, air traffic control or even sensitive surveillance systems.

Supporters of OSS have responded with allegations that the paper was a veiled Microsoft response to recent reports of rising US government and military interest in open-source systems. Microsoft is reported to have confirmed that it does provide funding to the Alexis de Tocqueville Institution but to date has refused to comment on whether it had sponsored this report.



Open-source office suites

One development that will probably increase awareness of the OSS model is the growing popularity of 'StarOffice' and 'OpenOffice.org' – both direct competitors to Microsoft Office. StarOffice was developed by Sun Microsystems as an affordable alternative in office productivity suites that run on multiple operating systems, including Solaris, Windows, and Linux. StarOffice 5.2 was released in June 2000 and now retails for £24.99 compared with £405.99 for Microsoft Office XP Standard.

StarOffice 5.2 includes word-processing, spreadsheets, presentations, drawing and graphics, e-mail and web publishing. Crucially it provides compatibility with Microsoft Office files. Sun Microsystems released much of the code for StarOffice to the OpenOffice.org project that it both sponsors and participates in. Future versions of StarOffice from 6.0 will be based upon the OpenOffice.org collaboration. Version 6.0 will offer enhanced features, XML-based file formats and improved Microsoft Office compatibility. At the time of writing, only the Linux version of StarOffice 6.0 was available in the UK but the Windows version will be available by the time this article is published and will probably retail at around £50.

Alternatively the OpenOffice.org software can be freely downloaded from www.openoffice.org so anybody can perform their own comparison (ironically upon their familiar Windows operating system if they wish) with the copy of Microsoft Office that they probably already use. There are a number of third party add-ons included in StarOffice that are not available in OpenOffice.org.

These include certain fonts, a database component, some templates, a clip art gallery and WordPerfect file filters. The key drivers behind the growth of business interest in StarOffice include the massive price differential and negative sentiment towards the new

> Microsoft may respond by adjusting prices

Microsoft licensing and upgrade policy. This new policy requires volume users to subscribe to Microsoft's new Software Assurance scheme, paying 29% (in the case of Office) per annum rather than receiving reduced price upgrades as and when the user wishes to upgrade. Furthermore, in order to qualify for entry to the scheme you need to be on what Microsoft considers to be the current version.

Linux servers

Early adopters enthused about the robustness and low cost of Linux as a server operating system. Realistically, though, Linux was generally only adopted by corporates with IT departments that could support the technology and even then only for what were considered to be non-critical applications. The most popular uses of Linux have been for web and e-mail servers, however, and today many would consider these to be business critical.

A number of national governments around the world have declared that they will adopt Linux. In the UK, some local authorities and education organisations are reported to have used Linux servers where possible in an effort to reduce costs but it is difficult to obtain data detailing the extent and nature of the use of Linux in such cases.

In the SME sector Linux has begun to become more acceptable as a commercial offering. For example, if your web site is hosted on a shared web server there's a good chance that it is a Linux server, and there's also a good chance that you neither know nor care. If you opt for a dedicated web server you'll probably be given the choice of Windows2000 or Linux.

Linux financials

A number of vendors of financial software have announced that they are or will be providing solutions based upon Linux. Most SMEs select financial systems on the grounds of matching their functionality and information requirements rather than what server operating systems are supported. If the cost saving offered by the Linux solution represents a small proportion of the total cost of the project, how many are going to choose Linux over an option that is perceived as being far safer? Furthermore it will be interesting to see how many sales representatives, pressed by a potential customer to come down off the fence, will confidently recommend Linux over Windows.

Conclusions

The potential drivers to greater business adoption of Linux and open-source software in general include:

- a desire to reduce reliance on Microsoft products (or possibly even more emotive considerations);
- a philosophical commitment to the open-source movement;
- a promotion of the Linux option by vendors of business critical systems; and
- cost.

One might conclude that, at the end of the day, cost will be the prime consideration for most commercial users but that to make a difference this will have to be significant. Of course, the response of Microsoft to the open-source threat has so far concentrated on reinforcing potential nervousness of adopting open-source technology but it is not difficult to imagine that they might, when the threat grows, respond by adjusting their pricing.

Overall, Linux developments during the course of the next three years are likely to be far more significant than during the last three. F&M

This is an abridged version of an article which was first published in the July edition of Chartec News.

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Shared services – back to the future

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Rashpal Hullait of KPMG first wrote for the Faculty about shared services in March 1999, when the practice was still a relatively new phenomenon in Europe and technology was still on the threshold of the internet revolution. Here, he revisits the subject.

'Shared services' is still a topic very much debated in boardrooms – particularly in the light of increased pressure to add shareholder value amid generally disappointing stock market performance. Sharing services meets that objective. However, the timescales for delivery of benefits may vary with the speed of change of which an organisation is capable.

The shared services model provides an effective solution for a number of business issues, because it:

- *enables transformation of support functions* – the concept of shared services has been successfully applied to finance since 1999, and increasingly other functions are being considered as potential candidates, eg IT, human resources, procurement and administration. This has led to the development of multi-functional business service centres that have an impact on the traditional reporting lines and governance models of the past;
- *enables cost reduction and diversion of resources to value add activities* – the savings generated from moving to a shared services model are typically quoted in the 30% to 40% range, but it is possible to gain further savings over time particularly with the advent of web-based technology. The widest use to date has been in the elimination of paper and distribution of documentation for approval over the web. Further there is now the ability to generate and deliver web-based reports, allowing existing service centres to reduce headcounts further and, where integrated systems exist, to improve the speed of communication of business critical information. The transfer of resource to value added type activities has been a major bone of contention for a number of organisations. Some have really struggled with defining this role as it often means a complete rethink of the information required to run the business (the reality is often not as complex as some departments make out);
- *reduces transaction processing costs leading to improved margins* – once again the reduction will come over time. A common mistake is to blame the service centre when transactions costs rise. However before pointing the finger of blame the organisation must understand that the service centre is a processing centre – if you put rubbish in then you will get rubbish out, and should therefore not be surprised when costs rise; and
- *facilitates post merger integration or development in different geographic areas* – shared services provides the perfect platform for integration. Nothing could be simpler – you have an existing facility, activities are migrated across from the acquired business and the costs of absorption are often marginal.

> Accountants can take some credit as pioneers

Three approaches

There are three different approaches appropriate for implementing a system and shared services:

1) implement the system, then move to shared services;
2) move to shared services, then implement the system; and
3) implement the shared service centre and the IT platform together.

In 1999 I would only have recommended the first two options, on the basis that simultaneous implementation was too much and the probability of success too low. Now, though, I would recommend the third approach, for three reasons.

Firstly, as clients have done this successfully in a number of instances, we have incorporated that experience in our methodology.

Secondly, the upheaval only happens on a one-time basis. Given that the population touched by a new implementation is wider than ever before with the use of web-based self-service tools, it is a change that you would not want to go through on an iterative basis.

Finally, the only sensible way to ensure a global or regional template is followed during an IT implementation is to ensure that there is transparency over what is implemented and how the processes are followed in terms of user adoption. Shared services allow you to monitor these and thus any deviations from the original design are more readily flagged thus allowing corrective action to be taken should it be so desired. This in turn allows the organisation to implement systems effectively, and timescales can be compressed, reducing costs.

In summary, the shared services concept has come a long way. There is a move to business services as consolidation of activities has extended beyond finance and into other areas of the value chain. The accountants can take some credit as the pioneers of a model which, when successfully implemented, can bring significant benefits. F&M

Directors' remuneration – paying for performance

Ruth Bender is a lecturer at Cranfield School of Management, specialising in finance and corporate financial strategy (see page 8).

At the Faculty's annual general meeting on 28 May, committee member **Ruth Bender** *(right)* gave a talk on directors' remuneration and its relation to performance, the subject of her current PhD research. Helen Fearnley reports.

Ruth started by pointing out that there is no right answer to the question 'how should we pay the directors?'. She cited the example of a scheme which in hindsight had not created shareholder value, but which presumably had been designed in good faith. With that in mind she set out the objectives of her talk: to discuss value-creating remuneration strategies, to consider current practice in executive pay, and to review the Department of Trade and Industry (DTI) consultation document on directors' remuneration.

Value-creating remuneration strategies

Ruth pointed out that paying for performance is unlikely to make top executives work any harder, but should focus their energies in a direction rewarded by the scheme. Because of this, it is essential that the reward scheme links to the corporate strategy. This serves two purposes: it encourages the executives to deliver to the strategy, and it acts as a signal throughout the organisation, and to the outside stakeholders, as to how the company wishes to be perceived.

Expanding on material in her article in *Management Quarterly*, Issue 15, Ruth suggested that remuneration committees need to consider both the level of pay (ie how much should be paid for 'expected' performance?) and the structure of the pay (how much of that should be performance-related, and how should it be linked to that performance?). She pointed out that the structure of pay in high-growth companies is often more highly geared than in mature industries, and suggested that this could be for two reasons. Firstly, the directors have more influence on the company's direction and results in the high growth environment, and so the high ratio of performance-related pay aims to drive them towards success. And secondly, individuals who are attracted to these companies are risk-takers, and demand the potential of a very high reward for their achievement.

Regarding the level of pay, Ruth noted that companies tend to benchmark this against the market. The issue then arises as to the most appropriate comparators: companies in the same sector, or in the same FTSE index, or those facing a similar competitive environment? Furthermore, such comparisons are often made based on the size of the company – but is that size as measured by turnover, or market capitalisation, or net assets, or employees? The remuneration committee has to consider all of these issues, and decide which is most appropriate in the circumstances.

Current practice

Ruth then turned to the nature of annual bonus schemes. There are various possibilities for structuring such schemes, but one of the key issues is the potential bonus available to the directors. This has been the subject of much press and institutional comment in recent months. However, Ruth suggested that some of that comment was misdirected. If a bonus scheme has the potential to pay out at say 200% of salary, press comment has focused on the fact that 200% is a high number.

Instead, it would be more appropriate to review the performance measures and, particularly, the targets in place that would have to be achieved if the directors were to receive that 200%. A scheme with the potential to pay out 200% but which only pays about 50% on average each year, could be a lot more effective than one with a 50% bonus cap, which pays out that 50%

Useful web sites

Share schemes (Inland Revenue) – contains description of share incentve schemes, checklists, articles of association and reporting requirements.
www.inlandrevenue.gov.uk/shareschemes

Executive pay tables (FT Careerpoint) – interactive pay tables for executive directors in the FTSE 100 which enable comparison of salaries, bonuses and options.
ftcareerpoint.ft.com/careerpoint

Executive remuneration (ICGN) – consultative document from the International Corporate Governance Network, published on 24 June 2002 (16 pages, PDF).
www.icgn.org/documents/remunerationreport.pdf

New Bridge Street Consultants – consultancy firm whose site includes a newsfeed covering executive share schemes and surveys of remuneration, and a Black-Scholes calculator for valuing share options.
www.nbsc.co.uk

More links are available from the ICAEW web site's links pages at: www.icaew.co.uk/library.htm every year. The former scheme gives executives something to strive for; the latter suggests that possibly the bonus targets are being set too low.

Market practice on annual bonus schemes was then considered, and it was noted that most companies have annual bonuses, generally with a significant profit-based performance element and some individual performance measures. The levels of bonus potential are becoming higher each year. Also, some 30% of companies, up from 20% last year, require directors to defer some or all of their bonus, commuting it into shares. More than half of these companies then award matching shares at the end of a further period.

> Should directors be rewarded on something out of their control?

Having given some details of performance measures in use in UK and US bonus schemes, and explained some of the issues that can make these measures unreliable (see *Management Quarterly* Issue 15, for more information on this), Ruth then went on to consider long term schemes.

Long term schemes can take many forms, the most common being either share options and/or long term incentive plans (LTIPs), which tend to pay out in shares. Ruth referred to survey data produced by New Bridge Street Consultants, which suggests that although there was a swing from options to LTIPs in the mid 1990s, fashions in executive remuneration are changing. Some 53% of FTSE 100 companies now have both an option and an LTIP; only 20% have an LTIP alone, and this percentage is declining each year.

Neither options nor LTIPs are without flaws, and various issues relating to long term schemes were addressed. These relate both to the structure of the scheme – over how many years does it run?, how is it decided what level of award to make?, etc – and to the performance measures in use. The most commonly used performance measure for share options to 'vest' is earnings per share (EPS) growth, and Ruth showed that a widely-used target – growing EPS at inflation plus 3% – will generally not even match the cost of equity, and is difficult to justify as creating value. For LTIPs, the most common performance measure is total shareholder return (TSR). However, in many companies the share price is not a reflection of the directors' performance, but instead reflects market sentiment. Whilst there is no doubt that directors can influence market expectations, is it appropriate to reward them on something that is often out of their control?

DTI consultation document

Finally, Ruth turned to the DTI consultation document on directors' remuneration, which was issued in December 2001 for comment by March 2002. Comments having now been submitted, the DTI is in the process of reviewing its proposals, and Ruth noted that the document she was discussing may be superseded in some respects. Nevertheless, given that the government's intent is that the proposals should be in place for years ending on or after 31 December 2002, it is an interesting insight into the way the government is thinking.

The DTI sets out some key aims in the consultation document, which relates to UK-registered companies listed on major stock exchanges. It wants companies to publish a remuneration report which discloses details of individual directors' packages, as now, but places much more emphasis on the company's remuneration policies.

Specifically, the consultation document suggests that the remuneration report should contain a forward-looking statement of remuneration policy.

This should explain the rationale behind the policies that have been adopted. It should also set out the characteristics of the long term scheme(s) in more detail than companies do now, including details of the companies in the comparator group(s), vesting schedules, and the performance criteria underlying the scheme.

Interestingly, commercial confidentiality is not considered a valid reason for not disclosing these performance measures, although for annual bonuses there is no requirement to disclose commercially sensitive information about performance measures and targets.

Another potentially contentious area is that companies will have to disclose graphs setting out their performance against comparators on all of their long term measures over a five year period. This applies even if the company's performance period is other than five years – which could lead to situations where the relevant targets, over say three years, have been met, but the graphs indicate poor performance. Such disclosure, Ruth pointed out, may or may not improve shareholders' knowledge of their company, but is unlikely to reduce the controversy on directors' remuneration.

An area which is likely to improve the level of debate is that companies will be required to disclose the termination payments that would be due to directors under their contracts, were they to leave. Given the controversy surrounding some of these large payments, this is probably a welcome addition to disclosures.

> Companies will have to disclose termination payments

Conclusion

Ruth concluded by describing her own research project, looking at how companies actually set their directors' remuneration. Her final thought was that this was a fascinating area, but very complex – given that there is no right answer, remuneration committees have to weigh all the available information and relate it to their corporate strategies in order to establish the most appropriate value-creating schemes. F&M

At Cranfield, Ruth Bender teaches a wide variety of subjects on the MBA, short courses and in-company programmes. She is the co-author of 'Corporate financial strategy', Butterworth Heinemann, 2002. She is studying for a PhD at Warwick Business School and is researching the way in which FTSE companies set their executive directors' remuneration. Tel: 01234 751122 or e-mail: R.Bender@Cranfield.ac.uk.

MARKETING

Tesco's revolutionary new 'lean' regime

The philosophy of 'giving customers what they want' has taken on a whole new meaning at the supermarkets group Tesco, according to **Alan Mitchell**.

Alan Mitchell writes extensively on marketing and finance, and is a former editor of Marketing *magazine.*

The secret of successful business is to increase your costs as much as possible and to let marketers fan out from their departmental bailiwick and run riot across every operational detail of the business. Sound crazy? Perhaps. But this is a provocative way of describing a philosophy which seems to be working at Tesco, and could be applied almost everywhere else.

For over five years now, Tesco has been constructing its 'house of lean' – an attempt to apply lean manufacturing principles first formulated by Toyota in Japan to UK grocery retailing. It embraces three basic principles:

1) value is always defined by the customer, not by what's easy or efficient for the company;
2) cost is good – it is what companies incur adding value for customers. It's the source of their revenues and profits; and
3) waste is bad – it is anything and everything the company does which does not add value for the customer.

A long way

These simple principles may sound obvious, but they reach a long way. Take the example of the two litre PET bottles of Coca-Cola that are delivered to Tesco stores in cases with a cardboard bottom and a plastic shrink-wrapped top.

How do these cases add value for the consumer? They add a little value. They help Tesco and Coke deliver the product in pristine condition. And because they're relatively easy to load on and off trucks they help keep transport costs down.
But now look at the waste. In-store staff have to wrestle with the secondary packaging – the cardboard and plastic – to get at the product, before lifting each bottle out, one by one, to place it on the shelf.

Reusable

They often have to do this – blocking traffic in the aisle – just when the store is most crowded, because that's when stocks tend to run low. They then have to gather up the discarded secondary packaging, crunch it up, and store it ready for disposal – which represents another layer of extra activity.

Instead, Tesco wants to introduce a form of reusable secondary packaging that can be rolled out of the factory, straight on and off trucks, and straight to the shelf where customers can simply lift individual bottles out when they want them.

> Is this the ultimate triumph for marketers?

The steps it has taken to reach this conclusion are important. Instead of focusing on 'costs' in abstract, it has unpicked each and every process and activity – the 'value streams' as Tesco's lean process manager Barry Evans calls them – to disentangle value-adding cost from waste.

It has ignored functional silos, blending a marketing input (to pinpoint where the real 'value add' is), with an operational input (how does this particular activity or process contribute to that value?) and a financial input (to identify current costs, potential savings, and the cost of realising these savings).

And it has followed these value streams wherever they flow, beyond its own corporate boundaries. Its proposals for change not only affect what its own staff do in-store, but what its supplier does in its factories (including what machinery and materials it buys), and the supplier's supplier too: it requires a completely different form of packaging.

Shrink-wrapped secondary packaging may not sound like the stuff of a business revolution. But it's just one tiny example of an awesomely huge challenge – and opportunity.

Studies by Professor Dan Jones' Lean Enterprise team at Cardiff Business School estimate that only about 1% of the total cost companies incur is 'good' cost that directly adds value for customers. Around 99% is waste: waste that comes from unnecessary waiting, handling, reworking, doing things that don't need to be done, etc.

Leeway

Jones' team estimates that world class organisations have got this waste down to 96%. This margin gives them the leeway to deliver more value for customers via increased costs and/or reduced prices. They can only do so, however, if marketing insight – what is it that the customer really values? – is put in charge of 'cost cutting'.

Is this the ultimate triumph for marketers? Perhaps. Or perhaps not. After all, how do those expensive TV ads and junk mail campaigns add value for consumers? Are they a genuine cost? Or are they just waste? F&M

FINANCIAL REPORTING

Be prepared – the IAS changeover clock is ticking!

In his latest Update column, **David Chopping** returns to the subject of implementing International Accounting Standards (IAS). In terms of preparation, he warns, it is in 2003 – rather than 2005 – that the changeover begins to bite.

David Chopping is the technical partner of Moore Stephens, London. He is a member of the technical and practical auditing committee of the Audit and Assurance Faculty.

2005 may seem a long way away. It isn't. By now, most people are probably aware that, with limited exemptions, listed companies throughout the EU will have to comply with International Accounting Standards from 2005. But anybody considering putting off doing anything about it until then will face problems.

Looked at simply, a listed company will need to produce its first IAS accounts for 2005, assuming a December year end. But those accounts need comparatives, which need to start from somewhere. The first year that IAS will make a difference is actually 2003.

Of course it may be possible to deal with all the necessary changes at the end. But producing listed company accounts is rarely a simple process at the best of times: trying to deal with three year ends in one go would simply be inviting chaos.

IASB reviews its standards

It is not just companies that need to work hard to ensure that they are ready for the changeover. The International Accounting Standards Board (IASB) is also undertaking a wide ranging review of its standards.

While the EU decision is not the only driver, it is a major factor in the IASB's decision to propose revisions to many of its standards. In May, an exposure draft including proposals to change 12 of the 34 existing standards was published, and since then further proposals have been published to alter two more, arguably the most contentious. With 2005 looming, UK companies are paying far more attention to the proposed changes than they ever have in the past.

At the same time, the Accounting Standards Board (ASB) has issued a wide range of financial reporting exposure drafts (FREDs) to bring UK practice into line with international standards even before 2005. Many changes are minor, but some will involve major changes to existing practice (*see list, right*).

The proposed changes in respect of financial instruments are more wide ranging. They include greater guidance on the classification of compound instruments and derivatives that are based on a company's own shares, changes to the scope of the financial instruments rules, tightening up of derecognition rules, additional guidance on measurement of fair values and additional guidance on identifying and measuring impairment.

The UK proposals cover hedge accounting (currently an area without much in the way of UK guidance), foreign exchange, related parties, earnings per share, post balance sheet events, stocks and work in progress and tangible fixed assets.

Most of the proposed changes involve a tightening of existing rules. However it is noticeable that, particularly in respect of related parties and tangible fixed assets, the proposals eliminate existing rules or guidance without replacement – eg the detailed rules on revaluation procedures in Financial Reporting Standard (FRS) 15 would disappear, to be replaced by much vaguer requirements.

The Institute's president has already drawn attention to the, perhaps temporary, deterioration in standards with a move to international standards. The current exposure drafts would appear to support his view.

The terminology used in the FREDs is based on international standards, generally using American terms. Stocks become 'inventories', long term contracts become 'service and construction contracts', tangible fixed assets become 'property, plant and equipment', and post balance sheet events become 'events after the balance sheet date'. After Enron (and WorldCom), the US seems to be losing the argument on practices, but winning the argument on words. F&M

Areas of change

Among the areas covered in the ASB's exposure drafts are:

- changes to the basic presentation of financial statements;
- the abolition of fundamental errors, so that all material errors will require prior year adjustments;
- various small changes to the rules on property, plant and equipment;
- greater clarity on the rules for foreign exchange;
- extensions of disclosure in respect of related parties, and clarification on some of the problem areas;
- changes to the situations where companies are exempt from producing consolidated accounts;
- changes to the treatment and disclosure of associates and joint ventures;
- minor changes to the calculation of earnings per share; and
- the extension of the definition of investment properties to cover leased assets.

FORTHCOMING FACULTY EVENTS

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

● 18 September
HALF-DAY CONFERENCE
(Chartered Accountants' Hall, London)

'MEASURING AND MANAGING INTANGIBLES' – VARIOUS SPEAKERS

This conference examines from several angles the growing interest in intangibles. David Phillips of PricewaterhouseCoopers discusses 'Finance'; Dr Robert Shaw of Marketing Best Practice Ltd, speaks about 'Marketing'; consultant Andrew Mayo looks at 'Human capital'; and Keith McMillan, professor at Henley Management College, speaks on 'Reputation'. Chairman of the conference is Tony Powell, director of Intellectual Capital Services. Registration is at 9.00am; the conference begins at 9.30am; summing up is at 12.45pm; and buffet lunch 1.00pm.

● 23 September
HALF-DAY SEMINAR
(SFEU, Castle Business Park, Stirling)

'BEYOND BUDGETING' – JEREMY HOPE, CAM-I BBRT

This seminar looks at the case for moving away from traditional budgeting, which can be a handicap in today's evolving and turbulent markets. Companies must move from forecasting to real-time responsiveness and from centralised decsion-making to devolved power and responsibility. Jeremy Hope, a BBRT programme director with CAM-I, explores this topic from various angles. Registration is at 9.00am; the seminar begins at 9.30am; and buffet lunch 1.00pm.

● 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.

RECORDINGS OF FACULTY LECTURES

The following lectures and conferences held by the Faculty in 2002 are available, in both **audio** and **video** format.

To obtain a recording, please tick the audio and/or video box on the tear-off response form opposite.

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

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.

Waste of space? How UK firms could save a fortune

John Sommerville is a corporate and valuation consultant at Bidwells.

Are you managing your property efficiently? A recent RICS survey suggests that UK businesses could save huge sums by using their properties better. **John Sommerville** of Bidwells explains.

UK businesses are throwing away up to £18 billion a year through poor use and management of their property. This is the startling finding of a recent report commissioned by the Royal Institution of Chartered Surveyors (RICS). For many companies, property is the second highest cost of production, after staff costs, yet many businesses are unaware of the overall cost of their accommodation. Active management at the right level of the company can improve the bottom line, by as much as 13% according to the research.

So why are companies behaving in such an irrational and wasteful way? There are several reasons.

Firstly, many businesses have a poor appreciation of their property portfolio. There is no register of assets, setting out the extent of the freehold and leasehold buildings used by the company and little appreciation of the cost of occupying buildings. Interestingly waste is greatest in those companies that own their property rather than those companies that pay rent.

Established companies operating out of sites that have expanded over the years, or from a number of different sites through mergers and acquisitions, treat property as a 'free cost'. Bearing in mind that roughly two thirds of all commercial and industrial property in the UK is owner-occupied, the potential number of companies affected is huge.

Secondly, properties are rarely high on the agenda at boardroom level. The management of property is often handled by operational managers who are more concerned with delivering a product or service rather than optimum use of space. The business plan will often work in isolation of any property strategy, if indeed there is one.

Owners should learn from tenants

The report found that companies that rented property were generally far better at using it efficiently. And therein lies the route for savings for companies that own their premises. Tenants go through the process of understanding a detailed contract for occupying the building and the rent they pay is regularly re-assessed at rent review. This appreciation of the unit cost allows managers to plan ways to reduce occupancy and directly save money.

For some owner-occupiers, the solution may be to sell their property and lease it back, to give the double benefit of releasing capital and giving a greater understanding of cost. This will not suit everybody however. In industries where buildings need to be adapted quickly and frequently, like the brewing industry, the need to obtain the landlord's consent prior to making changes would be unworkable.

Businesses can, however, benefit from the following cost cutting ideas:

- prepare a property strategy to sit alongside the business plan;
- carry out a property audit to understand property as a unit cost;
- introduce an internal charging system to concentrate operational managers' minds on ways to reduce occupancy or occupy cheaper property;
- look at the options for sub-letting vacant space; and
- look at ways to reduce occupancy, eg 'hot desking' or home working.

Give your property the priority it deserves and ensure a review of these and other steps to see if your company can add pounds to the bottom line. F&M

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Finance & Management

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