THE INSTITUTE OF CHARTERED ACCOUNTANTS IN ENGLAND & WALES

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Faculty of Finance and Management

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Real options – exploring the myths

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Where to find real options on the web

Readers interested in our real options feature (*page 3*) may find these web sites helpful:

real-options.de – academic real options web site based in Germany, with an international focus. Includes a listing of recommended books on option theory, with abstracts and full text where available.
www.real-options.de/

Real Options Group – informative web site, developed by a consultancy specialising in real options research. The site includes case studies of international companies, and an overview of the concepts involved – supported by two fully featured presentations on application and management.
www.rogroup.com/

Real Options research (Centre for Financial Research, Cambridge) – real options page from the CFS, based at Cambridge University. The site maintains an outline of current research, along with links to the full text of the proceedings of a forum.
www.cfr.jims.cam.ac.uk/research/real.html

Real Options Selected Links – the most comprehensive selection of real options links on the internet. Includes tutorials, models, software, and frequently asked questions.
www.puc-rio.br/marco.ind/ro-links.html

Real Options: Theory meets Practice – official web site of the annual conference on real options. Includes abstracts and full text of papers for the conference from 1999 to 2001.
www.realoptions.org/

These links are also on the ICAEW's banking and finance links page, part of The Library & Information Service's award-winning links pages (www.icaew.co.uk/library.htm).

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Comments and suggestions about FINANCE & MANAGEMENT should be addressed to Chris Jackson BA FCA, Head of the Faculty (see left).

ABSTRACTS FROM LIBCAT

Parrish G – Opt in
Financial Management, March 2001: p36-37 (2 pages)
● *Traditional financial tools fail to link complex and changing strategic aims with financial reality. The author explains how the real options approach can help to improve your decision-making.*

Damodaran A – The dark side of valuation – valuing old tech, new tech and new economy companies
London : Pearson Education, 2001 (179 pages)
● *The book is structured around the valuations of five technology firms – Motorola, Cisco, Amazon.com, Ariba and Rediff.com. Chapters cover: the dark side of valuation; show me the money – the fundamentals of discounted cash flow valuation; the price of risk – estimating discount rates; cash is king – estimating cash flows; looking forward – estimating growth; estimating firm value; management options, control and liquidity; relative valuation; earnings multiples; other multiples; real options in valuation; and value enhancement.*

Hargreaves I – UK: waiting for broadband business?
Accounting and Business, Vol.4. No.5. May 2001: p20-21 (2 pages)
● *A recent survey of broadband access, conducted by Netvalue, an internet research organisation, put the UK second to bottom in a survey of 11 countries' broadband connectivity. In Britain, anyone who wants a broadband link has, essentially, two practical choices: to ask BT to upgrade their existing phone line using ADSL (asymmetric digital subscriber link) technology or to connect to a cable television system. Other options, such as wireless or satellite broadband services, are at present more theoretical than real. The author asks why it is taking so long for broadband access to become more widely available in the UK, compared to almost everywhere else.*

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

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Aren't all options real?

In the first of two articles on real options **Tom Copeland**, managing director of the Corporate Finance Monitor Group in Cambridge, Massachusetts, and co-author of the recently-published book 'Real Options: A Practitioner's Guide', explains the concept and its practical applications.

This is an article about the options that managers have to exercise types of flexibility in decision-making. A real option is the right, but not the obligation, to buy (or sell) a real asset for a predetermined price (called the exercise or striking price) for a predetermined period of time (called the life of the option). The underlying real asset might be an investment project like a new facility, a research and development programme, a new product under development, or the exploration and development of an exhaustible natural resource.

Management usually has great flexibility to make decisions that change the value of an asset by exercising the right to expand or contract, to open or close, to extend or abandon, or to defer a project. These flexibilities are often relevant in the evaluation of merger and acquisition programmes.

Financial options are also contingent claims that depend on the value of an underlying asset – in this case, a security. But owners of financial options – those traded on the options exchanges of the world – are buying and selling side bets that cannot affect the value of the underlying security. Real options may be enhanced because managers can increase the value of the underlying project itself.

Real options also occur in our everyday lives. Suppose, for example, that you want to drive from London to Madrid. Most people would map out the fastest route, and begin the journey. But there is uncertainty to be dealt with – detours, traffic jams, bad weather, speed traps, and breakdowns. It would be worth something to avoid these obstacles at the lowest cost – taking the least time. This added flexibility is the value of the option to change direction. The exercise price might be the cost of buying detailed maps, a radar detector, a citizens band radio, and a geopositioning indicator. If the value of the option (ie the value of flexibility) exceeded that cost we would happily buy the equipment and start our journey with the ability to change course easily.

Principle

More and more companies are using real options analysis (ROA) to supplement, or replace altogether, their standard net present value (NPV) analysis that is based on the principle of discounting expected future cash flows at the company's weighted average cost of capital. EXXON, Mobile, British Petroleum, Shell, and Texaco all use ROA to evaluate their exploration and development decisions. Airbus uses real options to evaluate aircraft delivery options that are offered in its marketing programme.

After teaching corporate finance at the graduate level for 30 years, I am ready to declare that the standard tool for evaluating corporate investment decisions, NPV, systematically undervalues every project – the only question is, by how much? Experienced managers often go ahead with negative NPV projects for 'strategic' reasons. Their intuition is telling them that NPV fails to capture or to value flexibility. Once a project is started, they can scale it back or abandon it altogether if it does worse than expected, or they can expand or extend it if it does better than expected, and they can defer its start up rather than investing immediately. In other words, they can actually manage the project – a fact that is assumed away by NPV analysis that, like the pre-planned (and inflexible) route from London to Madrid, assumes away flexibility in decision making.

Deep-in-the-money?

Sometimes the difference between the value estimates provided by the two techniques, ROA and NPV, is trivial. This will happen when the project NPV is high – so high that it is unlikely that there will ever be any need for flexibility – one would not have to manage a course change, just proceed as fast as possible. Such an option is said to be 'deep-in-the-money'.

The difference will also be trivial when the project has a large negative NPV. No amount of flexibility can rescue the project – so it is very likely that the options embedded in it will never be exercised and are therefore nearly valueless. These are 'deep-out-of-the-money' options.

However, when there is high uncertainty, and the flexibility to respond to it, and finally when the NPV of the project is close to zero – then real options will have high value relative to the NPV and the answer can change by several hundred percent. These are 'near-the-money' options.

Simply recognising an option when you see one can be a challenge. I remember having an expensive lunch with a friend, Steve Ross (at that time a chaired professor at Yale) who wagered the cost of lunch that I could not answer a question correctly. It was this: "Suppose that you can put a dollar into a black box any time during the next year and that precisely one year later you receive $1.05 with absolute certainty. But the current interest rate at a bank is 10%. How much is the black box worth?"

After a few seconds I replied: "The box is worth nothing because I could put my money in the bank now and secure a higher rate of return." Upon hearing my (incorrect) answer, Steve handed me the bill. "What did I do wrong?" I said. "You assumed that

'... fine tuning their intuition with real options analysis... '

interest rates are constant," he replied. "If there is any chance whatsoever that the rate will fall below 5% sometime during the year, you can exercise your option and make an economic profit. The black box is an option on interest rates."

Of course. And as I reflected on it, I realised that I had personally been involved in a similar situation. As a young married man, I bought a life insurance policy that gave me the right to borrow at a 9% fixed rate against the cash value of the policy for as long as I owned the policy. I didn't think much of it at the time because market rates were 3% to 4%. But in 1981 the rate on short-term government notes was 16%. Even I realised that borrowing on my policy at 9% and investing at 16% represented an opportunity for risk-free arbitrage. Millions of other people did the same and several insurance companies went out of business as a result. The right to borrow at a fixed rate was a life long option on interest rates. In my case, on the day I bought the policy, it was roughly a 60-year option, and was virtually certain to be in-the-money sometime during its life.

Ancestors

Real options have been around since our distant ancestors first walked the face of the earth, and the intuition of decision makers has served them well. But in a world where innovation makes the birth and death of businesses faster than ever before, and where knowledge management requires increasingly flexible interactions among business partners, it is more than a little useful not only to recognise real options but also to value them. That is why giant corporations with billions at stake are fine tuning their intuition with real options analysis.

So could you. 'Real Options: A Practitioner's Guide'*, is the first 'how-to-do-it' book on valuing real options. It assumes no maths higher than algebra, and no computing skills beyond an Excel spreadsheet. Yet it explains how to model all types of simple options (deferral, expansion, contraction, abandonment, and extension), as well as switching options (the right to enter or exit an industry, or the right to shut down and then reopen a manufacturing plant or a mine), and compound options (options on options). It also shows how to value compound rainbow options (compound options with multiple sources of uncertainty), for example, research and development, exploration and development, and new product development.

Ubiquitous

Applications of real options are ubiquitous. They include committed lines of credit in banking, property and casualty insurance contracts, any phased investment (eg the construction of a factory, a rail system, a new aircraft design), any merger and acquisition programme, small high-growth companies (eg internet and e-commerce), opening and closing of production facilities, all cancellable operating leases, any project that can be scaled down or cancelled, any project that can be deferred, accelerated, or decelerated, all real estate leases with the option to renew or extend.

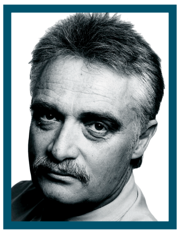
In a subsequent article, I will shift from explaining what real options are and describe more about how one can value them without a Cray computer and a PhD.

Tom Copeland is managing director of the Corporate Finance Monitor Group in Cambridge, Massachusetts.

** 'Real Options: A Practitioner's Guide', is co-authored by Tom Copeland and Vladimir Antikarov and published this year by Texere, of New York and London, priced at £35. Tel: 020 7204 3644 or visit: www.etexere.com/realoptions.*

How Swedish managers get good results!

Why do Scandinavian countries produce such a disproportionately large share of Europe's – and, arguably, the world's – best performing companies? Business writer **Tom Lloyd** suggests the answer lies in the Scandinavians' enthusiasm for adopting – rather than merely prescribing – innovative management ideas.



Between them Sweden, Denmark, Finland and Norway have a population of about 23 million people. That's less than 6% of the combined population of the 16 countries that had companies in a recent Financial Times survey of Europe's top performing companies. But these Scandinavian countries provided four of the top 10 performers (by total shareholder returns) in the past five years and 14% of the 492 companies mentioned in the survey. If sectors where they had no representatives are excluded, the Scandinavian quartet accounted for 17% of the total.

Their companies aren't all tiddlers either. With names such as Carlsberg in brewing; Atlas Copco, Sandvik, Scania, SKF and Volvo in engineering; Hennes & Mauritz in retailing; Electrolux in consumer durables; Nokia and Ericsson in IT hardware; Novo-Nordisk in pharmaceuticals; Skandia in life assurance; and Norsk Hydro in oil and gas, Scandinavian companies can scarcely be said to have been constrained by the small size of their domestic market. On the contrary, one reason why Scandinavian firms have punched above their weight of population is that they encountered the limits of their domestic markets sooner than the firms of other countries.

Business model

In the 1920s Swedish entrepreneurs Ivar Kreuger, of Swedish Match, and Axel Wenner-Gren, of Electrolux, invented the multi-national business model, and might have contributed more to management thought if Kreuger had not killed himself after his empire collapsed in 1932, and if Wenner-Gren had not been suspected (probably unfairly) by the Americans of being a German spy in the second World War.

An intriguing difference between the Scandinavian and American 'schools' of management is that while the reputations of American 'gurus', such as Peter Drucker, Chris Argyris, Warren Bennis, W Edwards Deming, Gary Hamel, Henry Minzberg (Canada), Ted Levitt, Richard Pascale, Tom Peters, Michael Porter, Peter Senge and Noel Tichy have usually outshone those of the practitioners they have influenced, the opposite is the case in Scandinavia.

While Drucker was inventing the American management 'guru' tradition in the 1970s, Hans Werthén was being billed as the saviour of Electrolux, and Erik Rhenman and Gunnar Ehrlemark (unknown outside Sweden) were quietly coaching a new generation of business superstars. Rhenman was the mentor of the more famous Richard Normann, inventor of an influential new approach to managing 'service' businesses, and Ehrlemark's pioneering work on marketing services won international recognition through Jan Carlzon, the charismatic chief of the SAS airline.

Scandinavians are not as interested in ideas, per se, as are Americans, and reserve most of their admiration for practitioners, who use ideas to create and improve companies. As Percy Barnevik, Sweden's most famous practitioner 'guru', said: "In business, success is 5% strategy, 95% execution."

Global company

Barnevik had already distinguished himself at Sandvik when he was appointed president and chief executive of the ailing Swedish electrical engineering group, ASEA, in 1980. Within a few years he had turned ASEA into one of the world's first 'global' companies with a string of acquisitions, culminating in a merger with Brown Boveri of Switzerland in 1988, to create what is now ABB (classed as a Swiss, rather than Swedish company in the *Financial Times* league table). ABB was voted 'Europe's most respected company' three years running in *Financial Times* polls, and its famously de-centralised structure was seen by, management experts, as a prototype for the post-industrial-age corporation.

The structure of Copenhagen-based International Service Systems, devised by CEO Paul Andreassen in the 1970s, was also widely admired. Andreassen built a global business in the previously fragmented commercial cleaning industry by breaking up national baronies into half a dozen or so small companies in each country focusing on one market segment apiece. New businesses began to emerge as a result and the company grew rapidly. Management experts use the case as an example of how structure can actually be equivalent to strategy.

Another of Sweden's great practitioner gurus, Ingvar Kamprad, began selling home furnishings by mail order in 1943, and opened his first store in 1953. The huge sofas-to-saucepans IKEA warehouse retailer into which the company has evolved bought the Habitat chain in the UK from Sir Terence Conran in 1992 and now has stores in 28 countries including Russia and the US. It is generally acknowledged to have pioneered the so-called 'category-killer' retail model subsequently emulated by the likes of 'Toys R Us', and Kamprad's management style, with its emphasis on the corporate culture and 'walking around', has also been widely applauded in the literature.

New breed

The origins of the Finnish company, Nokia, lie in the European forestry and paper industry still dominated by Scandinavian companies, such as Stora and UPM-Kymmene. Finnish Rubber Works and Finnish Cable Works were added to the paper-making business in 1967 in a three-way merger, and in the 1980s Nokia moved into computers, monitors and televisions. In 1981, it made the first phones for the NMT system – the world's first international cellular mobile phone network – and when the GSM digital mobile standard became operational in 1991, Nokia was first in the market with handsets. In 1992 Jorma Ollila, then president of Nokia Mobile Phones, became head of the whole Nokia Group and sold 'non-core' businesses, to focus exclusively on telecommunications. Nokia began appearing in the management literature as the exemplar of a new breed of strategically agile company that the gurus predicted would come to dominate an increasingly turbulent and unpredictable business world.

Lars Kolind, who was appointed CEO of the Danish hearing-aid company Oticon in 1988, is also widely cited as a pioneer in the construction of adaptable organisations. Having stabilised the troubled company, he issued a memo in January, 1990, saying Oticon needed 'break-through' products and this would require staff "to think the unthinkable, and make it happen." He dismantled Oticon's formal organisation and made projects, as opposed to functions and processes, the focus of work. Project teams continuously form, disband and re-form. Project 'leaders' (anyone with a good idea) compete for resources and people. Senior managers give advice and support, but make no decisions. Kolind said that one of the main jobs of management is to "keep the company dis-organised."

'Success is 5% strategy, 95% execution... '

Kolind resigned as president in May, 1998, but in the October 2000 issue of Forbes Global, Oticon's parent company was ranked among the world's 20 best small companies.

Apart from its guru practitioners, Scandinavia was, in my view (but I could be biased) the source of the 'knowledge management' concept, about which so much has been written in recent years.

According to the American writer, Tom Stewart, it all began with an article entitled 'Brainpower' he published in Fortune in spring, 1991. In his book, 'Intellectual Capital; the new Wealth of Organizations', (Doubleday/Currency, 1997) Stewart says that Leif Edvinsson, director of intellectual capital at Swedish insurance group, Skandia, was given the job (the first of its kind) after he showed the 'Brainpower' article to the head of Skandia's assurance and financial services (AFS) division.

Breakthrough

In his own book, 'Intellectual Capital – realising your company's true value by finding its hidden brainpower' (Harper Business, 1997), Edvinsson (and co-author Michael Malone) say the real breakthrough was in 1995, "when Skandia released the world's first public intellectual capital annual report."

In my view, it began with the publication of 'Kunskapsföretaget' ('The Knowhow Company') by Karl-Erik Sveiby and Anders Risling (Liber, 1986) and the next step was the publication of the book I wrote with Sveiby, 'Managing Knowhow', (Bloomsbury, 1987). The seminal event was Sveiby's formation of the Konrad group of executives and accountants of Swedish 'knowledge organisations' in 1987. The Konrad report was published in Swedish and some 6,000 copies were sold, so it is hard to believe Edvinsson was unaware of it, and of its sub-division of knowledge capital into customer capital, structural capital and human capital, when he began his important work at Skandia AFS in 1991.

The importance of Edvinsson and Stewart is not that they were pioneers, but that they were the first to publish knowledge management books in America. For, despite the important contributions Scandinavian 'guru' practitioners have made, the management debate is still largely an academic – and an American – one.

More's the pity. The dominant Anglo-Saxon 'school' of management could have learned a thing or two from the Scandinavian school. It could have learned, much earlier, about the differences between the management styles needed in the manufacturing and service sectors; about the close relationship between strategy and structure; about what Barnevik called the "tremendous, unused potential in our people"; and about the emergence of 'intangible' assets as the primary sources of competitive advantage.

Above all, by studying Scandinavia's recent social and economic history, we could still learn much about how to foster an entrepreneurial, pro-business culture in a society firmly wedded to the principles of social democracy.

Tom Lloyd, a former editor of Management Today magazine, is now a writer/consultant whose five published books include 'Managing Knowhow' (Bloomsbury, 1987), co-authored with Karl-Erik Sveiby, and 'Entrepreneur!' (Bloomsbury, 1992). Email: Tloquence@aol.com.

PROFILE (1)

From bebop to business

Management consultant **Geoff Seeff,** who recently joined the Faculty committee, tells Helen Fearnley of his background and his three main aims.

New committee member Geoff Seeff originally planned to be a jazz musician. After completing his articles with London-based Wallace Cash & Co in 1969, which he survived by playing violin and saxophone on the ‘weddings, bahmitvahs and funerals’ circuit, he decided that the last thing he wanted to be was an accountant. However, he says, it transpired that, “the last thing the world wanted was another jazz musician – and not a very good one at that!” Some three decades later, jazz’s loss has become the Faculty’s gain.

Geoff went on to train and practise as a management consultant, initially with two of the large international accounting firms, and more recently with a major firm of cost consultants and project managers. The motivation for seeking election to the Faculty committee, he explains, followed a long period of feeling that the Institute and its “activities had become increasingly irrelevant to me and my sort of work.” The launch of the various faculties reawakened his interest and he began to feel that it was time to put something back.

Seeff is keen to promote three issues dear to his own heart. The first of these relates to all non-auditing chartered accountants – he wants the committee to focus on how best the Faculty can represent the interests and concerns of that growing constituency. “This is not only a matter of offering guidance on the problems faced by accountants working in commerce but also ensuring that those working in the field of financial management provide a really effective service to business and government.”

The Faculty, he says, must help persuade those organisations to value the services of chartered accountants above other accountants and, indeed, other non-accounting professionals with similar functions.

Debate

The second area in which Seeff is interested in seeing development has its roots in his own PhD research at the University of Birmingham 30 years ago, when he studied ‘decision making and measurement of effectiveness’. His research was based on work by mathematical psychologists and aimed to bring together financial and non-financial indicators in project evaluation. “I would like to see the Faculty take a lead in providing a forum for debate on quantitative evaluation techniques”, he says.

The final issue which concerns Seeff is financial management in an era when the private and public sectors are increasingly working in a variety of partnership arrangements. In his view, “this calls for a new type of financial management for which traditionally trained accountants will not have been prepared. Whilst the profit motive is still essential for the private firm in a public-private partnership (PPP), it may merely be one goal along with, say, safety and service quality (eg for rail operators). Regulators and government bodies may have greater influence and constraint on both management decisions and even accounting policies than company directors and this raises a number of corporate governance and financial accounting issues.”

Following the doctorate, his own career took him from working as a consultant at Coopers & Lybrand to being a director at Stoy Hayward. A period of secondment to the Department of the Environment, where he headed up the grants appraisal unit for the Inner Cities Division, led him to specialise in the subject of urban regeneration. Hence after leaving Stoy in 1989 to become head of consulting and director of finance at quantity surveyors and project managers Widnell, he now – following its merger last year with Currie & Brown – heads the enlarged firm’s regeneration division.

Meanwhile, alongside his family and an active political interest (he was a parliamentary and GLA candidate for the LibDems) jazz continues as a hobby – listened to and occasionally indulged in, by special request, at social events. These days, however, he does the hiring!

PROFILE (2)

Building a career in the City

Peter Franklin brings a wealth of financial services expertise to the Faculty committee, as Helen Fearnley reports.

Peter Franklin, having spent almost his entire working life in business as opposed to practice, says he has always perceived the Institute as "run by and for those in the profession, despite there obviously being a greater proportion of the membership working in industry."

The Faculty, in contrast, strikes him as "a door to the outside world, in the way it looks after those in industry – albeit that they are only part of its membership." Hence Franklin decided, with encouragement from incumbent committee member Kevin Bounds, that he would offer himself for election. "Rather than just whinging, I want to champion the cause of accountants in industry."

Franklin is a big fan of the current moves to increase the Faculty's breadth of membership. "I do not see why it should limit itself to chartered accountants involved in finance and management. Many people who are in finance are not chartered accountants. Yet the Faculty can be of use to us all."

He is also keen that the Faculty continue its production of relevant information such as its *Good Practice Guideline* and *Manager Update* products "in my experience, unequalled for quality of material produced on such a regular basis." And with his background in financial services, he thinks there is even scope for the occasional seminar on a financial services subject, where relevant.

"Basel 2, for instance, relating to the capital adequacy of banks and other institutions is a veritable vipers' nest, involving billions of pounds, and of great significance to anyone in the big City institutions."

Progression

No stranger to the City himself, Franklin describes his career path as akin to "the lurching of a drunken man." Objectively, it looks more like the smooth progression of a man adept at performing a given task and moving swiftly on. In any case, it has furnished him with specific technical expertise in the financial accounting and operations area within financial services.

After acquiring a law degree, from University College, London, he qualified as an accountant with Thomson McLintock (1976). Two years later, he moved into commerce, where he has remained.
In 1981, after spells in shipping and insurance, he joined Salomon Brothers International as manager of international control, later becoming head of operations. As he remembers "this was at a time when the entire cast of characters from 'Liar's Poker' was in residence. It was in those long-gone City days when the word 'character' was up there in neon lights – with the word 'obnoxious' right beside it."

In 1986 County NatWest provided another challenge. Having joined to set up the gilt-edged market-maker, this was subsumed into the capital markets division where he rose to become overall director of operations combining both the financial and the operations side. He also became the County NatWest representative on the implementation team for the integration of NatWest's world-wide treasury business. This was, he says, a thankless task.. "Although the logic of integrating the operations of the clearer and the investment bank was impeccable, the economics were impossible."

His penchant for making a difference in small companies led him next to take the job of finance director and group company secretary at Rea Brothers, "a small merchant bank facing imminent disaster", in 1989. With colleagues, Franklin re-engineered the whole business from products to customers. As a result the major shareholder was able to sell it as a profitable concern to Close Brothers.

Then in 1994 came the move to the European Bank for Reconstruction and Development (EBRD), aimed at helping the Russian and Eastern European countries move towards a market economy. He was there, as operations director, for four years.

Franklin is now an interim manager (recently at Nationwide) drawing on his wide and varied experience to add value to the projects he undertakes. He no longer craves titles as he reckons: "I've had all the good ones."

TAX **UPDATE**

Getting intellectual

Francesca Lagerberg considers the implications of the latest consultation on the reform of intellectual property relief.

Francesca Lagerberg is the senior consultant to the Tax Faculty of the ICAEW (www.taxfac.co.uk).

Each new year is accompanied, so it appears, by a further consultation on the reform of intellectual property relief and intangibles in general. We have had consultations every year since 1998 and this year was no exception with the release of a Technical Note in March 2001 entitled: 'Taxation of intellectual property, goodwill and other intangible assets: the new regime'. This included illustrative draft clauses. There are hopes that at long last we may be nearing legislation, which could form part of the Finance Bill 2002.

Why is this issue so important and so fraught that it has taken over three years to reach this stage? Intellectual property sounds like a rather nebulous concept that brings to mind such items as patents, trademarks and copyrights. However, it covers much more besides, with its ambit stretching over 'knowhow', brand names and software. In short it is the means of protecting knowledge and ideas and as such it is 'big business' as in the modern world such items hold the key to the wealth of many organisations. For example, the Coca-Cola brand was estimated to be worth £52 billion in 1999.

The reason for changing the existing UK rules stems from the need to keep the UK competitive and the belief that the current regime is too complex and outmoded, thus encouraging companies to seek more favourable tax regimes elsewhere. At the moment there is a hotch potch of rules, mainly derived from case law, that are inconsistent and at times unfathomable. For example, why should there be no tax deductions available for expenditure on the acquisition of trademarks and some types of 'knowhow', even though the benefit to be derived by a business from these assets may be used up over a relatively short period?

A new tax regime

The difficulty in making change has been the problem of ensuring the new regime does not overly penalise some of the affected parties. The latest Revenue Technical Note suggests that a new tax regime should apply to intangible assets (including goodwill), acquired after the commencement of the new rules, by a company subject to corporation tax.

For intangibles acquired after commencement, taxable profits and losses will generally be based on the profit or loss computed for accounts purposes (following the rules in Financial Reporting Standard 10 – 'Goodwill and intangible assets') and income and expenditure relating to intangibles will be treated as revenue items.

The amortisation charges on these assets will be tax deductible under the proposed new regime but only to the extent that the intangibles are purchased and have a limited useful economic life. For intangibles with an indefinite useful economic life, no amortisation charge will be made to the profit and loss account. However, there is discussion of making some tax relief available for the cost of acquiring such assets.

There is a proposal to allow companies to rollover profits on the disposal of intangibles into the acquisition costs of new intangibles, which means that profits on disposal will now be treated as income rather than capital gain.

The latest Revenue Technical Note on this area seems to be a positive step forward. In its response (published as TAXREP 10/01 on www.taxfac.co.uk) the Tax Faculty welcomes many aspects of the new proposals. It also notes that there is a need to align this project closely with the consultation on deferral relief for substantial shareholdings – another project that has been subject to several rounds of discussion. The fact that the suggested new intangible regime includes a proposed reinvestment relief into shares makes it vital that these two reforms are co-ordinated.

Clearly a major shake-up is ahead in the field of intangibles – be it in the next Finance Bill or not – and it is a wise organisation that considers tax planning now. This may involve determining what action to take under the current rules and the actions necessary when the new rules do eventually come into place.

To find out more about the work of the Tax Faculty either call 0207 920 8646 or email tdtf@icaew.co.uk or visit the web site at www.taxfac.co.uk.

TREASURY **UPDATE**

The case for outsourcing

Chris Mansell discusses the benefits of outsourcing the treasury function, and looks at some new electronic products which enhance the treasurer's work.

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

With the jargon and the promises swirling ever faster, the treasury manager in the smaller company, concerned with cash flow, order intake and whether the incipient recession is going to bite, might find solace in outsourcing his treasury routines.

Outsourcing the treasury function involves contracting a financial institution or other experienced organisation to handle day-to-day cash, debt and investment management, along with foreign exchange and any other treasury activity the business may require. For the larger businesses the potential savings in personnel costs on the dealing, operational, reporting, accounting and risk management sides are self-evident, to say nothing of the IT infrastructure and maintenance costs. Outsourcing is a real consideration for the smallest treasury operations as well. These generally require a minimum of two staff to ensure some division of responsibilities and holiday cover.

The whole notion of outsourcing has been enhanced by the use of web-based technology. For the itinerant treasury manager this means that constant contact can be maintained with the different business units, enabling trade execution, risk and cash management to be handled at will from anywhere across the globe. Potential levels of control have been dramatically improved.

Treasury managers may opt for an application service provider (ASP) which basically supplies the technology needed to handle the conventional transactions, at the same time looking after all the back-office functions. The alternative is the business service provider (BSP) which in addition offers all the front-office operations.

The company must provide the policy guidelines of course, but based on these, the outsourcer will consolidate the daily cash position to maximise returns or minimise borrowings. In addition there will be general ledger files to upload, reporting at various levels of sophistication and, if requested, consultancy support.

For organisations contemplating the BSP route, contractual and security aspects are critical. The outsourcing partner should be subject to external regulation and ideally affiliated to an utterly credible financial institution. Additionally the organisation's relationship banks will need detailed mandates setting out the levels of authority delegated to the outsourcing partner. The partner should have a written statement of limits – maximum exposures to both a particular bank and to any given currency.

Hedging restrictions, liquidity levels and the use of derivatives should also be covered. Not least the outsourcing partner's systems must interface with the company's general ledger so that all accounting entries are passed automatically in real time.

New electronic products

Treasurers have long regarded factoring and invoice discounting as a bad way to raise working capital finance – expensive due to the administration overheads and the inferior risk profile of the debtors, and disruptive of customer relations due to the severing of direct contact.

A possible way through this is being promoted by Demica. Called Citadel – Central, the system incorporates corporate finance technology that allows small and medium-sized companies to pool receivables and access cheap and liquid funding through the capital markets via securitisation. Financial institutions are also adopting this system to market new funding products that might ultimately replace expensive invoice discounting. For larger companies there is a global version which enables firms to pool trade receivables across the entire business and to tap into global securitisation markets with minimal extra administration.

Another area of specialist finance which is using e-business principles is the market for OTC (over-the-counter) instruments. An OTC product is a foreign exchange, money market or derivative instrument which is not traded on an exchange due to the credit status of one or both parties or the absence of a standardised format.

An electronic network is clearly a more efficient means of disseminating the 'request-for-quote' than the old-fashioned telephone. With treasurers understandably seeking a range of quotes for a special one-off transaction, electronic trading looks the way to go.

FORTHCOMING FACULTY EVENTS – 2001

To attend any Faculty event, please fill out the form which adjoins this page, remove it by tearing along the perforation, and mail it or fax it to 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.

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

'THE DATA PROTECTION ACT 1998 AND ASSOCIATED LEGISLATION' – LIZ SANDWITH, SANDWITH INTERNAL AUDIT SERVICES.
This lecture will provide a 'hands-on' overview of audit work that can help to ensure compliance with the new Data Protection Act, which came into full force on 1 March 2000. There have been significant changes to the range of information held electronically and manually by businesses, who must comply with the Act. Registration 5.45pm; lecture 6.00pm; networking and buffet 7.00pm.

Application forms for this lecture can be obtained from Louise Matthews, on 020 7920 8493 – Audit and Assurance Faculty, ICAEW. Cost – £29.38 (inc. VAT).

● 16 October
BREAKFAST SEMINAR
(Chartered Accountants' Hall, London)

'BUDGETING AND PLANNING FOR THE 21ST CENTURY' – JOHN MCKENZIE, ARMSTRONG LAING.
This seminar looks at the increasing inability of budgets to deliver, and explores ways for companies to develop more dynamic budgeting processes that go beyond numbers and tie in with the way businesses consume resources whilst still providing appropriate controls in today's changing business environment. Registration/breakfast 8.00am; seminar 8.30am-10.00am.

● 25 October
ONE DAY CONFERENCE
(Chartered Accountants' Hall, London)

'SHAREHOLDER VALUE – FROM MEASUREMENT TO MANAGEMENT' – SPEAKERS FROM SHAREVALUER, ATC, MARCONI, CADBURY SCHWEPPES, BAE SYSTEMS, KEPLER ASSOCIATES, AND VALUE PARTNERSHIP.
This conference considers both the 'measurement' of and the broader aspects related to the 'management' of value creation. Specifically the conference will cover issues such as: understanding the investor's perspective on value creation; identifying appropriate performance measures to guide value creation; using software tools to support value creation; and understanding and overcoming the implementation challenges inherent in 'managing for value'. Registration 9.00am; conference 9.30am-4.25pm.

● 22 November
BREAKFAST SEMINAR
(Birmingham – *venue TBC*)

'BUDGETING AND PLANNING FOR THE 21ST CENTURY' – JOHN MCKENZIE, ARMSTRONG LAING.
See 16 October entry above.

● 28 November
EVENING LECTURE
(Chartered Accountants' Hall, London)

'CUSTOMER RELATIONSHIP MANAGEMENT' – DR ROBERT SHAW, MARKETING BEST PRACTICE INTERNATIONAL LTD.
Customer relationship management (CRM) has established itself as one of the biggest investments that companies are making today. At its best, it drives up customer profitability and shareholder value. But at its worst, it is a disastrous waste ot time and money. This seminar describes the critical success factors and the role of financial management. Registration 5.45pm; lecture 6.00pm; buffet and networking 7.00pm.

● 4 December
BREAKFAST SEMINAR
(Manchester – *venue TBC*)

'BUDGETING AND PLANNING FOR THE 21ST CENTURY' – JOHN MCKENZIE, ARMSTRONG LAING.
See 16 October entry above.

RECORDINGS OF FACULTY LECTURES

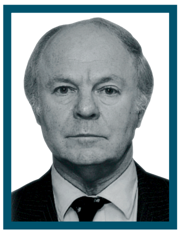
Recordings of the London lectures are available, in both **audio** and **video** format. To obtain a recording, please tick the audio and/or video box on the tear-off response form opposite.
There is a charge of £5.00 for audio recordings and £10.00 for video.

THIS MONTH

BEYOND BUDGETING
Robin Fraser and Peter Bunce of the Beyond Budgeting Round Table CAM-I Inc illustrate how to manage performance better without budgets – plus a contribution from David Berkeley of Bulmers.

How to build a winning team

In the second of two articles on team management, **Richard Alston** discusses the key ingredients of a winning management team and how to identify them.



Dr Richard Alston ran an international strategy consultancy before his recent retirement. He is now holding distance learning MBA (Management) courses for a private university. Email: rabath@supanet.com.

In my earlier article, I suggested that leadership is a management tool for influencing people's behaviour while management is a broader function involving the co-ordination and direction of people and resources toward the attainment of objectives.

From this it follows that successful team management can be observed not only in the results the team achieves but also in the manner in which the team gets those results. The following properties and performance characteristics should be looked for when seeking to identify a well-managed team:

- the manager is skilled in leadership, in understanding membership roles and in fostering interaction both within the team and with other groups, resulting in relaxed working relationships developed over time. Loyalty, high trust and confidence rest on group values and goals satisfactorily integrated from individuals' values and goals;
- members are highly motivated to achieve the goals of the team, have an active interest in optimum solutions, and are supported by an atmosphere for group work built on group and individual values;
- the manager fosters an atmosphere of participative safety in which goals are high enough to challenge but not create anxiety, and with high expectations of each member to perform. Emphasis on mutual help creates a supportive atmosphere for constructive criticism;
- team members demonstrate creativity, are clearly not 'yes' men, and the group is keen to develop members' potential. There is 'constructive' conformity, eg on operational and administration procedures. Relationships allow for full and frank communication both within the team and with other groups. Flexibility characterises the team and its members. There is a strong motivation to influence others and allow their influence;
- there is good upwards communication to the team leader and high receptivity to others' information. Important information is 'pushed', unimportant information excluded; and
- a well-managed team generates a feeling of security which in turn promotes initiative and delegation. Such teams do not lose a good manager easily and will want to take part in the careful selection of a new leader.

The team manager must address four functions necessary to the accomplishment of the team's objective:

- control of internal activities;
- enforcement of group values;
- linking with other teams; and
- protection from outside pressure.

His success in these has two principal effects on the team. First, the team's productivity or output. For example, a good sales manager will ensure that sales and service visits are balanced across the sales representatives in his team. Similarly, the good transport manager sees that vehicle routing is balanced across the drivers in his team. Both will ensure that the routing patterns meet fully the needs of best customer service.

Second, the leader has a strong influence on the team's stability and the satisfaction of individual members. A leader influences the individual members' satisfaction with the team. This satisfaction influences the individual members' willingness to show up on a regular basis to perform.

Finally, a good leader may not be a good manager but a good manager should be a good leader.