Finance & Management

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

Faculty of Finance and Management

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Communication and influencing skills

23 January – At an evening lecture in London, trainer and accountant Rick Payne will provide insights into improving these skills for personal and business success.
For further details, see page 16

IN THIS MONTH'S MAILING ...

Risk management

A special report (SR10)
This report looks at the increasingly crucial issue of risk management, with particular emphasis on the finance function and the roles that finance directors can play in monitoring and assessing risks.

KEEP UP TO SPEED ...

F&M*update*

The latest financial reporting, tax, employment and general corporate developments are covered in our four-page supplement (after page 8).

REPORTING

Financial reporting – the case against convergence

Financial reporting and corporate governance in the US and the UK are based on fundamentally different models. Attempts at convergence in an Anglo-American model of capital market behaviour are ill-founded, says **Tim Bush**, and are leading to confusion.

A shared common language can give the impression that the US and the UK also prepare financial statements and carry out corporate governance in similar ways. But, beneath the surface, the law relating to such activities in each country is entirely different in intent and effect. Hence efforts outside the US to achieve convergence in financial reporting, based on aspects of US-style regulatory financial reporting, are leading to confusion. Indeed, due to an anomaly within the US federal reporting system, introducing that country's financial reporting practices elsewhere is conceptually unsound.

US 'earnings-ism' versus UK capitalism

Financial reporting in the US is a federal matter regulated by the Securities and Exchange Commission (SEC) under the 1933 Securities Act and intended to ensure an efficient primary market in the issue of new shares and a similarly effective secondary market for trading shares already in issue. The aim, therefore, is that financial reporting should avoid fraudulent statements which might mislead investors. Meanwhile matters relating to the laws of property and to corporate objectives are covered at state level.

The UK financial reporting model, on the other hand, is based on company law. It is concerned with the shareholder base and those shareholders' corporate objectives – assumed to be a return on their capital investment, through activities based on a transparent business model involving a transparent level of commercial risk.

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The distinction between the rules-based US system of financial reporting and the principles-based British model of governance and financial reporting is that the latter – in which shareholders represent both the end customer and the enforcement mechanism – enables a decision on the most appropriate accounting treatment where the answer is not immediately obvious. In US reporting, where the enforcement and governance regimes are separate, that is not possible.

The US federal law created the 1933 act as the purpose for financial reporting, and the SEC was set up under the 1934 Securities Act as the regulatory enforcement agency for financial reporting matters. But governance of company behaviour is wholly a state matter and, because of the much weaker rights of shareholders in certain US states, shareholders most often have few enforceable rights.

The regulation underpinning the US-listed company model might be better described as federally-regulated earnings disclosure ('earnings-ism'), which addresses the question, 'are the accounts consistent in showing what a company might be worth when a share is exchanged?' By contrast the UK financial reporting model can be characterised as shareholder-based capitalism addressing the question, 'do the accounts show how efficiently a company is run on its capital resources?'

Different roles for US and UK external auditors

In the US, financial statements are prepared and auditors are employed by, and report to, boards, principally under the regulation established for market-pricing purposes by the 1933 Securities Act. This closeness with the client, being the board and not the body of shareholders, can create an agency conflict resulting in a lack of independence and a somewhat inhibited ability to act. The Sarbanes-Oxley Act is now addressing this issue with increased focus on audit committees overseeing auditors.

UK-listed company accounts are also published and audited. However, in contrast to US federal regulations, Companies Act section 235 (s235) requires that auditors are appointed by, and report to, shareholders as an

This article has been edited from 'Divided by common language' written by Tim Bush of Hermes Pension Management and published by the ICAEW. To order a copy of the paper visit www.icaew.co.uk/corporategovernance or e-mail corporategovernance@icaew.co.uk

obligation of the privilege of incorporation. They, and the audited financial accounts, primarily serve a stewardship function, but their utility goes further.

The contractual purpose of the s235 audit is quite simple – to address an agency problem. Those people charged with looking after the property of others should be accountable to them. They will therefore have an inherent tendency – not necessarily malign – to present their performance and stewardship on their own terms – hence the need for an unbiased independent agent, the shareholders' auditor.

> In the US, auditors report to boards

A British auditor therefore primarily performs a civil law function under contract whereas the US auditor principally reports for the requirements of SEC enforced regulation. In the absence of a contractual audit aimed at addressing the intrinsic objectives of the corporation, the shareholder in a US incorporated listed entity instead receives a regulatory audit. The shareholder's interest as an owner of something with intrinsic value is therefore subordinated in terms of financial reporting to a range of other players, particularly regulators and standard-setters.

Role of the accounting standards-setters

The frameworks of the Accounting Standards Board (ASB) for the UK and Ireland and the Financial Accounting Standards Board (FASB) for the US

differ, not because of the intellectual choices of the standard-setters, but because of the influences of the principles in national law. For listed companies in the UK, the role of the ASB has in effect been superseded by that of the International Accounting Standards Board (IASB), but the corporate governance framework of financial reporting in the UK is not affected by this change.

US GAAP

To accommodate 'common sense' accounting alongside the limited focus covered by the 1933 Securities Act, the US developed 'generally accepted accounting principles' (GAAP) as a point of reference. GAAP creates an additional framework alongside the principles of the 1933 act but without any overarching principles of its own. Hence GAAP has gaps, and it is these gaps that can be exploited in some situations, since GAAP does not have any guiding compass based in federal law.

Standards of US GAAP are substitutes for any unambiguous reference in federal or state law for accounting matters. The US GAAP regime is actually attempting to create something akin to law in the absence of federal law giving sensible guiding accounting and reporting principles. For this reason choosing to override US FASB standards, which is sometimes suggested, may sound compelling but would create confusion since there is no alternative steer or compass in ultimate law to justify non-adherence to the quasi-law of GAAP.

It is the lack of state regulation addressing external reporting that GAAP attempts to mitigate and force into an SEC-relevant and enforceable context. But due to the inherent tension between transparency (federal GAAP) and privacy (state law) it can be difficult to act prospectively so that the standard setting process in GAAP is ahead of actual mischief. Hence, Enron-type problems occur and standards are only, but not always, written after a mischief has happened.

The cost of regulatory confusion

A problem with inappropriate cultural exchange from the US into the UK is the cost effectiveness of process and regulation, especially when the regulation itself may be confusing entirely different objectives and actually leading to counterproductive behaviour.

The most critical problem may be that financial reporting is getting so complex that very few people genuinely understand the accounts any more. There may be direct relationships between clear civil law and simple but fulsome reporting (UK), and weak civil law – with strong but incomplete trans-jurisdictional regulation – and the need for complex rules and processes in financial reporting (US).

> IASB standards provide a good framework

If it is indeed ever possible to construct a robust conceptual framework for financial reporting and auditing around the aims of the 1933 Securities Act, it seems fair to conclude that this has yet to be achieved. Even if achievable, it is unlikely to sit easily with conceptual frameworks of other systems based on entirely different legally defined goals.

Conclusion – choose a simpler model for harmonisation

The standards developed by the IASB provide a good framework. However, any accounting or auditing standards framework must provide for override in the interest of the corporate objective (shareholder interest), as distinct from any standard-setter's or regulator's self-serving objectives.

IASB standards are already suffering from political interference in their setting, in a way that the ASB did not. Indeed the conceptual framework of the IASB, based not on a specific use for shareholders but something more general called 'decision usefulness', has introduced a multi-stakeholder concept, one result of which might be that the interests of the primary stakeholders – the shareholders – become subordinated to those of others, as recent political interference has borne out.

Rather than statutory reporting being given the status of an incidental subset of US-style (general purpose) financial statements, statutory (shareholder) regimes should be recognised as giving both purpose and authority, in a way that the US model does not currently have. (On this basis the US would have a proper form of shareholder-focused financial reporting and auditing, the absence of which has led to a repeating cycle of more standards, corporate failure and reputation loss.)

As a result, the rest of the world would maintain what has broadly worked well, in a far simpler way. The British model in particular has worked well with listed company requirements being an overlay to the basic statutory purpose for shareholders. **F&M**

UK accounting principles

In UK law the Companies Act applies to companies whether listed or not (as opposed to the US approach applying to listed companies only). And the UK accounting and reporting framework is set out in the Companies Act itself. The framework in the act sets out the requirements for the accounts to show a true and fair view, and sets out key accounting principles.

As well as setting out accounting principles, the act also sets out firm requirements for the disclosure of any financial commitments or other obligations that may have a bearing on the shareholders' view of the financial position of the company to which they have subscribed risk capital.

Whereas in the US, accounting standards have been essential to make up for problems in the basic framework, in the UK they have, up until the introduction of international financial reporting standards, been more for guidance than instruction, since the basic Companies Act framework itself is unambiguous as to the need for economically relevant information relating to stewardship. Beyond what the accounting information might say about what the company could be worth, the key test under British law is what the accounts say about how the company has been run on its resources for furthering the goals of the corporation.

Finance at the top of the leaderboard

Jonathan Orr is finance director (FD) of the PGA European Tour (the Tour), and of the Ryder Cup.
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When Faculty member **Jonathan Orr** became the PGA European Tour finance planner in 1992 he wanted to put finance on the organisation's agenda. After 9/11, as he tells Helen Fearnley, it was a key preoccupation…

Some business crises defy even the most rigorous of scenario planning – take, for example, the effect of the 11 September 2001 Twin Towers disaster on the Ryder Cup planned for later that month.

The timing could hardly have been worse, as PGA European Tour and Ryder Cup finance director (and Faculty member) Jonathan Orr explains. "Europe was the host for that year's match, scheduled to start on 24 September in Birmingham. The whole infrastructure – which takes three months to build from scratch – was ready. Everything bar the flowers was in place. Then, in the immediate aftermath of 9/11, the US PGA informed us that the US golfers in their team had no stomach for either airline flight or sport, and would not be coming. Obviously, without them there could be no tournament. So the 2001 Ryder Cup had to be postponed at less than two weeks' notice."

> Failure to hold the event would breach every contract

This turn of events could have spelled disaster for the Tour. As the membership body for professionals who play in tournaments – the cream of European golfers – it is responsible for an extensive schedule of golfing events played throughout the world. These range from the predictable European venues – Spain, Italy, France – to those much further afield, such as Australia, New Zealand, Dubai, Singapore, Indonesia, Malaysia, and China.

The Ryder Cup, however, is special. This bi-annual contest between America and Europe has acquired something of the status of the Olympics. The highest earning golfers from both continents waive their fees, playing for free in a three day long battle for possession of the prestigious Samuel Ryder golden chalice.

Potential financial disaster in all areas of income

Even more important, from the beleaguered Orr's perspective, the Ryder Cup is crucial to the Tour's commercial viability, the event being one of its two major sources of income (the other being the wider sale of television rights across the Tour).

Ryder Cup sponsors include such blue chip companies as Pfizer, Lucent, Rolex, and KPMG, and turnover in a 'home match' year is of the order of £40 million. However, since the event is bi-annual, and is hosted alternately by the two competing continents, this income source occurs only once every four years. Hence cancelling Europe's 2001 stint as host threatened to make a disastrous dent in the Tour's profits. Worse, it introduced the possibility of a welter of lawsuits.

As he recalls, "Whilst sympathising with the US team's feelings, we were faced with the prospect that failure to hold the event could put us potentially in breach of every contract we had entered into on the ground. And with 5,000 staff and a five storey 18th green hospitality unit and other infrastructure with a budgeted spend of £7 to £8 million, that was no small threat."

The one chink of light at the end of this extremely dark tunnel was that not only was the event insured, but – thanks to the soft insurance market of 2000 – was covered on fairly comprehensive terms.

However, the insurers were not just going to roll over and pay. Firstly, they needed some convincing that the policy included the fall-out from events 3,000 miles away, rather than in Birmingham (UK) as had been originally envisaged when they wrote the policy.

Hence, says Orr, "There followed a very nerve-wracking couple of weeks, during which they were unable to confirm that they would agree to meet the claim."

If the claim was not to be met, the outlook was grim. "Without an insurance payout, our balance sheet just wouldn't have been able to bear the cost. So during this period every would-be solution was considered, all of which were very unattractive and would ultimately have led to European golf being asked to pay the bill in one way or another."

CAREER TO DATE …

1986
BA (Hons) Business Studies, Oxford Polytechnic

1990
ACA Grant Thornton

1991
- finance controller, Nyckeln Finance, on secondment
- appointed European Tour group financial planner

1998
- chief finance officer, the European Tour
- additionally appointed finance director of the Ryder Cup

2001-2003
- negotiated £17.5 million insurance payment for impact of 2001 Ryder Cup postponement

Fortunately, the insurers came up trumps. They behaved, says Orr "impeccably". Even so they were, in golfing vernacular, "not going to allow me any gimme putts". There were endless meetings between Orr, the Ryder Cup's staging team, and the insurance adjuster, with the adjuster demanding full and comprehensive details of every contract entered into.

Far-reaching effects

Meanwhile Orr was not only trying to negotiate with genuine contractors but also fending off claims from parties that had not had so much as a hint of a contract with the Tour. Birmingham's hoteliers and restaurants had also lost money and expected recompense.

All the while, his dealings with aggrieved parties – both genuine and less so in their claims – had to be tempered by the fact that their services would be needed once again when the match was rescheduled.

Importance of detailed records

It was, he says, "a period in which I grew up fast. I learned to pick and plot my way through every situation, and also to stand my ground. Looking back, I had a row with virtually everyone I had to deal with during that time! But what the experience taught me most of all was the importance of having every agreement diarised, every contract signed, and all documentation in the file."

The claim was eventually settled two years later, at a hefty £17.5 million. One could almost feel sorry for the insurers. However, as Orr points out, their fate could have been far worse. The Ryder Cup was entitled to claim up to a policy limit of £36 million. However, he worked hand in hand with the adjuster in order to mitigate the claim as much as possible. For example it was both team captains' decision that the 2002 Ryder Cup "should exactly replicate the planned 2001 event – the same teams, the same logo, a year later". This meant that the 2001 logo-bearing merchandise did not have to be jettisoned, saving the insurers a tidy sum.

A further lesson Orr learned, therefore, was to "always read the wording of your insurance cover. The cheapest cover is worse than useless if it turns out you are not entitled to claim." Needless to say, the insurers took the converse of that maxim to heart. After the 2001 disaster, he says wryly, "the entire market tightened up the wording of the cover for the next event". But it says a lot for the way all sides conducted themselves that the same lead underwriter that paid out in 2003 also underwrote the 2004 Ryder Cup.

Prior to this 2001 baptism of fire, things had been going relatively smoothly for a man who admits that a career in accountancy didn't initially appeal. This reluctance was partly to do with his desire to avoid simply following in his father's footsteps, and partly to do with his natural affinity with more creative types. (His university leisure pursuits had mainly involved the theatre, though stopping short at any plan to tread the boards for a living.)

> Consultants offer the chance to cut through politics

In the end, however, there was no ignoring his facility for the subject, after scoring the highest ever marks in the accountancy papers for the first year of his business studies honours degree. He was further encouraged when his training at Grant Thornton brought him into contact with such 'artistic' clients as rock band Queen and the elderly artist Erté (whose management company actually offered him a job).

But it was his 1992 appointment as finance planner of the Tour, at the tender age of 28, which seemed to present the dream combination of a finance job in a creative field. Indeed, so far from being steeped in figures was the Tour that Orr was the only financial professional among a staff of 50 at the time.

Raising financial awareness

Even a reluctant accountant could see the need to put finance further up the agenda of an organisation then focused mainly on sales and marketing. But Orr had to work hard to convince his colleagues that budgets and financial controls were not necessarily bad things.

Eight years later, events took a turn which inadvertently strengthened his case. In 2000, when the so-called 'Gang of Four' – the leading European Tour players Seve Ballesteros, Jose Maria Olazabal, Bernhard Langer and Nick Faldo – suggested a lack of transparency in the Tour's finances, Arthur Andersen were appointed to conduct an external audit. As well as co-operating thoroughly with this comprehensive review, Orr had also to cope with the sudden keen interest of the press, the Tour's sponsors and other stakeholders.

But, as he explains, "In a way this was a great opportunity. I had been head of finance for six or seven years, and done all the basic things in terms of introducing budgetary cycles, cash flow forecasts, internal controls, proper management accounts etc. The next obvious stage was to increase finance's influence in the Tour's negotiations with third parties."

Using management consultants

All organisations, he feels, can benefit from the timely advice of management consultants: "It is a chance to get a new view on your existing internal mechanisms, to cut through politics and provoke some ideas for the future."

In this case, the consultancy firm found no evidence of financial impropriety. Further, the resultant 280-page report not only gave the Tour a new-found confidence in its

own potential but also – to Orr's delight – moved finance significantly up the agenda.

Prior to this turn of events Orr had probably had to work harder than most FDs to convey the need for profit growth. Although, on joining as the Tour's first qualified accountant, he had started out with "a fairly large degree of latitude as not many people were sure what to expect of an accountant," he had also had to be sensitive to the prevailing culture of marketing and sales. Also, with many of its members mainly interested in the quality of the greens and the clubhouse facilities, there was not much grass roots demand for further maximising profits.

Nowadays, though, the emphasis is far more on being commercially viable in its management of some 45 tournaments, many of which are subsidised by the Ryder Cup profits, and television rights revenues from various of its tournaments. Marketing and branding are paramount in order to persuade sponsors and the media that golf – as opposed to other sports – will attract the desired demographic audiences. In recognition of this, the Tour has a joint venture company, European Tour Productions (ETP), with the TWI TV arm of sports marketing giant IMG. ETP provides a steady revenue stream and allows the TV coverage to be consistently good quality throughout the year.

Since 1992 the Tour has grown extensively, and is now, Orr says, a maturing business. It operates with quarterly rolling annual forecasts plus a four-year plan (reflecting the cyclical nature of the Ryder Cup revenue) which is rolled forward annually. Also, following on from a weakness the Andersen report did throw up – the difficulty of benchmarking salaries in the golfing world – these are now benchmarked on the Hay point-scoring system.

> Decision-making tends to be subjective

Forward-planning helps to minimise the impact of unpredictable crises

Orr still reckons one of his major – if elementary – achievements has been to ensure spending and income are meticulously planned. As well as, in the long-term, preserving the Tour's assets for future generations this ensures that in the face of short-term crisis – as with the Ryder Cup 2001 – "we have all our ducks in a row".

In many respects the Tour, which is a private company limited by guarantee, is similar in outlook to a public company. Indeed, it strives for PLC-style governance and is firmly in the public eye. While more than happy not to be heading a quoted company, with all the concomitant investor demands over profits, expenditure and rationalisation, Orr admits that there is a flip side to that lack of outside influence. As he explains, "Your decision-making tends to be more subjective. There are times when you need to be very profit and cashflow-driven and there are other moments, for example when fostering grass roots golf or dealing with a member's concerns, when you have to go more gently. The key is appreciating when each approach is required; I think I have a good sense of, for example, whether a request to spend £10,000 on 'something for the membership' is justified or a try on."

Despite – or perhaps because of – working in this somewhat rarefied atmosphere, he greatly values the support network afforded through his Faculty membership, which he feels enables him to tap into others' experience of the latest management ideas.

After 13 years within a necessarily political milieu, he prides himself on an ability to pick his way through the potential minefield. "I know where all the bodies are buried in golf administration, and can help the Tour in its dealings with the outside world."

In short, Orr seems to have the perfect job for the 'arty' accountant, combining lightly-worn financial skills with the rarer ability to "communicate and deal with a professional who may be throwing a 'wobbly' on the eighth green". Hole in one. **F&M**

HARVARD BUSINESS REVIEW – EXECUTIVE SUMMARY

Hiring for 'smarts'

Yes, it's nice when a leader is charismatic and confident. And a great CV can tell you a lot about a person's knowledge and experience. But such assets are no substitute for sheer business intelligence, and they reveal very little about a leader's ability to consistently reach the 'right' answer, *suggests author Justin Menkes in a recent HBR article.*

How can hiring managers flag individuals with such 'smarts', ie business intelligence? Historically, the only reliable measure of brainpower has been the standard IQ test, which is rarely used in business settings because of the specific subjects it tests for – maths, reading, and spatial reasoning – and because of its multiple-choice format. However, despite its shortcomings, the standard IQ test is still a better predictor of managerial success than any other assessment tool companies currently use, Menkes argues. The author defines the specific subjects that make up 'executive intelligence' – namely, accomplishing tasks, working with people, and judging oneself. He describes how to formulate questions to test job candidates for their mastery of these subjects, offering several examples based on real situations. Knowledge questions, such as those used in standard behavioural interviews, require people to recite what they have learned or experienced; intelligence questions call for individuals to demonstrate their abilities.

The questions in an executive intelligence test shouldn't require specific industry expertise; any knowledge they call for must be rudimentary and common to all executives. And the questions should not be designed to ask whether the candidate has a particular skill; they should be configured so that the candidate will have to demonstrate that skill in the course of answering them. **F&M**

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Implications of the Corporate Manslaughter Bill

Peter Thompson explains the latest version of the Corporate Manslaughter Bill*, and why it concerns every director of every company in the country.

Peter Thompson is a consultant with insurance law firm Davies Lavery, having previously practised as a barrister for 27 years, specialising in criminal prosecutions. He successfully conducted the defence in Regina versus Euromin, a Health and Safety Executive corporate manslaughter prosecution.
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At present the offence of corporate manslaughter is governed by common law and requires the prosecution to prove beyond reasonable doubt not only that an unlawful killing took place but that:

- a responsible person within the company controlled the activities resulting in the death of the individual (the so-called 'controlling mind'); and
- that person was grossly negligent so as to be responsible for the death and could be – and generally is – also prosecuted, as an individual, for the offence of manslaughter.

What the Corporate Manslaughter Bill now proposes

In 1996 the Law Commission prepared a paper for the Lord Chancellor on 'involuntary manslaughter', with particular reference to corporate manslaughter, and made a number of recommendations on what was to be a new offence of 'corporate killing'. Much was said on the subject over the intervening years, but apart from an initial draft bill several years ago little had been done to progress this issue.

Now, however, active interest has been revived. On 23 March this year, the home secretary introduced the new draft Corporate Manslaughter Bill and invited responses from industry, trade unions and other interested parties by 17 June 2005.

Whether this latest bill becomes law cannot be confidently predicted, as it is not the first draft bill to be considered in the last nine years. Company directors cannot afford to ignore the implications, should it succeed (see box below).

Defining the terms

The bill introduces the statutory offence of corporate manslaughter, which occurs:

> "… if the way in which any of the organisation's activities are managed or organised by senior managers causes a person's death and amounts to a gross breach of a relevant duty of care owed by the organisation to the deceased".

A senior manager, for this purpose, is defined as:

> " … a person who plays a significant role in the making of decisions about how the whole or a substantial part of the organisation's activities are to be managed or organised or if that person plays a significant role in the actual managing or organising of the whole or a substantial part of those activities".

The bill also explains that a breach of duty of care by an organisation is a gross breach:

> "... if the failure in question constitutes conduct falling far below what can reasonably be expected of the organisation in the circumstances".

Further, the bill makes clear that a duty of care is owed not only to employees, but also to those who might reasonably be expected to be affected, namely visitors to an office or site and the public at large where goods and services are provided.

Unlimited fines

Significantly, unlimited fines are now proposed for organisations (which will include government departments) guilty of corporate manslaughter. The bill also proposes that the court would have the power to require the organisation to take specific steps to remedy the breach, as the court sees appropriate, and a failure to comply could be dealt with summarily with a fine limited to £20,000, or, upon indictment, with an unlimited fine.

'Controlling mind' – the current law

It should be remembered that the common law offence of manslaughter will still remain an available option to prosecute individuals, and the fact that the company will also be liable for corporate manslaughter will not preclude the prosecution of those individuals.

Historically, corporate manslaughter as an offence has not been before the courts that long. Manslaughter was thought to be an offence only capable of being committed by a human not a corporate body. However, Lord Justice Bingham in *H M Coroner for East Kent ex-parte Spooner (1987)* observed that he was "tentatively of the opinion" that an indictment would lie against the company as well as the individual.

Then in *P & O European Ferries (Dover) Limited (1991)*, (into the circumstances of the 'Herald of Free Enterprise' case

* *To view the draft Corporate Manslaughter Bill, and for further information, visit the Home Office web site at www.homeoffice.gov.uk.*

which resulted in 187 passenger deaths), Mr Justice Turner concluded that a company could also be deemed guilty of the offence of manslaughter provided that you could find somebody within the company, who was controlling the relevant activities leading to the death, equally responsible.

Since the collapse of the 'Herald of Free Enterprise' disaster case, where the individual defendants were acquitted, a number of major fatal incidents have also resulted in unsuccessful prosecutions against individuals and companies. Such cases include the Kings Cross Underground fire (killing 31 people), the North Sea Piper Alpha oil platform tragedy (167 people lost) and the Clapham Rail crash (35 deaths, 500 injured persons). In each case the prosecution could not show that the relevant acts were committed by those persons identified as the 'controlling mind', responsible for the gross negligence causative of the accident.

However, when it comes to smaller companies the requirement of finding the controlling mind is not such an obstacle. In *Regina (R) versus (v) Kite and OLL Limited*, which involved the drowning of four teenage students on a canoeing trip, the managing director of the leisure company was found to have been the man responsible for organising the event and, upon conviction, was sentenced to a period of imprisonment, reduced to two years on appeal. The company was also convicted of corporate manslaughter.

The difference seems to be the confusion of responsibility in larger organisations which has resulted in the failure to convict either the individuals or the company.

Current financial penalties

Whilst convictions of companies for the offence of corporate manslaughter have accordingly been few, the public at large has demonstrated forcefully its discontent that large companies are not being held to account.

In fact this public perception is not strictly true. Whilst the company might not be successfully prosecuted for manslaughter there may well be other offences contrary to the Health and Safety at Work Act 1974 or indeed other statutes leaving the company open to prosecution and potentially substantial fines.

> Directors will continue to be scrutinised carefully

In *R v Howe and Son (Engineers) Limited (1998)* the Court of Appeal laid down guidelines for sentencing in offences contrary to the Health and Safety at Work etc Act 1974, which were reinforced in *R v Jarvis C A Crim* on 26 May 2005. The fines for companies involving fatalities and subsequent prosecution for failing to meet required standards of care for its customers have included:

- *R v Great Western Trains (1999)*: seven died and 150 injured – Great Western Trains fined £1.5 million;
- *R v London Underground (1999)*: a passenger fell between train and platform – London Underground fined £300,000; and
- Network Rail and Balfour Beatty fines arising from recent convictions in Hatfield rail crash trial, £3.5 million and £10 million respectively.

There has also been growing demand for a change in the offence affecting corporate prosecution so that there would not be a need to prosecute individuals to conviction of manslaughter themselves before the company could be convicted of the offence.

Whilst a convicted company can anticipate a substantial fine, the individual person held responsible must still face the real prospect of an immediate custodial sentence.

Both the Health & Safety Executive and the police are anxious to reduce the number of deaths in industry as well as on public transport and would be delighted if their task were made easier for the prosecution and conviction of a company should the new bill be put on the statute books.

The ruling in July 2005 in the Hatfield prosecution that individual manslaughter charges should be dismissed at the end of a seven-month trial was yet another example of the difficulty of proving a case within the current parameters of the law and another reason for the home secretary to press ahead with new statute law on the topic. The even more recent acquittals of five senior rail executives in respect of alleged breaches of safety standards in September 2005 in the Hatfield trial simply adds to the public outcry for changes to be made to the law, sooner rather than later.

Directors of companies will continue to be scrutinised carefully with regard to the manner in which they conduct their business and are at risk of finding themselves in the dock for manslaughter along with their company, but companies will find themselves more easily convicted when the conviction of a director with responsibility for the negligence is not a prerequisite to the conviction of the company for the offence of manslaughter.

Conclusion: conduct a corporate health check

The onus must now be upon all directors of companies to ensure that health and safety is at the top of the agenda and vigorously enforced. Further, it will not just be the health and safety director that will find himself in the dock along with the company; it may well be any senior manager.

A failure to take this message on board now and to implement procedures within the company to ensure health and safety of employees and the public will only result in the most serious of consequences in the future to companies and their directors. **F&M**

PENSION TRUSTEE AND FINANCE DIRECTOR?

If you currently act in a financial capacity for your employer and sit on the board of trustees of the pension fund, we'd like to hear from you.
The ICAEW's Ethics Advisory Services are currently looking into the needs of members in managing these sometimes conflicting roles with a view to developing FAQs and other support material.
Contact caron.bradshaw@icaew.co.uk.

Soaring costs, emission penalties and alternatives

Tim Freeborn, a chartered accountant, is an analyst at Evolution Securities, a broker specialising in smaller companies.
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Dramatic rises in oil prices have moved global warming to the top of many governments' agendas. **Tim Freeborn** explains why costs have escalated, what carbon credits will involve, and more...

This article looks at the astonishing rise in energy costs, the arrival of carbon credits, and some of the alternative energy solutions which are emerging.

As a corporate broker with several energy sector clients it would be gratifying to have forecast this year's surge in prices. In reality we were as surprised as the rest of the market. The third quarter of the year is traditionally the strongest for energy prices as stocks are built up ahead of winter. Even so, a crude oil price of around $67 per barrel was well ahead of what, nine months earlier, we had expected.

There have been many factors at work but the rise of China and the continuing surge in US energy demand play a huge part. However, there are two sides to an oil price: barrels and dollars. While the oil majors have struggled to replace output with new discoveries, the US Federal Reserve has had no difficulty finding new reserves of dollars.

The M3 measure of money supply in the US has nearly trebled in the last 20 years, yet inflation in the shopping malls has been negligible. The entry of 300 million Chinese into the global labour market over this period has powered the growth of Wal-Mart and put an armlock on consumer price inflation. Those extra dollars have had to go somewhere. Property and commodities are in relatively fixed supply, so they have been the prime destination of this extra money. Equities have also benefited but it is relatively easy to manufacture new equities: just consider Google's $80 billion market value. Hence over these two decades – until August 2005 – oil price movements seem to follow closely those of M3.

Looking to the future, a further one billion Chinese people are yet to join the global market. India is making a serious play in service industries. Between them there seems little reason to expect labour costs to increase much over the next few years. This suggests long-term interest rates have scope to fall even further, creating a further engine for money supply growth.

The penalties in the European Trading System

Period	2005-2007	2008-2012
Penalty per tonne of CO2	€40	€100
Estimated quantity to be purchased within EU	60-70 million tonnes	250 million tonnes
Kyoto requirement	—	Greenhouse gas 1990 levels minus 5.2% by 2012
EU ETS requirement	—	1990 levels minus 8% by 2012
Burden on EU industry assuming credits at 50% of penalty	€1.3 billion	€2.5 billion

Source: Agcert International PLC

Restraining

Richer countries may have learned to grow gross domestic product (GDP) slowly, while restraining oil consumption. But the suspicion remains that a large proportion of this progress is thanks to exporting energy intensive industries to economies outside the Kyoto Protocol. Global oil consumption is still rising fast – up 42% in 20 years – dragging coal and gas prices in its wake.

> Global oil consumption is still rising fast

The Middle East contains two thirds of the world's supposedly proven reserves. But there is great uncertainty over these figures. There has been no proper audit of Saudi reserves in the last decade. Meanwhile the country generates nearly all its production from just 10 fields. The world has vast proven reserves of coal. Its oil and gas position is much less healthy.

This is why the US and China would like to see 'clean' coal take over from oil. But clean coal is expensive coal. Making gas from coal looks a reasonably attractive proposition, for instance. However, a power station plus gasifier costs 20% more to build than a conventional plant using pulverised coal. Even then, finding environmentally credible ways of sequestering the carbon dioxide (CO2) looks a further expensive problem.

There are two schemes for CO2 emissions trading: Kyoto Protocol and the

European Trading System (ETS). The ETS, applying to countries within the European Union (EU), comes into force in two phases: 2005-2007 and 2008-2012. In the table on the previous page we summarise the penalties within the ETS, along with its emission reduction requirements (with the less stringent Kyoto requirement included for comparison).

Allocations

Emissions allowances are relatively easy to trade. Within the EU, the allowances are awarded by national governments according to their allocations by the EU. Theoretical as it may sound, emissions trading is already big business. The relevant contract on the International Petroleum Exchange started trading at $4 but by mid-August had settled above $22 for the December contract. Consumers will not see this cost but it will add materially to electricity costs, particularly from 2008 when the penalty reaches €100 per tonne. A figure of €12.5 billion (see table) is equivalent to around 1.3% of the EU's GDP, or equal to £19 per person per year.

There will shortly also be trading of emission reductions from less developed countries. Agcert International, which floated earlier this year, is promoting a system in Latin America that reduces methane emissions from cow dung by burning it for electricity production and conversion into the comparatively less harmful CO2. Farming produces around 20% of the world's greenhouse gases, so this is probably only the first of many schemes.

As a broker we continue to look at a variety of emissions reduction and alternative energy propositions. Some are frankly harebrained, and many still require heavy government intervention to become 'commercial'. Within this semi-commercial category are opportunities such as biofuels and wind/wave and solar power.

Biofuels are currently not taxed at all in Germany. In the UK they receive a tax reduction of 20p per litre. Stories may appear of farmers happily making fuel, but in the past these have either depended on local tax breaks, as in the US, or (in Europe) on exemption/ avoidance.

Credible business models we have seen indicate a cost per metric tonne of biodiesel of $480. Each tonne generates around 1123 litres of fuel, giving a direct production cost of $0.43 per litre (€0.34). Until recently this meant biofuels were uneconomic against fossil fuels. In addition, this $0.43 cost depends on volume efficiencies and a stable raw materials price. The latest surge in crude oil has helped the picture.

The wholesale price of fossil-based ultra-low sulphur diesel reached €0.28 in June in Germany. But it seems likely that crude prices will need to hit our M3-inspired target of $80 per barrel to make biofuels sustainable without government intervention. But the use of emissions credits could help the picture even if cash-strapped governments tire of direct handouts. The EU will require diesel to contain 5.75% biofuel from 2010, up from the current requirement of 2%.

> Crude oil at $80 would make biofuels sustainable

Grim as it may sound, the destruction of the rain forests in Indonesia is freeing huge acreage for the creation of palm oil plantations. This is why we would be surprised to see massive price inflation in this raw material, even if demand for biofuel takes off.

Looking further ahead, we see a returning interest in nuclear power combined with more efficient generation technologies. Fuel cells have long been hyped as the solution to the world's energy problems. This is plainly ridiculous because they typically still require a fossil-based fuel. They do have some efficiency advantages over conventional combustion technologies, but these tend to be marginal. In any case, viable cells have yet to emerge in any major application. They began commercial life in submarines in the 1950s, and this remains, depressingly, their most important use.

Genuine

We believe there is more scope for using electrolysers in combination with nuclear electricity as a genuine solution to the world's energy problems. An electrolyser turns electricity into hydrogen, the exact opposite role performed by a fuel cell.

Why would anyone want to do this? A key disadvantage with nuclear power is the huge up-front fixed cost. This makes it suitable only for producing the base load, ie the minimum demand during summer months. In the UK this base load is only 20% to 25% of the peak winter demand, which is why nuclear has never generated more than this proportion of our electricity needs.

The base load could be hugely increased relative to the peak load if we ran our cars on electricity. Battery-powered cars show some progress, thanks to regenerative braking and smarter management software. But the real breakthrough may come from generating hydrogen from the mains via an electrolyser.

Current petrol engines can run easily on hydrogen. The big obstacle has been making the hydrogen economically and cleanly. Efficient electrolysers fitted into cars or motorists' garages would change this picture entirely. UK-based ITM Power hopes to unveil a unit in the first half of next year with a 250-watt capacity. In a few hours this would produce enough hydrogen for a typical day's mileage. At current electricity prices, the cost would be less than 50p per litre.

The crucial issue here is endurance. The unit must last long enough to make this 50p cost a reality. People wanting to use electrolyser units would of course need access to a power socket and mains water: not easy for flat dwellers but no problem for most home owners.

ITM's production system for cells and electrolysers replaces complex engineering with polymer chemistry. The cells virtually assemble themselves. In June it unveiled the world's first flexible cell. This property is not hugely important in itself but it demonstrates the stability of the system.

Conclusion

The short-term energy picture is likely to grow worse, if only because of the build-up of surplus dollars. But in the medium-term we are hopeful that technology will produce attractive solutions. **F&M**

Developing excellence in finance teams

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In a summary of their September Faculty lecture on the subject, **John Tranter** and **Steve Satterthwaite** explain how to develop loyalty in organisations through a sense of inclusiveness and belonging.

Much is written about the role of chief finance officer (CFO) as a leader, the changing role of finance, and the need for increasing flexibility of the finance team. At the same time, day-to-day decisions such as whether or not to outsource various processes, invest in new enterprise resource planning systems and the like, compete for space and attention in the CFO's in-tray.

How do CFOs respond? How can they take these decisions? Who will carry them out? How well will their teams deliver? What is outside of their control? How will it be managed?

Looking at accounting literature, most of us have little problem identifying the relevant assistance for technical issues. Accounting manuals give great detail on the application of accounting standards. Expert help is readily available. Our training is geared towards providing the analysis, logic and clarity of thought which are excellent skills when looking at the impact of balance sheets on shareholder expectations.

However, much of what a CFO deals with is less clear. There are ambiguities about day-to-day decisions, where there are judgement calls to be made. Investment appraisal can only go some way.

Building the right team

At some point the CFO has to develop a vision for the finance function and build the team to deliver it. The literature here is less full, less detailed and less analytical. Team building courses abound, but will they build the team to deliver the organisational goals?

The way we have approached this, and want to share with you, is based on three overlapping elements:

- strategic context and operational response;
- finance team alignment; and
- personal and team development.

Strategic context and operational response

Strategy always sounds a big subject. It summons images of away days, consultants and deep analysis before someone arrives with 'The Answer'. What CFOs often need is something simpler, which can be used as an analytical tool and the basis for communicating within the team and with stakeholders.

To do this, we developed a model (Figure 1, left – for the moment, look only at the quadrants ie excluding the ellipses).

This shows that, whilst as CFOs we might see our role as being the 'strategic partner,' our success starts from getting the basics right – the bookkeeping role. We have to deliver in all four quadrants. The steps we used with this model were threefold:

- examine what the deliverables are for each quadrant;
- determine the projects required to meet those deliverables; and
- use it as a communication tool.

The deliverables can only be determined by listening to the demands of the operational side of the business. Put simply, the bottom two quadrants

Figure 1 **CFO strategic partner model**

Figure 2 **Understanding personality through the MBTI**

of 'book-keeper' and 'controller' will tend to have more generic deliverables, independent of the sector the organisation is operating in. These are things which need to be done, the stoking room duties of the finance function. They may well be those activities which third parties can provide.

However, the top two quadrants are crucial to the success of the business and increasing competitive advantage. It is by aligning the outcomes of strategic partner and commercial manager with the operational needs, that the finance function will be seen to deliver added value. These are the activities which play a part in helping the organisation to maintain its competitive advantage.

To give a flavour of how this can look in practice, very top level key tasks which might be identified could include those shown (looking again at Figure 1, this time including content of the ellipses).

For each organisation the detail will be different and it is by working through that detail that the finance function can gain clarity about what it is there to deliver – every organisation needs a receivables function, but 'what', 'where' and 'how' is yours aiming to achieve, specifically?

A huge benefit from this process is the conversation which occurs with operational management in determining key priorities and deliverables. The model enables a structured debate to be had in a way which generates a common understanding of the issues facing both the operational and finance teams.

> The journey starts with a willingness to understand

The process also enables a discussion to be had around who is accountable for outcomes and who is responsible to support.

Alignment and development of the finance team

The model ignores one crucial element, however – people. It analyses the context but is silent on the people required to deliver the outcomes. People are your delivery mechanism. Their development is therefore paramount.

Technical skills and business skills can be taught and acquired by experience. And by developing a clear strategy for the finance team it becomes easier to pinpoint the key technical and business skills which need to be developed to deliver the necessary outcomes. Identifying individuals' development needs in the business and technical areas is relatively straightforward compared to the people skills.

Personal and team development

The aspect which is trickiest is the need to develop and enhance people skills. This is the bit which is the most nebulous and often, for those of us who like the certainty of numbers, the most intractable.

Dare we say that as a group we 'numbers people' like tangible outcomes, whilst the touchy-feely aspects of 'teambuilding' often leave us with unanswered questions over value for money, return on investment and clarity of outcomes?

What is clear to us though is that personal skills, including the ability to make things happen, are not things that can be ignored. Alongside the strategic and operational analysis we have therefore looked to align team development in a way which makes a clear link to the more tangible outcomes. The journey starts with a willingness to get a deeper understanding of our own strengths and preferred ways of working.

It is a statement of the blindingly obvious to say that people are different. Often those differences cause major misunderstandings and lead to skill sets being overlooked. An obvious example might be the clash between the 'big thinker' and the 'details person'.

How many conversations are fought to a standstill as each participant tries to argue that their view of the world is the 'right' one? This is a simplistic example but serves to show that teams need to know more about each other and themselves to be able to serve each other and the customer best.

What we looked for was something which would:

- encourage openness and trust;
- provide a non-threatening means to discuss differences in the team;
- allow us to value diversity in the team;

Figure 3

Team management wheel

- enable team members to value and work to the strengths of others; and
- help to confirm team strengths and discover blind spots.

The most effective tool we have found is the Myers-Briggs Type Indicator, (MBTI) a self-report questionnaire designed to help people understand behaviour preferences without getting too heavily involved in personality theory, or deep psycho-analysis. It is an analytical, value-free tool which gives easily understood, reliable and tangible insights into the way we are and – perhaps more importantly – into the potential effect we have on others (see Figure 2 on opposite page).

Used as a tool in team events, the MBTI helps us to understand and explain differences in people's behaviours and reactions. The model classifies personality in terms of our preferred (or most natural) ways of taking in information and making decisions.

People can be made aware of preference differences in a fun, non-threatening way which helps to get an enhanced understanding into their own behaviour preferences and those of others. This insight can then be further explored examining the characteristics of the different personality 'types' identified in the model and the potential areas for personal growth and development suggested for that 'type'.

Having a clearer understanding of both our own and others' preferences provides a wide range of applications in workplace settings, some of which are listed below:

- how we plan;
- our preferred style of leadership;
- how we like to communicate;
- how we like to contribute to the business;
- how we run meetings;
- our preferred style of learning;
- how we work at our best;
- how we like to solve problems; and
- how we manage stress.

> The links between tangible and intangible skills are clear

The greatest value comes from the practical application of the tool to the team discussion. Understanding your preferences enables you to think through strategies for communicating and working with people who operate in a totally different way. This makes us more effective and less prone to stress.

The MBTI approach focuses on us as individuals. The team management wheel shows the major roles that need to be carried out within any work team. The team is provided with a clear visual model and simple language is used that helps teams to discuss how people and tasks can link together in the most effective way. Whilst it is not necessary to have eight people in a team to cover all the team roles, problems can occur when there are gaps in the team.

The key is to develop well-balanced teams of individuals with complementary strengths and to work with the team to match work tasks to people's preferences in an appropriate way. These instruments do this by highlighting individual work preferences and providing a framework for identifying the work to be done.

Pulling it all together

We have used the above approach to enable us to follow a clear and robust process for analysing the task in hand, establishing teams with relevant skill sets and developing people to become more effective.

The objective for each stage of the process is as follows:

- *strategic positioning of finance function* – to have the function and tasks aligned to meet key outcomes required by the business;
- *team alignment* – seeking to ensure that team roles are understood and relevant skills are acquired; and
- *personal alignment* – each individual gains understanding of the way they work and the impact on communicating with the team and customers.

This process gives individuals clarity to think through their personal development planning in the context of their team and the requirements from their business on their role.

The links between tangible and intangible skills using this approach are clear, and even those of us who prefer hard numbers and analysis are supported by a safe, insightful and robust process. **F&M**

TAX UPDATE

Flat tax – does it have va-va-voom?

Ian Young is technical manager of the Tax Faculty.
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Is the recently mooted flat tax the right way to simplify the UK tax system? **Ian Young** examines both sides of the argument.

Everyone seems to have been talking about flat tax recently, and some commentators even appear to view it as the panacea for every tax ill. Why now, and is it really such a good idea?

The debate has been fuelled by the fact that many of the new accession countries joining the European Union (EU) last May already have flat tax and seem to have more dynamic economies than many of the longer-established EU members. So the argument that flat tax creates a dynamic economy seems to have some (evidential) support.

But whether or not a flat tax is actually a good idea is a more complex question. Four main reasons are put forward in its favour:

- it simplifies the tax system;
- it reduces top rates of tax;
- it stimulates growth; and
- it encourages compliance.

First of all let's define what is meant when people talk about a flat tax.

If they are talking about income tax then the basic proposition is that there should be only one rate of income tax together with an enhanced personal allowance before the single tax rate starts to apply. You also get rid of the whole range of special reliefs and other deductions which may all have been introduced for a jolly good reason but end up making every tax system incredibly complex and difficult to understand.

Playing about with the figures for a flat tax

Hence the Adam Smith Institute, for instance, put forward the proposal last summer that the personal allowance should be increased to £12,000 with a flat rate of 22% applied to all income in excess of that allowance. Such a system would make everyone better off and the lower earners proportionally better off than the wealthiest individuals (though that is before taking into account the tax credits the present system affords the less well-off).

However, the problem with this proposition is that it would reduce tax revenue by an estimated £50 billion – more than a third of the current £140 billion revenue from income tax.

> The UK tax system is far too complicated for its own good

You can play around with the numbers to produce whatever result you would like. Another exercise, carried out on behalf of the *Economist*, showed that with a personal allowance of £10,000 and a flat rate of 30% the effect would be revenue neutral ie the same amount of tax collected as under the present system. Unfortunately that proposal would leave everyone with income between about £20,000 and £50,000 worse off and a government which put such a proposal forward would resemble a turkey voting for Christmas!

Other evidence for and against

One argument for the flat tax is that when rates are too high there is a disincentive to work and an incentive to 'cheat' the system. Hence the 1979 top rate income tax of 98% was reduced over the next 10 years to 40% where it has remained ever since. Quite a number of reliefs were also removed at the time and incentives such as employee benefit were taxed more harshly, but that was accepted as a reasonable trade-off and a fairer way to organise the system.

Other contentions – that a flat tax stimulates growth and encourages compliance – are difficult to prove. The majority of the countries that have introduced flat tax have tax systems and economies which are very different from those of the UK and critics therefore argue that it is unrealistic to compare them.

In relation to UK compliance, one argument put forward is that the UK already "has a law abiding people" (Martin Wolf, the *Financial Times*, 6 September 2005). Yet we have a black economy which is estimated to be over 10% of the total economy, or well in excess of £100 billion.

In addition the government is currently putting forward the argument that there is a tax gap – the amount of tax businesses should be paying but are currently avoiding – which it estimates to be more than £30 billion. So perhaps we aren't as compliant as some would suggest.

Ensuring further debate

So what is the government doing to ensure there is a proper debate about flat tax? HM Treasury produced a paper on the subject which it was forced to publish under the Freedom of Information Act. However, although it is clear the Treasury is not 'pro', about a third of the paper was blanked out, making it hardly a brilliant contribution to the debate.

Meanwhile, the Conservative opposition has set up a special commission to look into reform of the tax system and if all this talk about flat tax achieves one thing I hope it will be to have a wide-ranging and informed debate about how we can improve the quality of the UK tax system which has got far too complicated for its own good. **F&M**

MARKETING UPDATE

Has lifetime value got long to live?

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

Retaining high lifetime value customers is central to many corporate strategies. But **Alan Mitchell** worries that this may be a wild goose chase.

Buttering up customers with high lifetime value has become the linchpin of many organisations' marketing and customer relationship management (CRM) strategies. The aim is to refocus limited resources on those customers with the greatest return. Why invest good money in unprofitable customers? Why pass up the chance to delight profitable ones?

There is one small problem with this strategy, however, in that it assumes we can accurately identify high lifetime value in the first place. Calibrating the current profitability of existing customers has proved hard enough for many companies. Now new research is suggesting that companies' ability to predict future lifetime values is worse than useless.

Kellogg School of Management professors Edward C Malthouse and Robert C Blattberg tracked four companies' attempts to predict future customer value (a catalogue company, a service company with service contracts, a not-for-profit organisation and a business-to-business supplier).

Misclassified

Summarising their results in the *Journal of Interactive Marketing*, Malthouse and Blattberg propose two 'rules'. First, looking at those customers who turn out to be the top 20% most valuable customers in a year's time, 55% will have been misclassified and not received any special treatment. Second, among the remaining 80% less valuable customers, 15% will have been misclassified and given special treatment.

"A firm cannot assume that high-profit customers in the past will be profitable in the future nor can they assume that the historically low-profit customers will be low-profit customers in the future," they conclude. By discriminating against customers deemed to have low lifetime values, many firms are actually pursuing policies that are both counterproductive and self-fulfilling: on receiving less-than-best value and service, potentially valuable customers are turning to the competition instead.

In theory, companies could make better predictions if they had better data. Blattberg concedes that some industries with fantastic data sets (such as credit cards) may turn out to be better at predicting future customer value than his research suggests. But most firms' ability to gather such data is limited, the costs of doing so are high, and there is still a lot of inbuilt variability that never can be predicted. Hence firms should be "highly circumspect about their targeting and CRM strategies based on predicted customer value," he says.

> Many of the most profitable customers are 'butterflies'

Should one piece of research be allowed to overturn an entire bandwagon? Perhaps not. But it is part of a gathering pile of evidence now challenging the assumptions of 'loyalty' or retention marketing.

Loyalty marketers argue that acquiring customers is such an expensive business that it is better to focus limited resources on keeping those you currently have. The longer a customer stays with you the more profitable he or she will get, they continue. The same customer will also have a lower cost to serve while providing more positive word-of-mouth recommendations to other customers. Finally, a loyal customer will be less price sensitive.

Really? Empirical research to test these theories is not bearing them out. Working backwards through the claimed list of loyalty benefits, the accumulated evidence suggests that long-term customers actually become more price sensitive. They learn how to squeeze more value from suppliers and they strongly resent being 'taxed' for loyalty via higher margins.

Dynamics

Research into the dynamics of word-of-mouth recommendation suggests that customers give less, not more, word-of-mouth recommendations for long-term suppliers, largely because fresh new relationships are more top of mind than routine, stable ones.

Further, loyal customers are not cheaper to serve. The research evidence on this is mixed, but the overall conclusion is that loyal customers are more expensive to serve because they become more demanding.

Finally, the empirical research suggests that the correlation between longevity and profitability is weak to the point of non-existence. Many of the most profitable customers are 'butterflies' who fly in, spend pots of money with you, and then fly off again. Investing time, money and effort trying to retain them is futile, suggests Insead marketing professor Werner Reinartz.

Does this mean companies should terminate all retention marketing exercises? Not necessarily. For example, schemes that reward profitable behaviours – such as air miles – may well be worthwhile, suggests Blattberg. It's the attempt to construct programmes on the basis of estimates of future value that's questionable. **F&M**

FORTHCOMING FACULTY EVENTS

To attend any Faculty event, please fill out the form in the Events flyer which is part of this month's mailing. Telephone payments by credit/debit card can be made to 01908 248159 (all major cards accepted). Faculty members only may book by e-mail at fmfac@icaew.co.uk. For all queries, call the Faculty team on ***020 7920 8508****.*

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

'COMMUNICATION AND INFLUENCING SKILLS FOR FINANCE PROFESSIONALS' – RICK PAYNE
Trainer and accountant Rick Payne will provide insights into improving your communication and influencing skills for personal and business success. He will also discuss corporate communication programmes. Registration 5.45pm, lecture 6.00pm, buffet and networking 7.00pm.

- Faculty members: FREE
- Non-Faculty members: £20.00 (plus VAT)
- Event code: TFFMLEC060123
- Final date for receipt of booking details: 18 January 2006

6 February
MORNING LECTURE (Chartered Accountants' Hall, London)

'EMPLOYMENT LAW UPDATE' – DOROTHY HENDERSON AND ANDREW LILLEY
Dorothy Henderson, head of employment law and Andrew Lilley, employment law partner, at City firm Travers Smith offer a round-up of key developments in employment law.
Registration 8.30am; lecture 9.00am to 10.30am; pastries and coffee available at registration.

- Faculty members: FREE
- Non-Faculty members: £20.00 (plus VAT)
- Event code: TFFMLEC0600206
- Final date for receipt of booking details: 1 February 2006

13 February
AFTERNOON SEMINAR (1862 suite, Notts County Football Club, Nottingham)

'ETHICAL ISSUES FOR THE ACCOUNTANT IN INDUSTRY' – CARON BRADSHAW
The head of the Ethics Advisory Service at the ICAEW, Caron Bradshaw, invites you to explore the issues and identify the trigger points which will enable you to see an ethical angle before a problem arises. Course 2.00pm until 5.30pm, followed by one-to-one advice clinic.

- ICAEW members: £60.00 (plus VAT)
- Non-ICAEW members: £75.00 (plus VAT)
- Book by e-mail (eastmidlands@icaew.co.uk) or telephone Elaine Franklin on 01773 811010

September 2005 to March 2006
ROADSHOW (various locations)

'ICAEW PENSIONS ROADSHOW 2005-6'
Dates are now available for the ICAEW pensions roadshow, which will help employers, trustees and auditors understand the implications of the many recent regulatory changes. For more information, dates and venues, go to www.icaew.co.uk and click on 'events'.

ADVANCE NOTICE
'Performance measurement and management – public and private'
A Cranfield University School of Management conference
25 – 28 July 2006
For more information, go to
www.performanceportal.org/pma2006.htm

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Even if you're unable to attend a Faculty event, you can now download a recording to your PC via our NEW webcast service. This means you can have lunch at your desk, watch a lecture and include it as a part of your CPD activity. To sample a recent event go to www.icaew.co.uk/fmfac

IN FUTURE ISSUES...

Finance & Management
- Smart working to boost business
- XBRL – has its time arrived?
- Making your strategy come alive
- The insolvency practitioner's role

IN JANUARY'S MAILING...

- *Executive summary* – a quarterly guide to the key editorial themes and articles that have recently appeared in Faculty publications.
- *CPDplanner* – a publication to help Faculty members with their CPD obligations in 2006.

Finance & Management

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