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EDITORIAL

Welcome to our fourth issue.

In this ‘Annual General Meeting’ Issue we have four articles.

The first article discusses accounting for goodwill (given a new standard in the US) and the implications for Australian reporting entities.

The second article deals with the business goals of stock broking firms in Australia, Singapore and Japan and the factors that influence these goals. This article deals with questions of how and to what extent does culture impact on organizations, specifically stock-broking organizations.

Our third article provides insights into the nature of intangible assets, and their potential role in the evaluation of corporate performance. An industrial economics framework is used, whereby issues such as barriers to entry and competitive advantage is discussed as they relate to intangible assets. A review of financial reporting practices is also undertaken using Australian companies as the survey group.

Our last article is a reprint of a speech delivered to the 14th SAAJ-AIMR/JSIP Joint Seminar. It provides a thought provoking discussion of the investment and decision making processes used by large North American pension funds.

We would like to thank and acknowledge our contributors, the Securities Institute of Australia and the Security Analysts Association of Japan (SAAJ) for providing the articles that have been reprinted in this edition of the e Journal.

As always, enjoy!

Deepak Gupta – Institute of Finance Professionals NZ
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(Joint Editors).

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THE GOODWILL GAME
Implications of the new US accounting rules

By Keith Alfredson and Adrian Murray

When analysts are asked about goodwill amortisation expense, a common response is that they add it back to profit. Accordingly, some may be glad to learn of the recent issue of Statement of Financial Accounting Standards FAS 141 “Business Combinations” and FAS 142 “Goodwill and Other Intangible Assets” by the US Financial Accounting Standard Board (FASB). These Standards, which have spelt the end to goodwill amortisation in the US, have numerous significant implications which are of interest to Australian reporting entities. This article reviews the new US rules, some related issues and the way forward in Australian accounting for business combinations, goodwill and intangible assets.

The Rules

FAS 141 addresses the initial accounting for assets acquired in a business combination. A key feature of FAS 141 is the removal of the “pooling-of-interests” method of accounting for business combinations, which entitled combining entities to basically sum their balance sheets under certain circumstances.

FAS 141 also introduces a new criteria requiring identifiable intangible assets to be recognised apart from goodwill when those assets arise from contractual/legal rights, or if those assets are separable (including if the intangible is separable in combination with another asset or liability). The Standard even includes a list of assets that satisfy this recognition criteria, such as order and production backlog, customer lists and customer relations, items that are not normally be capitalised in Australia.

FAS 142 covers the subsequent accounting for goodwill and other intangible assets. Most significantly it prohibits the amortisation of all goodwill and “indefinite life” intangible assets, instead requiring detailed impairment testing procedures, based on fair value measurements, to be applied at least annually[i].

While FAS 141 and 142 are quite detailed, there are likely to be several implementation issues involved with the application of these Standards. Already the FASB staff have issued tentative guidance reading down the transitional provisions in FAS 141 requiring entities to reclassify pre-existing goodwill and intangible assets to conform with the new recognition criteria. The FASB has also established a working group to deal with issues that may arise if the new rules are applied to not-for-profit entities. Given these developments, the current FASB project revising purchase method procedures, and the FASB proposal for a project to increase disclosures of internally generated intangibles, accounting for business combinations and intangible assets should still be considered to be in a state of flux.

Earnings Volatility

An obvious appeal of the new rules, particularly to those entities carrying large amounts of goodwill, is the end to regular amortisation charges. Ed Kerschner, chief global strategist at UBS Warburg, has estimated substantial boosts to earnings in the US telecommunications industry (23% gain), aerospace industry (17%), business and consumer services sector (15%), metal and chemical producers (10%) and makers of capital goods such as machinery (9%) as a direct result of these rules[ii]. The early adoption of FAS 142 by US based gas distributor Airgas reflects this, with the company’s diluted earnings per share being raised from US$0.15 to $0.20 for the three months ending 30 June 2001, due to the adoption of FAS 142[iii].

However, FAS 142 has a mixed effect. For acquisitions completed after the introduction of the new Standard, many entities will be forced to attribute greater value to identifiable intangibles, reducing the goodwill number substantially. And whilst goodwill was previously entitled to be amortised over a

maximum of 40 years in the US, many of these new identifiable intangibles will be required to be amortised over much shorter periods, say two or three years.

The new rules are also likely to hit hard when business valuations are down. Billions of dollars of goodwill and other intangible assets have already been written off the balance sheets of US companies in recently issued quarterly reports. Some examples are: JDS Uniphase (US$44.8b writedown), Nortel Networks ($12.3b), VeriSign ($9.9b) and Corning ($4.8b). Given a damaged US economy (and perhaps also because FAS 142 gives entities the one-off chance to record impairment losses below the line as a change in accounting principle), there may well be unprecedented goodwill write-downs in the US over the next year as entities first apply the new Standards.

Market Relevant Information

A key reason given by the FASB for issuing FAS 142 was the view that goodwill amortisation expense was not a useful number for analysing investments. While this view is supported by recent academic work[iv], the question begs as to whether impairment reviews will be any better - especially given the likely cost of the new impairment testing procedures?

How will the market react to an impairment write-down? Most likely on a case by case basis. The delay in issuing financial reports may mean that in many cases an impairment write-down only confirms expectations already held by analysts. But even so, an impairment write-down may still reveal the magnitude of the problem, and management's awareness of the issue. In other cases, an impairment write-down may provide fresh evidence of a bad acquisition, or an unexpected deterioration in the fundamentals of the business acquired. Accordingly, whilst an impairment write-down is still a non-cash charge, there is every chance the US approach will convey more information than amortisation.

In issuing the new rules, the FASB also noted that users of financial statements are becoming aware that intangible assets are an increasingly important economic resource for many entities. FAS 141 goes part way to addressing the associated need for better information concerning intangibles, placing pressure on entities to increase recognition of identifiable intangibles separately from goodwill, and through detailed disclosure requirements such as the requirement to disclose the factors contributing to a purchase price resulting in goodwill.

Mergers, Ratios and Dividends

Some defendants of the "pooling-of-interests" method outlawed by FAS 141 argued that the new rules would prove a disincentive to merger activity in the US, because the purchase method replacing pooling would require entities to restate the assets of the acquired entity to fair value when preparing consolidated accounts. This will increase the asset base of the combined entity, placing pressure on key performance ratios such as return on assets and return on equity. Whether removing pooling will really have such an effect on merger activity is yet to be seen. In any event, as pooling of interests has been outlawed in Australia for some years the same implications are unlikely to exist directly for Australian entities.

An argument raised in an Australian context for removing goodwill amortisation is that amortisation expense may impact on the ability of an entity to take advantage of available franking credits, given the fact that goodwill amortisation is non-deductible for income tax purposes and that dividends are generally paid out of accounting profit. However, the same problem will exist for any write-off of goodwill or intangibles even if amortisation was no longer required.

The future for Australia

The International Accounting Standards Board (IASB), the pronouncements of which will be required to be followed by all entities listed in the European Union by 2005, is moving quickly to finalise an exposure draft of proposals that are likely to closely harmonise with the US rules, at least to the extent of the increased recognition of intangibles, and the non-amortisation of goodwill and certain indefinite life

intangibles. While there are several inconsistencies between current IASB proposals and the US rules, the elimination of pooling in the US and recent IASB developments represent a major step forward in harmonisation in this area demanded by a global investment market.

The Australian Accounting Standards Board is already under considerable pressure to adopt a US approach in its project on Intangible Assets. However, rather than taking this approach without fully considering the consequences, the AASB is participating closely with the IASB as part of the AASB's role as an IASB liaison standard-setter. The AASB has recently invited Australian entities to participate in field testing the US impairment approach through the assistance of the Group of 100. This field testing is intended to inform the AASB of the feasibility of the US approach for Australian entities, and to provide significant input into the IASB's deliberations. Undoubtedly the stage is being set for Australian entities to be applying radically new rules for goodwill and intangible assets, within the next two years.

Keith Alfredson is the Chairman, and Adrian Murray is a Graduate Intern at the Australian Accounting Standards Board. This article contains their views and does not necessarily represent the views of the AASB. Keith or Adrian can be contacted on (03) 9617 7600 or at standard@aasb.com.au

The business goals of stock-broking firms in Australia, Singapore and Japan

By Brett L Scarlett

Introduction

The continuing globalisation of business increasingly requires that enterprises align organisational task, structure and strategy across all operational geographic regions and countries. Goal setting and the process of developing and communicating a common, enterprise-wide, strategic framework is critical to the achievement of this alignment. Recognising the influence of national culture on the perceived importance of business goals from one operational geography to another is necessary for global enterprise effectiveness.
The doctoral research program, *Enterprise Effectiveness: a cross-cultural study of business goals,* examined the impact of national culture on organisational effectiveness objectives and on the interpretation of success for the enterprise. The research questions considered were:

- To what extent does culture influence the importance placed upon specific organisational effectiveness objectives?
- Does culture have a greater influence on the importance placed upon non-financial organisational effectiveness objectives than on financial organisational effectiveness objectives?
- To what extent does culture influence the interpretation of organisational success?

Comparative findings from three Delphi studies about the business goals of stockbroking firms in Australia, Singapore and Japan are reported in this paper. The initial round for each of the Delphi studies commenced by asking the participants:
Please think of yourself as a director of a successful [country specified] stockbroking firm. What are your business goals?
This intentionally very open question allowed participants to freely list their business goals, initially in any order. Subsequent Delphi rounds asked participants to rank the goals in importance.

Comparative findings

The major findings from the Australia, Singapore and Japan Delphi studies are that for all three, there is an apparent absence of a strategic framework; that frequency of citation by stockbrokers does not necessarily reflect importance and that short- and medium-term objectives outweigh the long-term. In terms of the most important business goal categories, the three studies had somewhat different outcomes. For Australia, compliance was the most important. For Singapore, customer centricity was most important. For Japan, compliance was most important, closely followed by customer centricity. Notably, for Japan, there were no financial goals ranked in the top five. Table 1 compares the goal categories for the top five ranked business goals for Australia, Singapore and Japan.

Table 1 Comparison of top goal categories by rank of first occurrence within the top 5 business goals

Australia	Singapore	Japan
Compliance	Customer	Compliance
Financial	Financial	Customer

Customers	Compliance	Market Positioning
Market positioning		

Compliance related goals are important for Australia, Singapore and Japan but are more important for Australia and Japan than for Singapore. Customer related goals are important for all three but are more important for Singapore than Japan and more important for Japan than for Australia. Market positioning related goals are important for Australia and Japan but are not represented in the top five business goals for Singapore. Financial goals are important for Australia and Singapore but are not represented in the top five business goals for Japan.

Dominant goal themes

Table 2 compares all categories of business goal by rank of first occurrence—the rank of the highest ranked business goal of that category—for Australia, Singapore and Japan.

Table 2 Comparison of all goal categories by rank of first occurrence

Rank of 1st occurrence Australia	Category	Rank of 1st occurrence Singapore	Rank of 1st occurrence Japan
1	Compliance	5	1
2	Financial	2	9
3	Customers	1	2
5	Market positioning	11	3
7	Research	30	18
14	Future strategic	29	26
21	Operations	6	14
25	Employees	16	7
39	Product/service portfolio	8	20
	Personal/Social/Community		19

For Australia, as shown by Table 1, the five most important business goals are categorised within four goal categories. Table 1 also shows that these four most important goal categories for Australia—compliance, financial, customers, market positioning—encompass the goal categories representing the five most important business goals for Singapore and Japan. However, for Singapore, the rank of first occurrence of a market positioning related business goal is 11th and for Japan, the rank of first occurrence of a financial goal is 9th (see Table 2). Thus only customer and compliance related goals are consistently important for Australia, Singapore and Japan. But this summation omits the important (for Australia and Singapore) financial goal category. Hence, a theme based approach is proposed where the important goal categories for Australia are encapsulated as *compliance constrained financial performance*, for Singapore as *customer service driven financial performance*, and for Japan as *compliance constrained customer centric service*.

New goal category

The original nine goal categories were developed from the Australian business goal data after the initial Australian Delphi round. The participants were not guided into a framework of goals or goal categories. The 100 Australian Delphi first round business goals were categorised into the nine categories. The 40 Singapore Delphi first round business goals were readily categorised into the same nine categories. The 55 Japan Delphi first round business goals

were allocated into the same nine goal categories used for Australia and Singapore. However, six of the 55 Japan Delphi first round business goals did not fit into these categories. These goals were allocated to a new category of personal/social/community related goals. In the Japan Delphi, this new goal category was more frequently cited than operations, research, compliance and future strategic related goals. Five of the 11 respondents to the initial Japan Delphi round included at least one goal of this type in their response. One respondent had two personal/social/community related goals and no other goals. Revisiting the categorisations for Australia and Singapore, confirmed that there were no goals of this type identified. Thus the goal category of personal/social/community is considered as unique to the Japan study.

Absence of a strategic framework

For Australia, Singapore and Japan the business goals identified by the respondents to the initial Delphi rounds were a mixture of objectives, goals, measures and even, arguably, strategies and tactics. In part, this is a matter of terminology. The definition of a "goal" was intentionally left open, as was the definition of "successful", to allow participants to express their own views with only minimal guidance. The responses suggest that there is a diversity of interpretations of "goal". For the Japan Delphi, this confusion of strategies, objectives, goals and measures is potentially accentuated by Japanese/English language issues.

But terminology aside, this strategic confusion is potentially symptomatic of more fundamental issues. This, together with the number of business goals identified: 100, 40 and 55 for Australia, Singapore and Japan respectively; suggests the absence of a generally accepted and commonly understood strategic framework in the stockbroking industry, a framework that relates strategy, objectives, goals and measures. It also suggests that there is a potential disconnect between the business strategy and the day-to-day business drivers as understood by the individuals engaged in the operations of the business. If so, it implies the absence of a process for strategy development, goal setting and communication.

As further basis for the assertion that there is an absence of a strategic framework, consider the range of goal categories represented by the goals identified by each respondent. For Australia, one respondent identified goals from only two of the nine goal categories while another identified 15 goals across seven categories. For Singapore, individual respondents identified goals from five or six categories of the nine categories. For Japan, individual respondents identified goals from one to six categories of the ten categories used for the Japan Delphi.

Frequency of citation

For Australia, Singapore and Japan the data indicates that frequency of citation does not necessarily reflect importance. It may do, but this cannot be assumed. For Australia, market positioning, financial and employee related goals accounted for more than half the business goals identified in the initial Delphi round. But only the financial goal category was substantiated as important. For Singapore, financial, market positioning and employee related goals accounted for more than half of the business goals identified in the initial Delphi round. But, as for Australia, only the financial goal category was substantiated as important. For Japan, financial, customer, market positioning and employee related goals accounted for more than half of the business goals identified in the initial Delphi round. But only the customer goal category was substantiated as important.

Conversely, the goal category of compliance was the least frequently cited in the initial Delphi round for Australia and Japan and was one of the four least frequently cited for Singapore.[1] But after the third Delphi round, for Australia, Singapore and Japan, a compliance related goal was ranked as one of the most important business goals. For Australia and Japan, a compliance related goal was ranked as most important. So in summary, frequently cited goal categories were found to be of only moderate or low importance and infrequently cited goal categories were found to be of moderate or high importance. Thus frequency of citation does not necessarily reflect importance.

Important business goals

[1] More frequent than only research related goals, and equally as frequent as product/service/portfolio and future strategic goal categories.

The top five business goals for Australia and Singapore represent a reasonably balanced perspective. For Australia, the top five represent goal categories of compliance, financial, customers and market positioning. For Singapore, the top five represent goal categories of customer, financial and compliance. For Japan, the top five business goals represent compliance, customer, and market positioning. Due to the absence of a financial goal, this cannot be regarded as a fully balanced perspective.[2] See Table 3.

Table 3 Top five business goals for Australia, Singapore and Japan

Australia		Singapore		Japan	
Business goal	**Importance**	**Importance**	**Business goal**	**Importance**	**Business goal**
Compliance with the law and the appropriate ethical and regulatory standards.	1.11	1.00	Client focus.	1.00	Comply with local rules and regulations. To ensure that our transactions with clients adhere to both the laws of the respective countries and our company rules.
Achieve target return on equity.	1.22	1.25	Maximise company profit in the most capital efficient manner.	1.33	Achieve customer satisfaction and establish a good relationship with them.
Achieve target client service/quality standards.	1.22	1.25	Provide excellence in customer service.	1.33	To earn a reputation as a creditable trustworthy company.
Maximise shareholder wealth within target risk parameters.	1.33	1.25	Shareholder value.	1.33	To make the company one of the most recognised brands in Japan.
Establish the firm as the premiere stockbroking firm in Australia (eg to be the broker of choice in target market, to be on the preferred panel for the top 20 fund managers).	1.33	1.33	Professionalism.	1.50	Improve customer satisfaction.

For Australia, Singapore and Japan short-term goals are apparently given more emphasis than medium- and long-term goals. For example, the first occurrences of future strategic goals are ranked 14th, 29th and 26th respectively for Australia, Singapore and Japan.

Cultural dimensions underpinning business goals

The differences in importance of the goal categories for Australia, Singapore and Japan (see Table 2) are not obviously explained by reference to Hofstede’s cultural dimensions.[3] Potentially, only the compliance and market positioning goal categories can be explained in this way.

The compliance goal category can be aligned with the ‘uncertainty avoidance’ cultural dimension. The relative importance of compliance related goals, by rank of first occurrence, for Australia, Singapore and Japan is reasonably consistent with the ‘uncertainty avoidance’ profiles for these countries. The market positioning goal category can be associated with the ‘masculinity’ cultural dimension, particularly as the intent of many of the business goals in this category relate to market dominance. The relative importance of market positioning related goals, by rank of first occurrence, for Australia, Singapore and Japan is reasonably consistent with the ‘masculinity’ dimension profiles for these countries. This is a quite limited endorsement of Hofstede’s cultural dimensions as an explanation for the

[2] This presumes the mandatory inclusion of a financial dimension within a balanced framework.

[3] See Hofstede, G. 1980, Culture's Consequences: International differences in work related values, Sage Publications, USA and Hofstede, G. 1994, Cultures and organizations: intercultural cooperation and its importance for survival - software of the mind, Harper Collins, UK.

differences in the importance rank of the goal categories for Australia, Singapore and Japan. However, considering each of Hofstede's cultural dimensions and the most directly related goal categories for each dimension, suggests that the Delphi findings are not inconsistent with Hofstede's cultural dimensions: 'power distance', 'individualism', 'uncertainty avoidance'. But for the cultural dimensions of 'masculinity' and 'long term orientation' the findings appear to be counter-intuitive. Each cultural dimension is now discussed in turn.

On the 'power distance' cultural dimension Australia is low and Singapore is high; Japan is in between but somewhat low. None of the nine original goal categories are directly related to this cultural dimension. However, the goal categories of financial, customer and employee are indicators in the sense that financial goals may equate with power and that customer and employee goals may relate to concern for the community. Financial goals are of high importance for Australia and Singapore. Customer goals are important to Australia, Singapore and Japan but are more important for Singapore than for Australia and Japan. Employee goals are of low importance for Australia and are of moderately high importance for Singapore and Japan. This finding is reasonably consistent with Hofstede's cultural dimension of 'power distance'.

On the 'individualism' dimension Australia is high, Singapore is low; Japan is in between but somewhat low. The employee goal category is the most directly related to this cultural dimension. This goal category is one of the least important for Australia, correlating to Australia's high 'individualism'. It is of moderate importance for Singapore and Japan. Somewhat more important for Japan than for Singapore. This finding is reasonably consistent with Hofstede's cultural dimension of 'individualism'.

On the 'masculinity' dimension, Japan is high, Singapore is low; Australia is in between but somewhat high. The customer goal category, as a potential indicator of a more feminine culture is the most directly related to this cultural dimension. Financial goals, or a focus on material success, are also a related to this cultural dimension, but as an indicator of a more masculine society. The customer goal category is one of the most important for Australia, Singapore and Japan. It is more important for Japan than for either Singapore or Australia—but only very slightly. Financial goals are one of the most important goal categories for Australia and Singapore but are of only moderate importance for Japan. So a strongly 'masculine' culture gives a very similar emphasis to customer service to that of more 'feminine' cultures and a strongly 'masculine' culture gives less emphasis to financial goals than more 'feminine' cultures. Thus on both these indicators this is a potentially counter-intuitive finding.

On the 'uncertainty avoidance' dimension, Japan is high, Singapore low; Australia is in between but somewhat low. The compliance goal category is the most directly related to 'uncertainty avoidance'. This goal category is one of the most important for Australia, Singapore and Japan. However, it is more important for both Australia and Japan than Singapore. This finding is potentially somewhat inconsistent with Hofstede's cultural dimension of 'uncertainty avoidance' as two low 'uncertainty avoidance' cultures place high emphasis on compliance.

On the 'long term orientation' dimension, Japan is high, Australia low; Singapore is in between but somewhat high. The future strategic goal category is the most directly related to 'long term orientation'. This goal category is not ranked as important for Japan. Although it is only of moderate importance for Australia, it is ranked as more important for Australia than for either Singapore or Japan. Potentially, this is a counter-intuitive finding. However, for Japan, financial goals had less importance than for Australia and Singapore. Thus, to the extent that financial goals are an indicator of a short term focus, the data suggests that Japan places less emphasis on the short-term than Australia and Singapore.

In summary, the data for some business goals is not inconsistent with Hofstede's cultural dimensions. However, for some of the business goals, Hofstede's cultural dimensions do not directly or consistently explain the differences in the importance ranks for the countries considered here. This apparently critical finding has a most important aspect—while one cultural dimension may not directly explain the differences for a specific business goal consistently for all countries, a combination of cultural dimensions may afford a reasonable explanation. This suggests that an understanding of the interplay of the cultural dimensions and the relative strength of each is most important. It also suggests that national culture may be best represented as a distribution of values rather than by a characterisation based solely on one-dimensional differentiations.

In some cases, it may be that less importance is given to business goals that are underpinned by strong cultural traits. Japan, for example, gives relatively less importance to the financial goal category than may be expected in relation to Japan's profile on the 'masculinity' cultural dimension. Japan also gives relatively less importance to the future strategic goal category than may be expected in relation to Japan's profile on the 'long term orientation' cultural dimension.

Business goals may be subject to influence from a wide range of contingency variables and stakeholder perspectives. So the control and isolation of such factors was a necessary research design consideration. Here, the methods used to minimise variables other than national culture were the selection of countries with similar socio-economic development; the consistent industry sector and organisational task of stockbroking firms; the stakeholder perspective being that of a Director of the firm; and the age, education, work experience and social status of the participants as Directors of the firm. The Delphi studies were conducted within the stockbroking industry. Thus minimising potential cultural variables and to the extent possible, highlighting national culture derived differences. The stockbroking industry has an industry culture. The influence of this industry culture on the national cultures of Australia, Singapore and Japan has not been controlled. There were also other important factors that were not controlled—for example, choice of competitive strategy and organisational size. By asking participants to assume that they are a director of a successful [country specified] stockbroking firm, the intention was that respondents conceive of the firm as primarily domestic rather than a multinational, certainly rather than as a foreign multinational. Thus, potentially, variation due to organisational size is limited. That leaves choice of competitive strategy as the major uncontrolled variable.

Given the difficulties involved in recruiting panellists, there was little prospect of forming Delphi panels with the added constraint that the participants' own firms have chosen very similar competitive strategies. This could have been addressed by either studying a single organisation with operations in each of Australia, Singapore and Japan or by extending the question for the initial Delphi round by asking participants to assume that they are a director of a successful [country specified] stockbroking firm and also to assume that [specified competitive strategy] has been adopted. For both these alternatives, differences in the importance of business goals could potentially be attributed to national culture but these differences would be constrained by the particular competitive strategy. That is, rather than the open approach adopted here where differences in the importance of business goals are derived from the directors' perceptions of the business goals of a successful firm in the particular country. Hence, the extent to which the directors are representatives of the national cultures studied here is a most important factor. Based on nationality of birth, nationality and work experience the Australian and Japanese panels were good representatives of their respective national cultures. Based on nationality of birth and nationality, the Singapore panel, with the early loss of a number of Singapore nationals was relatively less representative of the Singapore national culture. But the Singapore panel did have a satisfactory level of Singapore-based work experience.

In any case, even if participants had adopted different competitive strategies, these choices did not prevent a consensus being reached in each of the Australia, Singapore and Japan Delphi studies. Thus suggesting that within each Delphi study, choice of competitive strategy had little influence. Theoretically, each panel may have coincidentally been homogeneous in choice of competitive strategy and again coincidentally, different to each of the other two country panels in their choice of competitive strategy. But this seems unlikely. The risk that different Delphi panels have different outcomes, even when the panellists are characteristically very similar, is more likely. However, this is a fundamental issue with the Delphi method, one that can only be dealt with by testing the findings using a different research method.

Conclusions

The objective of *Enterprise Effectiveness: a cross-cultural study of business goals* was to examine the impact of national culture on organisational effectiveness objectives and on the interpretation of success. Within the context of the Delphi studies, the proposed research questions are now considered in turn.

To what extent does national culture influence the importance placed on specific organisational effectiveness objectives?

The Delphi data shows that there are differences between Australia, Singapore and Japan with regard to the importance placed on specific organisational effectiveness objectives. Further, to the extent that variables other than national culture have been minimised, then this is a consequence of national culture. The differences in some of the goal categories are particularly clear due to the wide range of importance rankings. Table 4 is derived from Table 2. It lists the goal categories and shows the range in rank of first occurrence for each. It is sequenced by range in rank of first

occurrence[4]. Differentiation is least evident for the goal categories of compliance and customers and most evident by virtue of the additional goal category introduced for Japan.

Table 4 Range in rank of first occurrence by goal category

Range in rank of 1st occurrence	Category	Rank of 1st occurrence Australia	Rank of 1st occurrence Singapore	Rank of 1st occurrence Japan
2	Customer	3	1	2
4	Compliance	1	5	1
7	Financial	2	2	9
8	Market positioning	5	11	3
15	Future strategic	14	29	26
15	Operations	21	6	14
18	Employees	25	16	7
23	Research	7	30	18
31	Product / Service Portfolio	39	8	20
Max	Personal / Social / Community	N/A	N/A	19

Does national culture have a greater influence on the importance placed on non-financial organisational effectiveness objectives than on financial organisational effectiveness objectives?

The data indicates that there is a national culture influence on financial goals. However, of those goal categories that clearly show differences (see Table 4), financial goals are the least differentiated. Thus the finding is that the data does support the assertion that national culture has a greater influence on the importance placed on non-financial goals than on financial goals.

To what extent does national culture influence the interpretation of organisational success?

A comparison of the Australian top ranked goal categories with Singapore and Japan suggests that national culture does have some influence on the interpretation of organisational success:

- For Australia, the compliance goal category is the most important (by rank of first occurrence). This goal category is ranked first for Japan and fifth for Singapore.
- For Australia, financial goals are second most important. This goal category is ranked second for Singapore and ninth for Japan.
- For Australia, the customer goal category is third most important. This goal category is the most important for Singapore and the second most important for Japan.
- For Australia, the market positioning goal category is ranked fifth most important. This goal category is 11th most important for Singapore and third most important for Japan.

However, four goal categories represent the top five business goals for Australia, Singapore and Japan. These are compliance, financial, customer and market positioning. Goal categories of compliance and customer are consistently of high importance confirming some limitation of the influence of national culture on the interpretation of organisational success.

The continuing globalisation of business requires the alignment of organisational task, structure and strategy across all operational geographies. Goal setting and the process of developing and communicating a common, enterprise-wide,

[4] The range is shown here as a useful indication of the differences in important rankings but the numeric value of the range is questionable because of the different numbers of business goals for each country.

strategic framework is critical to the achievement of this alignment. Recognising the influence of national culture on the perceived importance of business goals is necessary for global enterprise effectiveness.

Evaluating intangible assets: The new financial management, reporting and analysis challenge

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21 October, 2002

This paper provides insights into the nature of intangible assets, and their potential role in corporate performance evaluation. Central to the analysis is an industrial economics framework, which aligns intangible assets with barriers to entry into an industry or competitive advantages. A review of management and financial reporting practices adopted for intangible assets is undertaken through a survey of Group of 100 companies in Australia, with the aim of providing insights into how such investments impact performance, are reported and incorporated into performance evaluation.

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1. Introduction

Financial reporting has been likened to an information highway that should serve the needs of those who use it. The consequences of failing to satisfy these needs include the inability to raise and/or allocate capital efficiently (Jenkins, 1994). A major challenge in an environment of globalisation and accelerating technological innovation is ensuring that relevant information is provided, through both internal management reports and external financial reports, to enable efficient decision-making. Failure to develop relevant reporting practices will at best make reports irrelevant, at worst misleading. This paper aims, through a survey of major Australian firms, to provide insights into the nature of intangible assets, the management and accounting practices adopted with respect to such assets, and the potential relevance of such information for both internal and external users. Evidence is presented of identifiable intangible assets arising from strategies to develop competitive advantage, and increasingly representing the value created within the firm by management. Accordingly, information on the development of such assets will be critical internally for evaluating managerial performance and externally for determining the level and persistence of earnings by financial analysts.

2. The increasing significance of intangible assets

3.

Whether traditional financial reports, that generally emphasise tangible assets, are maintaining their relevance is the subject of much academic debate. For example, Collins, Maydew and Weiss (1997) investigate the association between market values and earnings and the book value of equity across the years 1953 to 1993. Focussing on the explanatory power, measured as adjusted R^2 in regressions of earning and book value on market value, they find that the value relevance of earnings has declined over time, having been replaced by an increased relevance of book values.[5] On this basis, they conclude that the relevance of financial statement information is being maintained and possibly enhanced. However, this result is counter-intuitive and further consideration of this result is suggested.

Firstly, the decline in the value relevance of (aggregate) earnings could be a consequence of an increase in the incidence of reported of losses and transitory items, and the inclusion of these items in operating earnings.[6] This is interpretation is consistent with studies Basu (1997) and Elliott and Hanna (1996) who identify losses and transitory items as reducing the relevance of current period earnings.

Secondly, Collins et. al. give scant consideration to changes in the coefficient on book value, and implications thereof. It is notable that the coefficient on book value of equity is increasing, and in the latest period, 1983 to 1993, is significantly greater than one. Furthermore, the increase in the coefficient on book value above one is most pronounced for intangible asset intensive firms. An alternative interpretation of this result is that unrecognised intangible assets are increasingly relevant, and the apparent improvement in explanatory power in book value is attributable, and limited, to circumstances where unrecognised intangible assets are correlated with tangible assets (i.e., an omitted correlated variable problem). This interpretation is consistent with evidence provided by Amir and Lev (1996), who focus on the intangible intensive cellular telecommunications industry where tangible assets are relatively insignificant (as evidenced by a mean market value to book value ratio of 12.34 in 1993) and not likely representative of intangible assets.[7] In this industry, traditional financial information has very little explanatory power for market values. Furthermore, if the gap between market values and book values is increasing, as suggested by Lonergan, Stokes and Wells (2000)[8], reliance on a correlation between

[5] Similar results are reported in Francis and Schipper (1999) over the period 1952 to 1994.

[6] For example, in an Australian context this has in part arisen as a consequence of amendments to AASB 1008 *Profit and Loss* that have increasingly required the reporting of losses as part of operating earnings.

[7] Within an Australian context a similar situation would probably exist. For example, Singapore Telecommunications Ltd had a market value to book value ratio of 12.1 at 30 November 2001.

[8] Lonergan, Stokes and Wells (2000) report an increase in the mean market to book ratio from 1.128 in 1979 to 3.819 in 1997 for a sample of Australian firms.

recognised tangible assets and unrecognised intangible assets to ensure the continued relevance of accounting reports may be increasingly untenable.

Progress towards resolution in this debate doubtless requires an enhanced understanding of the potential relevance of intangible assets. Insights into the nature of intangible assets are provided in Kaplan and Norton (2001a and b). They comment that in the later part of the 20th century intangible assets have come to the fore, and strategies for achieving competitive advantage, or creating value, have shifted focus from tangible assets to intangible assets. Importantly, they identify intangible assets as either developed from, or utilised in, strategies for developing competitive advantage, and reflect the drivers of firm performance.[9] This guides both the identification of appropriate performance measures[10] and the implementation of strategic plans. A natural extension of this is that intangible assets should form an integral component of corporate performance evaluation, both internally and externally.

With the aim of further developing this view of the nature of intangible assets, and the accounting and management practices adopted for such assets, and with the assistance of the Group of 100, a survey was distributed to member companies. Whilst inducing a large firm sample bias, selection of these firms is justified by the greater propensity for disclosure of identifiable intangible assets by these firms. The survey instrument was developed in conjunction with Lonergan Edwards and Associates and PricewaterhouseCoopers (PwC), and was pre-tested on a sample of PwC clients. Due to the limited research previously undertaken with respect to intangible assets, the survey is necessarily exploratory. Furthermore, the intended diverse range of target companies dictated general questions concerning intangible assets and management and reporting practices adopted with respect to such assets.

We received responses from 17 companies, which represents a response rate of less than 20%. This greatly limits the extent to which responses can be analysed, and the potential for making inferences. The responses are from firms in a relatively wide range of industries, with the only industry with three (or more) responses being mining.

Where possible, comparisons are made between the responses of firms in the same industry. With respect to questions concerning the nature and perceived importance of intangible assets there is general correspondence across firms in the same industry. However, across industries there is considerable diversity in the nature of "perceived" intangible assets (i.e., brand names, research and development, licences etc.). This suggests that future, more detailed, studies of intangible assets should control for either industry or particular categories of intangible assets.

A common theme that emerges from answers in the survey is that "acquisition at a cost" and "reliable measurement" represent necessary criteria to be satisfied before an intangible asset can be recognised in financial reports.[11] However, these views on recognition need to be contrasted with responses identifying intangibles as critical to firm success assets (e.g., brand names and patents), and responses asking whether certain expenditures create assets (e.g., advertising and R&D). Hence, while there is acceptance of the importance of intangibles to firm success, there is reluctance to reveal the value of these assets and to incorporate these assets in performance measures.

As suggested by the above comment, respondents identify significant expenditures being incurred on advertising and research and development. The importance of these expenditures to firm success is reflected in responses relating to the perceived importance of the related intangible assets. For example, the mean response to the perceived importance to the businesses of brand names is 6 (out of 7), and for patents 5.4 (out of 7). Similarly, significant effort is devoted to the development of management practices

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9 This approach is also suggested by the corporate strategy literature, e.g., Porter (1985).

10 Performance measures may be financial or non-financial depending upon the ability to express the intangible in monetary terms.

11 This reflects the requirements of AASB 1015 *Accounting for the Acquisition of Assets.*

and information systems and this reflects in the perceived importance of management practices and management information systems (respectively 5.5 and 5.4 out of 7). Details of the perceived importance of specific types of intangible assets are presented in Table 1.

Table 1
Importance of types of intangible assets

	Minimum	(n=17) Mean (1-7)	Maximum
Market Access Related Intangible Assets			
Customer Service	1.0	5.2	7.0
Product Quality	2.0	5.5	7.0
Quality Accreditation Programs	2.0	4.8	7.0
Reputation Within Industry	4.0	5.9	7.0
Broad Range of Products	1.0	4.5	7.0
Brand Identification	1.0	6.0	7.0
Advertising	1.0	4.6	7.0
Key Location	1.0	5.0	7.0
Market Structure Related Intangible Assets			
Geographic markets	1.0	4.7	7.0
Vertical Integration	2.0	4.0	6.0
Technology Intangible Assets			
Trade Secrets	2.0	5.3	7.0
Trained Personnel	3.0	5.7	7.0
Ability to Manufacture Specialty Products	1.0	3.7	7.0
Innovation in Manufacture	1.0	4.6	6.0
Technological Superiority	2.0	4.9	6.0
Licenses	1.0	5.1	7.0
Refining Existing Products	2.0	4.9	7.0
Developing New Products	1.0	5.3	7.0
Research and Development	2.0	4.6	7.0
Patents	1.0	5.4	7.0
Copyrights	1.0	4.6	7.0
Management Intangible Assets			
Management Practices	3.0	5.5	7.0
Management Information Systems	3.0	5.4	7.0

For each firm, the mean value of the importance of intangible assets is calculated and compared to perceived competition within the firm's industry, as estimated by respondents. The correlation of 0.45 is consistent with intangible assets representing strategies (or the product of strategies) to develop competitive advantages.

Respondents believe intangible assets are more important today than they were 10 years ago, and that they are more critical to developing competitive advantage than expenditures on tangible assets. Whereas 13 respondents identify investments in intangible assets as being more important (equal or greater than 5 on a 7 point scale) today than 10 years ago, only 6 respondents identify investments in tangible assets as being more important (equal or greater than 5 on a 7 point scale). Similarly, while 14 respondents believe expenditures on intangible assets are critical (equal or greater than 5 on a 7 point scale) to the firm developing competitive advantage, only 11 firms believe expenditures on tangible assets are critical (equal or greater than 5 on a 7 point scale). These results are summarised in Table 2.

Table 2
Relative importance of Investments in Assets

	Minimum	(N=17) Mean (1-7)	Maximum
Relative importance of tangible assets compared to 10 years ago	2.0	4.2	7.0
Relative importance of intangible assets compared to 10 years ago	4.0	5.4	7.0
The strategic significance of investments in tangible assets	3.0	5.1	7.0
The strategic significance of investments in intangible assets	3.0	5.5	7.0
Extent to which firm success can be attributed to investments in intangible assets	2.0	5.1	7.0

In combination, the results in Table 2 are consistent the with depiction by Kaplan and Norton (2001a and b) of intangible assets resulting from, or being subject to strategies for developing competitive advantage, and their becoming increasingly important. It also confirms the appropriateness of incorporating intangible assets into performance evaluation, both internally and externally.

4. Management and Internal Recognition of Intangible Assets

A further potential indicator of the nature of intangible assets is provided by the evaluation techniques applied to evaluate investments in such assets. A feature of Table 3 is that firms generally adopt similar practices to evaluating investments in tangible and intangible assets. With respect to investments in intangible assets, the techniques most commonly used to evaluate investments are cost / benefit (12 firms), payback (14 firms), net present value – NPV- (13 firms) and internal rate of return (12 firms). Only 1 firm reported utilising option pricing to evaluate investments in tangible and intangible assets.

Table 3 **Evaluation of Expenditures**		
	(n=17)	
Techniques used to evaluate expenditures on assets		
	Tangible Assets	Intangible Assets
Cost/Benefit Analysis	15	12
Payback	16	14
Net Present Value	16	13
Internal Rate of Return	15	12
Option Pricing Models	1	1

Where firms use NPV to evaluate investments, this is commonly undertaken over periods of 3-5 years (6 firms) or 6-10 years (6 firms). Terminal values are generally determined on the basis of EBIT multiples (5 firms) or cash flow multiples (6 firms). The discount rate is generally the weighted average cost of capital for the firm (12 firms).

Notwithstanding the similarity in methods used to evaluate tangible and intangible assets, respondents are reluctant to support recognition of intangible assets. Often critical in the decision to recognise an intangible asset is control of the benefits flowing from the asset, or protection. A wide range of techniques are identified as being used to protect intangible assets (e.g., brand names (15 firms), trademarks (14 firms), patents (13 firms), ownership / vertical integration (13 firms), competitive pricing (12 firms) contracts with distributors (11 firms), litigation (11 firms), quality accreditation (10 firms) and copyright (9 firms)). However, for only 9 firms is the means of protecting the intangible asset included in project evaluation. Furthermore, the cost of protecting the intangible asset is included in project evaluation for only 6 firms.

Reflecting a reluctance to recognise intangible assets, Table 4 reports that ten respondents recognise advertising as potentially creating an intangible asset, however only six recognise research and development as potentially creating an intangible asset and four recognise management information systems (MIS) as potentially creating an intangible asset.

Table 4 **Creation of Intangible Assets**		
	(n=17)	
Irrespective of accounting treatment adopted, is an intangible asset created by:		
	Yes	No
Advertising	10	7
Research and Development	6	11
Management Practices and Information Systems	4	13

Particularly noteworthy in Table 4 is the attitude to management practices and information systems. Significant resources are devoted to the development of management practices and information systems and, to the extent that it facilitates more effective and efficient management, could give rise to an

intangible asset. For example, of the 11 firms that are perceived as having more integrated operations (equal or greater than 5 on a 7 point scale), 9 standardise management information systems. This is consistent with management information systems representing an important strategy for co-ordinating and controlling the activities of the firm, and capturing human capital within the firm. However, contrary to expectation, of these same 11 firms, 6 grant significant management autonomy (equal or greater than 5 on a 7 point scale).

Highlighted in Table 5 is the limited propensity for firms to recognise intangible assets in their financial reports. Whilst 10 firms recognised identifiable intangible assets in the internal accounting records, this is generally restricted to acquired assets only. Internal or management reporting of intangible assets tends to reflect external reporting requirements with the most common basis for recognition being cost, cost less amortisation or discounted cash flow (as a consequence of an impairment in value test).

Table 5
Internal Recognition of Intangible Assets (n=17)

Recognition of intangible assets in its internal records			
In the accounting systems			10
Separate from accounting records			1
Not at all			6
	Yes	No [12]	
Are acquired intangible assets recognised?	14	3	
Are internally generated intangible assets recognised?	3	14	
How are intangible assets valued for internal reporting?			
Cost			7
Cost less amortisation			14
Discounted cash flow			5

Consistent with the limited internal reporting of intangible assets, only 6 firms report identifiable intangible assets are incorporated in performance measures or evaluation.

If intangible assets are capturing information on successful strategies for developing competitive advantage and identifying the performance drivers within the firm, this result would suggest that notwithstanding the promotion of broad based performance evaluation schemes (e.g., Balanced Scorecard), only limited progress has been made in applying these approaches in practice.

5. External Reporting of Intangible Assets

Establishing the link between strategies for developing competitive advantage and intangible assets indicates a potential relevance not only to internal users, but also to external users of financial reports. Reflecting this, many Australian firms voluntarily disclose such assets with Wyatt, Matolcsy and Stokes (2001) finding that 41% of firms disclose identifiable intangible assets over the period 1993 to 1997.

[12] This suggests that respondents are burying intangible assets acquired in goodwill.

Furthermore, Koh and Godfrey (2001) provide evidence that these disclosures are value relevant for equity investors.

However, there is some scepticism as to whether intangible assets are fully appreciated by equity investors. Whilst 13 respondents believe intangible assets have contributed significantly (equal or greater than 5 on a 7 point scale) to the firm's success, only 8 respondents believe intangible assets contribute significantly (equal or greater than 5 on a 7 point scale) to the firm's share price. This discord could be attributable to either share market participants discounting the importance of intangible assets, or alternatively, the significance of intangible assets being less understood by share market participants, with the lack of disclosure relating to intangible assets doubtless having an impact.

For external financial reporting purposes 15 firms recognise identifiable intangible assets in the balance sheet, with relevant accounting standards identified as the primary determinant of disclosure. Firms generally recognise acquired identifiable intangible assets (15 firms), and this is supported by claims that for these assets reliable measurement is possible (16 respondents). In contrast, for internally generated assets, only 6 respondents believe reliable measurement is possible. An active market is identified by 7 respondents as a prerequisite to the recognition of identifiable intangible assets.[13]

Table 6
External Recognition of Intangible Assets (n=17)

Recognition of intangible assets in its external financial statements.			
Balance Sheet.			15
Management discussion and analysis.			0
	Yes	No	
Acquired intangible assets are recognised.	15	2 [14]	
Internally generated identifiable intangible assets are recognised.	3	14	
Acquired intangible assets can be reliably measured.	16	1	
Internally generated intangible assets can be reliably measured.	6	11	
An active market is required for reliable measurement.	7	10	
Separate identification of identifiable intangible assets enhances the information content of financial reports.	12	5	

Notwithstanding the reluctance of firms to recognise internally generated identifiable intangible assets in the financial statements, 12 respondents believe that disclosures relating to such assets enhanced the

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13 This is consistent with IAS 38 *Accounting for Intangible Assets.*

14 This suggests that respondents are burying intangible assets acquired in goodwill. To the extent that the intangible asset is identifiable this is inconsistent with AASB 1015 *Accounting for the Acquisition of Assets.*

information content of financial reports. One respondent identifies proprietary costs as a justification for not disclosing such assets.

With respect to the accounting practices adopted for identifiable intangible assets (see Table 7), 11 respondents believe that amortisation is appropriate.[15] All those not supporting amortisation maintained that it is inappropriate because asset values are not declining. Notwithstanding the attitude to amortisation, respondents agreed that the application of an impairment of value test is appropriate.

Table 7
Accounting Practices for Intangible Assets (n=17)

	Yes	No
Intangible assets should be amortised.	11	6
Intangible assets should be subject to an impairment of value test.	16	1

A negative adverse share price reaction is an expected consequence of compulsory amortisation by 10 respondents. The most commonly cited reason is a reduced ability to pay dividends (9 respondents). Other reasons cited included reduced asset value per share (6 firms), small shareholders don't understand (6 firms) and institutional investors don't understand (1 firm).[16] By comparison, 5 respondents believe that there will be no share price reaction to compulsory amortisation of intangible assets as firm cash flow will not be impacted.

With respect to the ability to pay dividends, 12 respondents state that their firm would have a reduced ability to pay dividends as a consequence of compulsorily amortising intangible assets.

Table 8
Impacts of Amortising Intangible Assets (n=17)

	Yes	No	
Amortising intangible assets adversely impact your share price.	10	7	
Reason for amortising intangible assets adversely impacting share price.			
Institutional shareholders don't understand			1
Small shareholders don't understand			6
Reduced ability to pay dividends			9
Reduced asset value per share			6
Reason for amortising intangible assets not adversely impacting share price.			

15 Amortisation of intangible assets is consistent with AASB 1021 *Depreciation*, however respondents may be influenced by recent development in the United Stated with respect to goodwill.

16 It is interesting that these beliefs persist, notwithstanding research findings that sophisticated investors add back depreciation.

Amortisation doesn't impact cash flow			5
Immaterial impact			2
	Yes	No	
Amortising intangible assets would reduce the firms ability to pay dividends	12	5	

A common theme across these responses is that reliability and economic consequences come to the fore as the determinants of appropriate accounting policies for intangible assets. This seems to outweigh consideration of the potential value relevance of such information, particularly for performance evaluation.

6. Conclusions

The survey provides limited evidence of intangible assets having greater significance than 10 years ago. Furthermore, the survey reveals intangibles as being more important in competitive industries where they represent strategies or the product of strategies for developing competitive advantage.

The evaluation of investments in intangible assets largely mirrors that of tangible assets, suggesting that financial reporting practices for these differing classes of assets should not be greatly divergent. However, a major issue from both a management and financial reporting perspective remains how to ensure exclusivity with respect to asset use, and the associated protection of asset value. This is not necessarily being addressed in project evaluation.

The recognition of intangible assets for internal reporting purposes is not significantly different from that adopted for external reporting purposes. A consequence of this is intangible assets are typically not recognised in management reports and not included in performance measurement or evaluation.

Whilst the disclosure of identifiable intangible assets is seen as potentially enhancing the information content of financial reports, such disclosures are limited. Generally the disclosure of identifiable intangible assets is limited to acquired assets, and these are typically recorded as cost or cost less amortisation, as required by accounting standards AASB 1013 *Goodwill,* AASB 1015 *Accounting for the Acquisition of Assets* and AASB 1021 *Depreciation*. The majority of firms believe that amortisation is appropriate. Reliable measurement is seen as an impedient to the recognition of internally generated identifiable intangible assets, and potentially to the revaluation of identifiable intangible assets. It is significant that these accounting practices largely ignore the potential to provide information on the value created by management through the development of intangible assets, which is relevant to financial analysts and other external users of financial statements. Furthermore, the mandatory amortisation of intangibles rather than impairment of value test, places these accounting practices in conflict with those in the United States. There the FASB has recently mandated the "purchase method" for consolidation (SFAS 141), and imposed an impairment of value test for goodwill and other intangible assets rather that amortisation (SFAS 142). However it should be noted that interest rates have been falling since SFAS 142 was issued, and intangible asset values will generally have increased, or at least maintained value. In these circumstances impairment of value tests are unlikely to be problematic. When interest rates rise again, identifiable intangible asset values will fall and impairment of value tests will become highly contentious, especially in a likely environment of poorer operating performance.

The majority of respondents believe that compulsory amortisation would adversely impact share prices. The majority of respondents believe that compulsory amortisation would reduce their ability to pay dividends. However these responses are difficult to reconcile with findings that sophisticated investors add back amortisation, and dividend constraints can effectively be overcome by share buy backs.

Some caution must be exercised in interpreting these results. The response rate is very low and this greatly limits the extent to which responses could be analysed, and the potential for making inferences. Furthermore, to the extent that the survey targeted financial statement preparers, the sample is not representative of all parties involved in the financial reporting process. Finally, variation across industries suggests that future studies of intangible assets should control for either industry or particular categories of intangible assets.

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[i] For a more detailed look at the FAS 142 impairment test for goodwill, see Alfredson, K. and A. Murray “Testing the Boundaries of Goodwill” *Company Director*, September 2001: 17-18.

[ii] Karen Talley “Earnings Reports Will Look Better With Goodwill Gone” *Wall Street Journal*, 6 August 2001.

[iii] Airgas Inc. Press Release, 13 August 2001.

[iv] See for example: Moehrle, S.R., J.A. Reynolds-Moehrle, and J.S. Wallace, 2001 "How Informative Are Earnings Numbers That Exclude Goodwill Amortisation?" *Accounting Horizons*, 15(3):243-255 and Jennings, R., M. LeClere and R.B. Thompson, 2001 "Goodwill Amortisation and the Usefulness of Earnings" *Financial Analysts Journal*, 57(5):20-28.

The Investment Process and Decision Making at Pension Funds

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Below is a speech delivered by Mr. Gunn to the 14th SAAJ-AIMR/JSIP Joint Seminar entitled "Managing Pension Funds" held on 4 March 2002 in Kisarazu City, near Tokyo, Japan.
The Security Analysts Association of Japan (SAAJ) has obtained Mr. Gunn's permission to reprint it in the E-Journal.

Introduction

My remarks today are about investment decision making, and the principles used in general by large North American pension funds.

I will be speaking today about nine elements that should be included in the management process of all major funds. These elements are not restricted to investment management. They relate to the management of the business of the fund. That is to say, managing the pension enterprise, the framework for investment management.

The nine key elements that are involved are:

1. The governance of the pension plan itself. Canadian studies indicate that this is more important than many professionals recognise.
2. Plans must have a clearly defined investment strategy. A large number of funds have a general investment strategy, but the most successful funds place heavy emphasis on defining strategy in detail.
3. A well managed fund will have standards for rebalancing asset mix when the movement of markets, or the movement of securities cause asset mix to vary from policy.
4. All fund managers should decide how much investment management should be undertaken within the fund, and in areas staff who work directly for the fund should specialize. This is a concept used in business today to improve corporate performance. Pension funds should apply this concept to investment management operations.
5. Risk management. Good fund managers should attempt not only to earn positive returns, managers should also concentrate on retaining profits once they have been earned.
6. It is important for managers not only to earn returns in one or two sections of a fund, they must also look to managing a fund as a whole. This tends not to be emphasised adequately in portfolio management theory.
7. The seventh element is understanding benchmarks. The use of benchmarks does vary in different markets.
8. The eighth is managing the value created by investment professionals. Some believe that efficient market theory means that individuals cannot add as much as they think. I am not certain this is valid, and I believe professional management does add value to investments.
9. The ninth element is managing people. All professional organizations need to ensure that staff are properly managed if true long term value is to be earned. Intellectual talent is a decisive asset of a pension fund and should be treated well.

Internal Pension Plan Governance

I would like to begin by discussing plan governance, the over-riding structure of a pension plan itself. It is important to realise that the fundamental structure of a plan can be a source of value. A good governance process can create value, but a poor process can reduce it. I will give some details further in my remarks.

According to the governance model most frequently discussed in Canada, all pension plans should be seen as fiduciary activities. That is, an exercise in the management of trust by trustees and fiduciaries. In the standard model there are three levels of fiduciaries:

- Governing Fiduciaries
- Managing Fiduciaries and
- Operating Fiduciaries

Good governance involves having clear separation of roles into these three levels.

The Governing Fiduciaries are the first level. Their role is to act for the sponsor of the plan. They are typically a board of directors for large, public plans such as ourselves, or the trustees named by the board of directors of an industrial corporation. This group has two primary responsibilities. First, to set or approve all policies of a pension plan. This includes setting asset mix for a fund. Second, the governing trustees co-ordinate the benefits of the plan with the assets of the plan, and in so doing, ensure the plan is properly structured, with contributions and expected long-term investment income sufficient to pay pensions.

The Managing Fiduciaries are the investment professionals. Their role is to undertake the investment process, to define investment policy, asset mix and other essential policies and present them to the governing fiduciaries for approval. It is the managing fiduciaries who then handle all the day-to-day investment activities. To have this model work best there must be clear separation between the roles of the governing and the managing fiduciaries. The governing fiduciaries role is to approve policy, not to make and direct individual investment decisions.

The third group are the Operating Fiduciaries. This group includes the people who undertake tasks for the Managing Fiduciaries. It includes external investment managers, the custodians, the back office and others. Again, individuals who are operating fiduciaries should not confuse their role with the managing fiduciaries. The operating fiduciary has delegated authority to undertake an investment programme, not to question the programme itself.

The value of clear separation of fiduciary powers has been demonstrated in North America. Separation of duties is an aspect of defining core competencies. It has clearly been seen to add value, because each group of fiduciaries understands its role. Empowering investment professionals, and not interfering with the investment process adds value. A study undertaken by a Canadian consulting group estimates that a poor governance process is costly. The study estimated the cost can be as high as 60 basis points. It can override or offset almost all the value generated by the investment professionals.

Clearly Defined Investment Strategy

Defining investment strategy is the single most important activity to be undertaken by the governing and the managing fiduciaries. There are four elements that should be clearly articulated as the key components of investment strategy. These are: the asset mix, the tolerance for risk, the understanding of when policy should be reviewed and the general framework for how funds are to be managed.

As I said a few moments ago, there are clearly separate roles for the governing and managing fiduciaries in this process. In establishing Asset Mix the separation of these roles should be clear. The way we define the role at OMERS is to say that the governing fiduciaries “own” the asset mix. That is to say the governing fiduciaries should assess all the information provided on asset class performance and clearly understand the issues of how asset mix ultimately determines the outcome for the fund. The governing fiduciaries are ultimately the ones who must explain overall fund performance to the beneficiaries for better or for worse.

The development of the policies are usually guided by the managing fiduciaries. The investment professionals typically work with consultants and other advisors to study up-to-date information. The managing fiduciary should work through all the alternatives and make a recommendation to the governing fiduciaries.

These recommendations typically involve only the high level asset mix and the main asset classes. Decisions on implementation should be retained by the managing fiduciaries. This authority should be retained, became the manner of implementation is a separate source of value. If it is not managed properly value can be lost.

Asset mix theory suggests that a very high portion of total investment return comes from asset mix itself. That theory is generally true but there is an aspect that is rarely discussed in the literature. This aspect is that the portion of total return that comes from asset mix varies by market. The theory that 80 percent of total return comes from the asset class decision comes from efficient market theory and market modelling undertaken 50 years ago. My view is that the market efficiency varies. Some are more efficient that others.

Explicit discussion of risk is a new element in investment management. Risk has always been a feature of portfolio construction, and we are all used to of where individual asset classes sit on the efficient frontier. However, there is a higher, conceptual level of risk that needs to be considered in the construction of a pension plan and that is the overall appetite for risk. For example, the OMERS plan is relatively risk-adverse. The OMERS pension plan is a defined benefit plan for what is in effect a large group of employees who earn low to average wages. For most of the employees their pension plan is one of their most important financial assets, and they can become upset by market events, or newspaper or media stories suggesting that there are financial difficulties. Accordingly, the managing fiduciaries tend to avoid risks by limiting exposure to individual securities or markets, and generally manage to limit volatility in returns.

This profile is unique to our fund and it is not shared by other plans in Canada. The Ontario Teachers plan, for example, has a higher risk appetite.

We call this risk strategic risk, and all managing fiduciaries should take it into account in structuring and managing a plan.

While asset mix and strategic risk profile are determined primarily by studying long-term trends, it is necessary to review asset mix on a regular basis. Markets do follow long-term trends but there can be significant time periods where markets do not follow trend. We have a saying “invest for 30 years, but change every five”.

Whether five years will always be the correct interval is a matter of judgement. The original principle was to adjust asset mix at the beginning of a market or an economic cycle. It is good practice to do this, and judge whether the assumptions made five years previously still apply. In North America this is called “zero based reviewing”. It is an opportunity to adjust for new realities on a formal basis. There are always awkward decisions to make, and a formal review allows them to be made in a proper fiduciary and

professional fashion. The questions on this slide should be openly asked and everyone's best judgement applied. It is by these processes that the opportunities to create value are identified.

The next step is to define the actual investment process that will implement asset mix. Strangely enough, this aspect of the investment process is rarely emphasised adequately. People are happy to keep their plans in their minds, but this is not the best practice. You do not construct a house without detailed plans, and you should not construct a pension plan without full plans as well. It is only when all plans are fully laid out that contradictions and anomalies appear. It is best to resolve them before implementation.

There are several elements that should be formally documented by the investment professionals, and some are listed as follows:

- How will we manage the asset classes?
- What should be done internally?
- What should be done externally?
- What will the relationship with external managers be?
    - Trusted strategic partner?
    - A casual supplier to be hired or fired on short notice?
- What is the standard for changing a programme?
- Where should the best and brightest staff be?

If you ask yourself these questions you will have a much better sense of what should be contained in an overall investment strategic plan for a major fund. These questions go well beyond the challenge to a portfolio manager of asking the person how the individual mandate will be managed. These questions apply to running a fund as a total enterprise.

Some of these questions take a great deal of thought. The answers will not be obvious and they will not be the same for all funds. For example, some funds in the United States change their programs in a mechanical process. A fund could have, for example, 50 managers. Each year, the worst five – those with the worst multi-year results – are dropped and five new managers are hired. Other funds follow different processes and guidelines that can be applied if there is change at any time.

One of my personal favorite questions is to examine our own staff model, and the structure of some of our suppliers, and ask where are the best people working. It can give you very interesting insight into your own fund and your sub-managers.

Rebalancing Strategy

One of the most difficult tasks in managing a fund is knowing when to rebalance asset classes. If it is done well it can be a source of value for a fund. If it is not done well there can be a loss of value. All managers should have a clear strategy that is based on the unbiased application of professional skills. The worst enemy of a portfolio managers are the emotional aspects of the market: fear and greed. Fear that decisions may be wrong or ideas not work. Greed in thinking that prices will rise forever, and you should extract every drop of value. We all realise that emotional responses are not rational, and we should remember rational behaviour finds value.

I would like to give you an example of how rebalancing works within the OMERS Fund.

We begin by having ranges for our main asset classes; cash, fixed income, public market equities, real estate and private market equities. Our equity range, for example is 55% to 65% of the total Fund. A range of this order would be typical for a Canadian pension fund. These ranges are approved by the governing fiduciaries. The investment group, or the managing fiduciaries add on top a series of other ranges. These include non-Canadian content and regional asset mix ranges, currency hedging

standards, derivative and hedging instrument standards. One of the fundamental features of our process is the belief that most of the time, most of the economies of the world are growing. Securities markets ultimately reflect economic activities, and thus tend to rise in more time periods than they fall. Our rebalancing reflects this. Our rebalancing thresholds are asymmetric. That is to say the amount of variance above the mid-point is generally greater than the amount below the mid-point. We are reminded that we must rebalance when markets move but it gives us the opportunity to exploit the natural market movement.

Our policy is to rebalance at any time, rather than wait for specific dates. It allows us to seize the moment and have the advantage of potentially moving before others. We do not act rashly, without forethought. We will always review market conditions before we act.

I will never forget the observation made by the head of a Wall Street firm where I worked many years ago. He said "You should never say you like a security but you want to wait until it falls in price before you buy it. When it reaches that price there may be a serious problem with the company. You should think instead of reviewing your position first, act second".

I have regularly followed his guidance. Sometimes however, there is no clarity after reviewing the market. In that case we have a default position. When in doubt we will rebalance.

This brings us to the next question: what is rebalancing and what is market timing? We are all taught as professionals that rebalancing is good, market timing is poor. I would like to give you an example. A market forecast made in the year 2000 about expectations for 2001 is as follows:

Predictions for Market Movements in 2001

Total Return	***Predicted***	***Actual***
Toronto Stock Exchange	**+12%**	**-12.6%**
S&P 500	**+10%**	**-6.5%**
MSCI EAFI	**+12%**	**-16.3%**
MSCI World	**+11%**	**-11.4%**

(I) Data from William M. Mercer Ltd. Investment Accounting 2002 Fearless Forecast

You can see the forecasts are all symmetrical. They are also all wrong. Badly wrong. But if this was the forecast, what did OMERS do?

We saw this as an opportunity not to make new investments, but rather an opportunity to adjust. I have listed in the accompanying overheads the rebalancing actions we took. It happened that each action worked for us to preserve value. Had we not acted, and held assets in Canada our performance would have been much worse. We preserved relative value by rebalancing, and have more assets to invest when markets recover.

Developing Core Competencies

Developing core competencies is a new aspect of investment fund management. Traditionally, each investment management enterprise tried to be a fully diversified manager. The internal staff groups of large pension funds also attempted to manage a large part of total assets by themselves. Today many realise this is not the best approach. No fund can hope to be world class in all areas, and a single investment manager should not aspire to be all things to all people as well. Markets and individual investments are increasingly complex and the ability to achieve excellence in all areas at the same time is fleeting. However, a well run fund can hire the best advisors, and thus leverage its position and its performance. While this approach may sound very familiar, there are significant differences today. Rather than viewing an external supplier of investment services simply as one of many, to be disposed of

at will, today's model sees key outside suppliers as strategic partners. The relationship is deeper and more profound. It enables today's pension funds to be best in class investors through assembling virtual staff who are actually resident in other companies but effectively dedicated to only a few major customers. The Canada Pension Plan Investment Board is one of the first to create such a virtual structure. CPPIB is the investment arm of the national plan or tier one pension plan for all Canadians. The President of the fund has indicated he would like to manage all the assets, estimated to grow soon to $100 billion, with a staff of no more than 30 people.

This approach allows individual funds to think in very detailed terms how staff can be best employed. The answer will be different for most funds, as it will depend on the individual objectives of each fund. From the individual nature of each fund should come the opportunity to develop a specialty that can generate extra value.

For example, some Canadian funds have developed unique abilities in the use of derivatives. Others have become significant suppliers of private equity capital in Canada and elsewhere. Some have developed special expertise in real estate. This is not so say that public market groups have been ignored or downplayed. It recognises that extra performance can be generated by concentrating resources in these areas in special ways.

Understanding Risk Management

Understanding risk management is the next key element I wish to discuss today. I will not give lengthy remarks on the subject, but rather touch on why it is seen as a more important today than in past decades. Risk management has evolved from the convergence of banking and investment. Risk assessment has always been a core feature of banking, and as new bank-like products enter the investment world risk assessment has changed. All investors are used to thinking about risk in terms of the efficient frontier, and Markowity's work on mean variance. His work undertaken some 50 years ago, indicated that risk grows faster than return, and risk is best controlled by constructing portfolios of different asset classes. Today, investment thinking has moved beyond this foundation. It is possible to structure the risk at a total fund level that increases the probability of achieving better than expected returns. Managing risk explicitly points to two fundamentally different ways of managing investments. The first, and more generally followed investment standard can be described as "just make money", or "get rich strategy". The second is described as "keeping your money", or "stay rich" strategy. Most major pension funds in North America are actively studying risk management today. They are looking to preserve the value they have earned. Managing to control risk means taking different investment decisions. Therefore it is important to recognise that there is an extra source of investment value to be obtained by studying this subject.

I would like to give you an example of how a specific risk management exercise created value for the OMERS funds.

Two years ago Nortel Networks, a global supplier of telecommunications equipment based in Canada began to increase in price significantly, following the price movement of similar companies in the United States. The price movement increased the company's weighting in the Toronto Stock Exchange index to an unreasonably high level. At one point the company represented almost one third of the index value. Its price was disturbing the Canadian market performance, and, as the shares were included at their full weight in all the Canadian indexes used for benchmarking purposes, significant fiduciary issues arose. One consequence was that the OMERS equity returns began to fall behind the benchmark by a wide margin. On investigation we discovered that all of our external managers and our internal active Canadian fund had uniformly under-weighted Nortel. In other words, our manager programme was not diversified, it was polarized. As such, the fund had acquired a significant tracking error risk. This risk was not intended by ourselves, nor was it an active bet made by a single manager, it was a collective bet,

known only to ourselves and paradoxically, none of the people who contributed to the decision could recognize the risk they had collectively created. We had, if you like, special information on how this one security would affect our programme. This risk was fundamentally unacceptable to us. We therefore decided to place a derivative based overlay on all our managers. This had the effect of limiting the risk if the shares continued to rise and it also enhanced our absolute performance. We were not happy with having one security effecting our fund to such a major extent, but our fiduciary duty and our risk management programme came together to protect the Fund.

Optimizing Results

One other aspect of fund management that is sometimes not well understood is the interaction between various programmes. Each manager would like to produce the best for each individual programme but that is not necessarily in the highest interest of the fund. At the highest level of a fund the various programmes are intended to diversify. Not all are supposed to be generating full returns all the time. If that were so there would be no diversification. It is essential to ensure the programmes remain as true diversifiers. Measuring this optimal state takes dedicated information management systems, as the correct point of balance is rarely obvious. I am told this is so because there are more possible combinations of risk and reward inputs on all the individual programmes than individuals can compute without assistance. Making the effort to determine what should be the best outcome at a total fund level can be an extra source of value for a fund.

Benchmarks and How To Use Them

All investment programmes use benchmarks, but there is now some interesting work underway to decide if there has been too much emphasis on performance relative to market based benchmarks.

The basis for today's emphasis on market based benchmarks is pension legislation in the United States. Some years ago a court ruled that pensioners were entitled to receive the market return, and fiduciaries had a responsibility to see that their pension plans had fixed income returns and equity returns that reflected the market on an overall basis. This presumes that stock market indexes do reflect overall markets accurately.

It is our understanding as managers of a globally invested fund, that market indexes around the world are not necessarily appropriate pension benchmarks. Not only are there issues with public market benchmarks , there are also issues with benchmarks for private equity, real estate and a wide variety of other assets. There is a trend growing in Canada to reassess the use of market based benchmarks. One of the forces causing the re-examination has been the recent poor equity market performance on a global basis. Market returns have fallen below the required funding rate of most plans. Investment managers may have been generating good relative returns, but absolute returns have not been satisfactory. There is growing interest in Canada in the use of absolute returns. Such a move would reflect the manner in which other financial institutions measure themselves. Perhaps if is now time measure pension funds in this fashion.

One of the more practical use of benchmarks however, is to use them as diagnostic tools. Benchmarks that are carefully selected can show that managers are truly adding value or not. There are some individuals who are very good at making money, and there are others who are very good at beating benchmarks. A constructive use of benchmarks can show all fiduciaries how a fund actually earns its returns, and can point to other opportunities to create and collect value.

The last point is that benchmarks are used in North America to determine compensation for managers. One senior official at another Canadian fund has asked whether there would be so much emphasis if benchmarks were not used for compensation. It is an interesting question, as all investment

professionals in North America expect to be paid in some fashion for the value they create. It is also a growing trend around the world.

Managing Value Added

One of the aspects of efficient market theory is the belief that it is not possible to construct a portfolio with superior return – risk parameters compared to the efficient frontier itself. Yet all investment managers entirely believe that they have the skill to exceed the market, and this exceeds the efficient frontier.

How can this be so? It is one thing to think that professional investors can show superior returns compared with individuals and the broad base of investors who constitute markets around the world. However, it is a different matter to expect professionals to consistently show superior results when compared to other professionals. What I personally suspect has happened in some markets is that the combined professional skills of professional investors has increased the performance of markets on an overall basis. Professional skill has changed the efficient market.

I believe however, there are two aspects to creating and managing value added that do exist today and will persist in time. The first is the unique goal of each pension fund determined by its asset mix and its risk profile. Achieving the return objective and exceeding the return objective remains an achievable goal because each programme is unique. It does not necessarily earn superior returns at the expense of other funds.

The second is that investments should not be restricted to public securities. Opportunities to apply skills are greater in examining opportunities in private markets, in the use of derivative strategies and in alternative investments in general. These markets provide an opportunity to apply professional skills to create value.

The role of the senior staff of a fund should include searching for opportunities where skill can be consistently applied. Not all funds all the time can expect to generate superior returns in all asset classes. It is however, possible to manage the skill that produces value added, and consistently earn superior return from some of the asset classes.

Managing People

This brings us to one of the last subjects in my remarks, managing people. The intellectual power of staff and strategic partners, if properly managed can create very positive returns. However, there is a temptation in investment management to place only limited emphasis on managing professionals. At OMERS we like to say we treat staff with dignity and respect. We will also invest in training and in personal development. All investment professionals tend to think they are special people. This is true, but this feeling is shared by all professionals in many areas, not just investing. Focusing talent on the overall goals of a fund is very important. I regularly remind my staff that the assets we manage are not our own. We hold them in trust for the workers in the province who have full faith in us to do well for them.

One of the other things all professionals should remember is that skills fade. Constant renewal is a key to both physical and intellectual skills. The market does not stand still and wait for us. Every day the market has new challenges for us. Part of our skill should be a readiness and a willingness to learn.

We should look to other industries and be willing to adopt both learning and what are called "change making" skills from them. New business models developed in industry to copy with changing markets and business conditions apply fully to investment management.

Investment management is a living process, and markets and investment assets evolve. Sometimes these changes can be difficult to absorb. That is why the culture of a pension plan should be responsive

in general. There should always be some staff members who will be excited by a new idea. Change may hand them their special opportunity to shine for the benefit of the fund.

In Conclusion

In conclusion, I would like to summarise my remarks. It is clear from the Canadian experience that well structured, well governed plans have better investment performance than others.
Clarity in strategy, clarity in process adds value.

Never be afraid of new ideas, but at the same time do not forget the rules of logic and laws of economics are not suspended. Markets will absorb new ideas, but will then return to the norm over time.

We should remember the full length of time required to invest pension money. We are investing for a complete working life and retirement time, not simply a few years.

Lastly, we should always remember that the trust that pensioners and their dependants have in us. We should never disappoint them.