




# Business Edge\*

Delivering our distinctive insights

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# Editor's Note



Over the years, *PwC Edge* has been sharing new thinking and bringing fresh perspectives to dealing with complex business issues. Feedback from our readers has given us encouragement that we have consistently enhanced value and provided competitive advantage to them and their businesses. In line with our focus on business and the confidence that we have provided leading edge thinking and solutions to complex business issues we have decided to re-brand this publication *Business Edge* in 2008.

To the laymen, valuation is an arcane science or an esoteric art. It conjures images of complex methodology and voluminous numerical input. Reality unfortunately is often not far from the stereotypical. So what is the outcome of mixing valuation with a variety of rules-based accounting standards? Financial statements which are difficult to comprehend even for the initiated.

In this issue we will try to simplify the complexities of fair value accounting and the multitude of GAAPs which are currently in use.

How can regulation overkill be avoided without resulting in governance failure? A case of bitter medicine is good for you in the insurance industry? When governance fails, how bitter is the consequence of obtaining competitive advantage by corrupt means? For those caught in the act, the long arm of the law is truly punishing, we tell you more in this issue.

Will turmoil in our capital markets brought on by egregious practices in the banking industry clear the M&A dance floor? We are sanguine that dancers will continue to grace the floor in the coming years to create the champions of tomorrow's banking industry.

CEOs of new businesses born out of M&A desperately seek to realise synergy through cost cutting. How keen are they in using old tools like outsourcing? What other benefits could be derived from outsourcing and strategic simplifications? We bring fresh perspective to these two business tools most often applied in a post-deal environment.

In closing, I would like to recognise the contribution of my colleagues in sharing their thoughts and perspectives on very interesting business issues with you. I would also extend my best wishes for a happy and healthy 2008.

**Kyle Lee, Managing Editor**



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# Are fair values truly fair?

Navigating the path of fair valuation under Financial Reporting Standards



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Many investors, directors and management, without specialist financial accounting or valuation background, do not really have the expertise to understand, evaluate and use the fair value information required by the accounting standards to be included in the financial statements of businesses. There exist significant changes in this area that investors, directors and management alike must be aware of. Extra care should be exercised when such information on the financial statements are relied upon for investment and other decisions by readers of financial statements.

The use of current values (including fair values) is fairly widespread through the International Financial Reporting Standards (IFRS) which the Singapore FRS is based on, as a requirement under the respective standards and others as an optional alternative to historical cost. The evolution of more prevalent use of fair values is derived by the needs of investors. Current values of assets and liabilities, instead of their historical values, are seen to be more relevant in some areas. Instead of how much was the historical cost to acquire an asset, it is now how much cash can the asset be exchanged for? Current values allow users to evaluate alternative uses of resources more effectively, as well as better estimate future cash flows. The income statement or revaluation reserves reflect the holding gains on which management's performance is also being evaluated.

# Are fair values truly fair?

In late 2006, PricewaterhouseCoopers (PwC) surveyed more than 50 buy- and sell-side investment professionals in the major investment centres in Europe and North America on their use of the balance sheet in their analysis of companies' performance and their measurement bases that best suit their needs<sup>1</sup>.

Generally, the results of the survey show that current values are much more useful for highly-liquid financial assets. Areas of concerns include the use of current value measurement on illiquid assets and many liabilities: Is management using the changes in current value estimates to mask operating results? Will the cost of implementing current values outweigh the benefits? Whose role is it to estimate the current value of the enterprise - investors' or management's? Is management able to provide reliable estimates of fair value?

## Reliability of fair valuation

One of the concerns of the investment professional is firstly, the need for management to evaluate how they can determine fair values reliably and secondly, for users of financial statements to evaluate management's fair valuation exercise.

What is fair value? Fair value is the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date. Hence, it is based on the existence of a market that is fairly active and liquid. This is not always the case in real life. Take for example instruments such as collateralised debt obligations (CDOs) or mortgage-backed securities (MBS). While a market may exist, this market may not be very liquid and is often dominated by just a few players. If a large chunk of these instruments are put up for sale, the spreads between bid and offer price quoted may vary significantly due to the lack of liquidity. This situation worsens when there is a market downturn or liquidity crisis. In the absence of an active and liquid market, entities will have to rely on a "mark-to-model" basis to derive a fair value.

## Mark-to-model fair valuation


"Mark-to-Model" valuation is a highly judgemental exercise generally regarded even by valuers as an art rather than a science. Inter-alia, "mark-to-model" valuation is highly subjective as it tends to rely on a set of input assumptions and forecasts which may not be directly verifiable to observable market data. Just to name a few obvious judgemental

<sup>1</sup> Full survey findings are included in the report "Measuring Assets and Liabilities: Investment Professionals' View" which can be obtained from [www.pwc.com/ifrs](http://www.pwc.com/ifrs)

# Are fair values truly fair?

parameters: Projected revenue/cash flow growth, discount rate and terminal value assumptions – which all require prediction of future events and possible outcomes. In reality though, different management, economists or valuers often possess varied views of the future.

It is worthy to note that different views on the sensitive parameters such as the discount rate and terminal value calculation can produce significantly different valuation results. As illustrated below, a percentage change in discount rate and terminal growth rate can result in a material difference in the valuation estimates.

	Year 1	Year 2	Year 3	Year 4	Year 5
Projected cashflow over next five years	100,000	115,000	132,300	152,100	174,900
	Scenarios				
Terminal growth rate	1%		2%		
Discount rate	11%		10%		
Computed results					
• Terminal value	1,766,490		2,229,975		
• Enterprise value	1,532,477		1,882,474		
	 <b>Difference in value = \$349,997 (23%)</b>				

## Disclosures under accounting standards

The accounting standards recognise the judgemental selection of assumptions and sensitivity to key parameters in the “mark-to-model” exercise. While the standard-setters work towards issuing more specific guidelines on fair value measurements, the current standards do require the disclosures of key assumptions, judgements and estimates in the financial statements where fair values of these assets are not obtained from observable market prices. The rationale of requiring these disclosures is rather obvious.

## Action plans for investors, directors and management

As seen from above, to prepare, review and understand valuation models (as different assets generally have different models), a significant level of investment in specialised training is required. Prudent management and audit committee members should seek appropriate professional help when appraising material assets in the financial statements of their

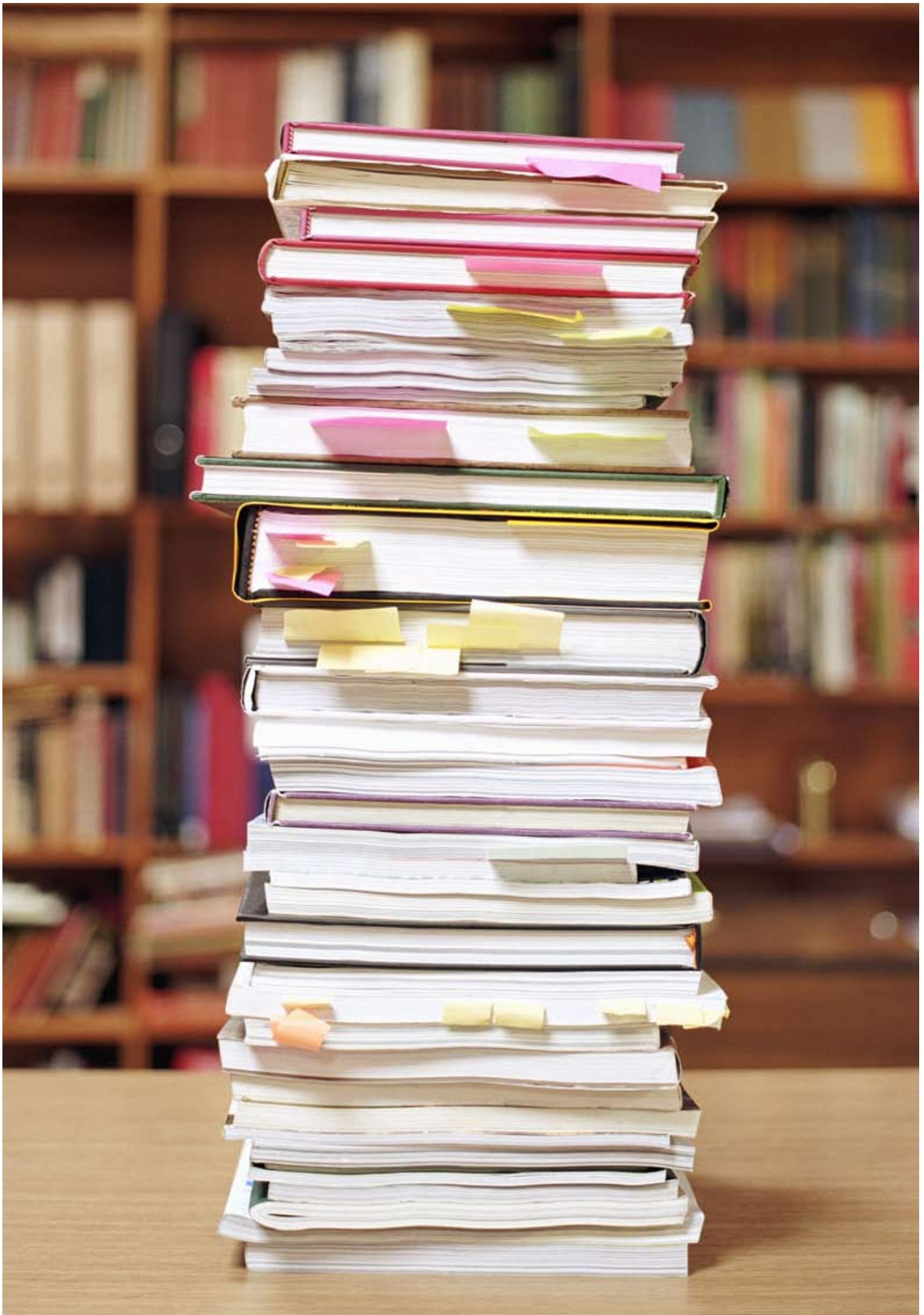
# Are fair values truly fair?

fair values. Even in such instances, the valuation methodologies and the underlying assumptions and inputs must be rigorously tested for their robustness by the management. Investors and other stakeholders should have a good understanding and be mindful of the areas of subjectivity in fair valuation. Most importantly, they need to know the right questions to ask management.

With this as a backdrop, whether you are an investor, director or management, you should be mindful that navigating the path to fair valuation is indeed a difficult trek to make. ■

This article was first published in The Business Times on 12 September 2007, titled "Fair value information: Its evaluation and use".





# Between the GAAPs

Is a common accounting  
language wishful thinking?



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The magazines holders on the window ledge are filled with copies of glossy annual reports received from the clients. Looking through the various reports, I see US GAAP (Generally Accepted Accounting Principles) “Profit before tax”, China GAAP’s 税前利润 and French GAAP’s “Profiter Avant L’impôt”. Intuitively, profit is profit, but is it always the case?

Thinking back, the foreign companies have traditionally used their respective country’s GAAP in their annual reports. To make meaningful comparisons among the three sets of annual reports, adjustments from one GAAP to another is required. Such reconciliations eliminate differences in accounting treatments arising from applying each country’s GAAP so as to adopt consistent interpretation and arrive at comparable information. It seems that different countries have different interpretation of profit.

# Between the GAAPs

In Singapore, there are a handful of foreign-incorporated and Singapore-listed companies that have stayed true to their respective national GAAP such as the Thai Beverage Public Company Limited (TBPCL) which prepared its annual reports in accordance with Thai GAAP. The TBPCL also presented reconciliation to International Financial Reporting Standards (IFRS) which outlined differences between Thai GAAP and IFRS, such as non-recognition of derivative financial instruments and the recognition of revaluation surplus of investment property in equity. Under IFRS, derivative financial instruments are required to be recognised and fair value changes of investment properties are recognised in the income statement.

In such a scenario, professional assistance needs to be sought from two parties, namely one with Thai GAAP expertise and another possessing IFRS expertise.

## Converging towards IFRS

Given the various GAAP differences that exist between countries, it is much to our delight when we note that 100 countries, including Australia, Russia, the 25 European Union (EU) member states, and several countries in Middle East and Africa are converging towards IFRS. This is good news for companies intending to raise cross-border funding in various parts of the world. Perhaps, going forward, the tedious reconciliation exercise need not be done when different jurisdictions are on the same IFRS platform.

This move towards a common set of principles-based accounting standards will result in more transparent financial reporting and greater consistency across the global capital markets. Companies will incur lower cost of compliance since only one set of financial statements can be used for filings in multiple jurisdictions. This is expected to facilitate cross-border fundraising; positioning the company as an international player.

With more countries embracing IFRS convergence readily, a recent research by PricewaterhouseCoopers (PwC) shows that these countries are in different stages of IFRS adoption, with some having selective adoption strategies. This results in differences in IFRS reporting, meaning that even though these countries are said to be converging with IFRS, there are still temporary differences in accounting treatments between countries. In our exercise advising clients on similarities and differences between national GAAP and IFRS, more vigilance needs to be exercised when comparing different GAAPs even though they are converging to IFRS. We caution you against assuming that no reconciliation is required.

In July 2005, the Committee of European Securities Regulators (CESR) issued a Technical Advice which stated that the US, Canadian and

# Between the GAAPs

Japanese GAAPs are equivalent to IFRS, subject to remedies<sup>1</sup>. This goes to say that they are not 100% equivalent yet, but that day will come. Besides US, Canadian and Japanese GAAPs, what about the other GAAPs? CESR is now conducting a more extensive exercise through its CESR's Consultation Paper, April 2007, to determine equivalence of third-country's GAAP on a worldwide basis.

## Where Singapore stands

How does Singapore fare in terms of our assessment as being IFRS-equivalent? Singapore accounting standards, known as Financial Reporting Standards (FRS), are almost completely harmonised with IFRS and are applicable to all entities. Singapore generally adopts new or amended IFRS within a three-month period but there are exceptions, one being FRS 40 Investment Property. International Accounting Standards (IAS) 40 was issued in year 2000 and effective for financial periods commencing 1 January 2001, while FRS 40 was issued in year 2005 and effective for financial periods commencing 1 January 2007. As of today, there are no timing differences between IFRS and Singapore FRS. The bigger task ahead for the Accounting Standards Board (to replace the Council on Corporate Disclosure and Governance with effect from 1 September 2007) is to present to CESR that the Singapore FRS is equivalent to IFRS despite the identifiable differences such as differing finance lease requirements and the one-off revaluation exemption from periodic revaluation for Property, Plant and Equipment, both under Singapore FRS. Based on the Consultation Paper, the Singapore standard setter, the Council on Corporate Disclosure and Governance (Accounting Standards Board with effect from 1 September 2007) will be required to submit an assessment of whether disclosures and measurement principles required by Singapore FRS are materially the same as IFRS and where they are not, an assessment of the differences.

Based on the developments described above, it is encouraging that many countries have indicated their convergence towards IFRS. However, business advisors including us at PwC should be careful in arriving at the conclusion that reconciliations are no longer required as being IFRS-equivalent does not mean the same.

## Going global

Today, with the convergence towards IFRS well underway, at least now when a CFO compares Singapore GAAP with China GAAP, he/she should expect more similarities than before since China has now made

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<sup>1</sup> This Technical Advice is the result of EU's mandate to CESR to determine IFRS-equivalent standards for listing purposes in the European securities market. Since 1 January 2007, AIM, the London Stock Exchange's international market for smaller growing companies allows all AIM companies to report under UK GAAP, US GAAP or IFRS.

# Between the GAAPs

a formal announcement in February 2006 to converge with IFRS. More similarities should swing by among the various GAAPs without the need for reconciliation.

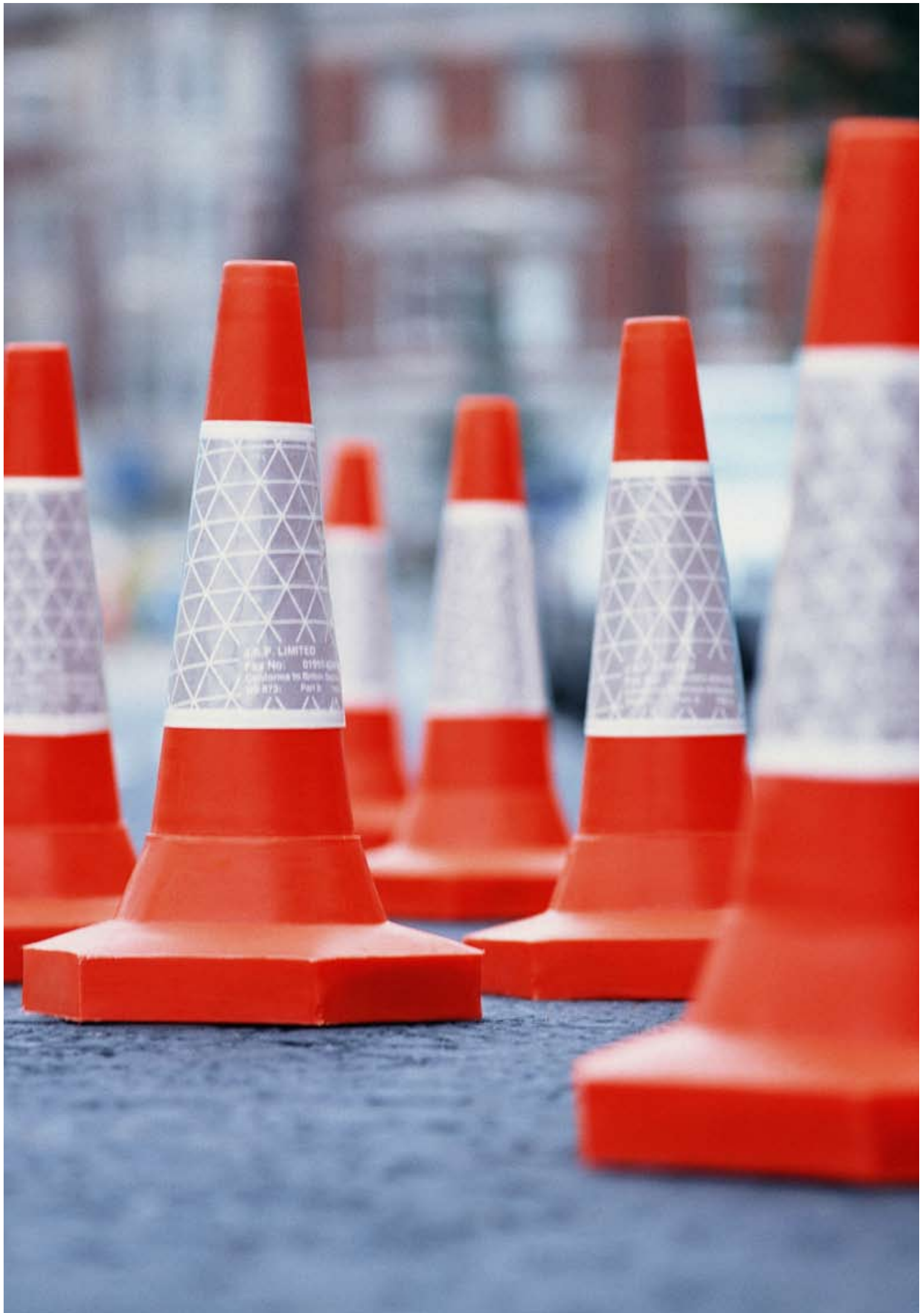
That leaves one missing link in relation to US GAAP. Is US GAAP moving closer to IFRS or vice versa? It is promising that in February 2006, the US Financial Accounting Standards Board (FASB) & IASB signed a Memorandum of Understanding in which they *“each acknowledged their commitment to the development of high quality, compatible accounting standards that could be used for both domestic and cross-border financial reporting. Both standard setters pledged to use their best efforts (a) to make their existing financial reporting standards fully compatible as soon as is practicable and (b) to co-ordinate their future work programmes to ensure that once achieved, compatibility is maintained.”*

While Corporate Singapore awaits the birth of a global accounting standard, on 30 April 2007 the EU and the US signed an agreement which seeks to ensure conditions for US GAAP and IFRS to be recognised in both jurisdictions without the need for reconciliation by 2009 or possibly sooner.

Looking at the above developments, in the not too distant future, bean counters and CFOs alike can look forward to profit being profit, with nothing between the cracks and certainly nothing between the GAAPs, regardless the business or accounting language that we may speak. ■

This article was first published in The Business Times on 23 August 2007, titled “Bridging the gap between accounting standards”.





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# Biggest bugbears in insurance:

Regulation overkill, natural catastrophes  
and management quality



Yip Yoke Har  
Tax Partner and Insurance  
Industry Leader

Insurance players the world over blame a series of factors for causing their headaches where some, particularly those that the incumbents have no or little control over, eventually develop into severe migraines. Nearer home, what are the biggest bugbears of the Singapore insurance industry? Are the city state's issues similar to its global counterparts or are they, *uniquely Singaporean*?

As Singapore strives to be at the forefront of adopting international best practices, Singapore insurers are highly exposed to international regulatory developments. In the last two years for instance, Singapore insurers have endured the adoption of new accounting standards and the implementation of a risk-based capital framework. Local players hence share their global counterparts' gripes about regulatory overkill. Of course, the industry also recognises the truth in the ancient adage that bitter medicine is good for you.

# Biggest bugbears in insurance

Regulatory overkill is identified as the greatest risk facing the insurance industry by the Centre for the Study of Financial Innovation (CSFI)'s latest Banana Skins survey, in association with PricewaterhouseCoopers (PwC). Over 100 respondents to the survey say that excessive regulation is endangering the industry by loading companies with costs, distracting management and creating barriers to competition and innovation. This finding is linked to concern about growing political interference, particularly in markets where governments regulate insurance products and prices.

## Over-regulation is widespread

With responses from 21 countries, the survey shows it to be a major issue in North America, Europe, South Africa and the Asia Pacific. Sectorally, concern is strongest among life insurance companies, followed by the general insurance sector. The survey quotes the chief executive of a major UK life insurer as saying "Regulation is becoming ever more intrusive, time-consuming and box-ticking. This is despite the rhetoric about principles-based regulation." More than 80% of the insurance industry respondents were senior executives or directors.

The survey is the first conducted of the insurance industry in the CSFI's long-running Banana Skins risk series which traditionally focuses on the banking industry.

From the PwC Singapore perspective, it is telling that over-regulation has emerged as the top risk for the insurance industry as it did for the banking industry in the CSFI's last survey on the banking industry in 2006. Clearly, this is a major issue for the financial services industry on the whole.

While risk is at the heart of the insurance business, growing compliance and competitive pressures are creating fresh headaches for the insurance industry. Such pressures will only increase over the next few years, as insurers the world over face a number of new demands, including the challenges of Phase II of International Accounting Standards IFRS 4, and Solvency II.

## Grappling with new rules

In the city state, the Monetary Authority of Singapore (MAS) has moved to enforce a risk-based supervision approach with greater onus being placed on the Board and senior management of insurers to ensure that sound risk management practices are in place. It has in the last two years released a succession of risk management guidelines covering many aspects of an insurer's business. More recently, in November 2007, the MAS released

# Biggest bugbears in insurance

more specific risk management guidelines to cover areas like product development, pricing, underwriting, claims handling and reinsurance management. A key challenge for Singapore insurers going forward is to develop effective enterprise-wide risk management systems which can provide both a platform for compliance and also improve business execution.

## Insurance - poor cousin of banking?

Over-regulation aside, the similarity between risks facing the banking and insurance industry ends here. Where insurance practitioners rank the quality of management as the third highest risk, their banking industry counterparts did not even rank that in the top 30 in the 2006 banking survey. Responses to the insurance survey show that widespread doubts exist about the industry's ability to meet growing challenges from regulation, new competitors, technological change and product innovation. Compared to the banking industry, the insurance industry evidently needs to offer better financial and professional rewards to attract and retain talent.

On talent crunch in the insurance sector, the experience in Singapore is similar. The labour market here is tight for all financial services professionals. The image of banking is sometimes seen as more "glamorous" and this does make it relatively more challenging to attract and retain talent in the insurance industry.

## Changing times

Other high-level risks identified by the survey include natural catastrophes and climate change, where insurance losses for the general insurance industry are rising fast, particularly in heavily populated areas. Even in Asia, catastrophes are becoming increasingly common, such as the 2004 Indian Ocean tsunami; the earthquakes in Taiwan, Philippines, Japan and Indonesia; the recent landslides and floods that devastated parts of Malaysia and Indonesia; and the storm waves that hit the coast of Indonesia in early 2007.

As for the life insurance industry, the main risks faced include growing human longevity and the soundness of assumptions going into the pricing of life insurance.

The survey was conducted at a time when the traditional cycle in the general insurance market is turning down. Respondents say that insurers are striving to maintain revenues by taking on extra risk, cutting prices and loosening the wording of insurance contracts. This raises concerns about

# Biggest bugbears in insurance

the profitability of the industry, and the risk that insurers will be exposed to “long tails” – insurance risks that could take years to materialise.

In Singapore, we have recently seen motor insurers succumbing to competitive pricing pressures and the MAS has been concerned enough to urge insurers to pursue underwriting and pricing discipline. There is also concern that new entrants to the direct insurance and reinsurance industry and the influx of new capital may also undermine pricing discipline. The view is that insurers should pursue sustainable growth and not sacrifice long-term prudence for short-term gains.

One of the operational challenges facing the industry is the modernisation of back-office systems and technology. Too much of the industry is technologically obsolete, even paper-based, which ties its hands when competing with new entrants to the business, such as better-equipped banks and Internet-based suppliers.

Although the survey exposes some potentially worrying risks, it also brings better news about the industry’s preparedness. Only 3% of respondents think insurers are “poorly” prepared to meet the risks that lie ahead. Just over 20% answer “well” and the rest gave a mixed response.

## Additional information about the survey

The Insurance Banana Skins survey was conducted in February and March 2007 and is based on 139 responses from 21 countries.

### The breakdown by type of respondent is:

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Brokers	6%
Life insurance	34%
Property & casualty	35%
Reinsurance	14%
Observers	11%

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The survey is the latest in the CSFI’s long-running Banana Skins series on financial risk, initiated in 1994. This is the first survey specifically addressed at the insurance sector. Previous surveys have focused on banking.

The CSFI is a non-profit think-tank founded in 1993 which looks at challenges to and opportunities for the financial sector. It has an affiliate organisation in New York, the NY CSFI. ■

# Biggest bugbears in insurance

## Greatest risks currently facing the insurance industry

- |    |                                |    |                             |
|----|--------------------------------|----|-----------------------------|
| 1  | Too much regulation            | 17 | Pricing new risks           |
| 2  | Natural catastrophes           | 18 | Terrorism                   |
| 3  | Management quality             | 19 | Complex instruments         |
| 4  | Climate change                 | 20 | Retail sales practices      |
| 5  | Managing the cycle             | 21 | Pollution                   |
| 6  | Distribution channels          | 22 | Interest rates              |
| 7  | Long tail liabilities          | 23 | Corporate governance        |
| 8  | Actuarial assumptions          | 24 | Demographic trends          |
| 9  | Longevity assumptions          | 25 | Contract wording            |
| 10 | New types of competitors       | 26 | Capital availability        |
| 11 | Investment performance         | 27 | Security of reinsurance     |
| 12 | Managing technology            | 28 | Availability of reinsurance |
| 13 | Equity markets                 | 29 | Business continuation       |
| 14 | Risk management techniques     | 30 | Fraud                       |
| 15 | Back office                    | 31 | Merger mania                |
| 16 | Political shocks and pressures | 32 | Too little regulation       |
|    |                                | 33 | Asbestos                    |

Source: Insurance Banana Skins 2007, The Centre for the Study of Financial Innovation's (SCFI) survey of the risks facing insurers.

This article was first published in Asia Insurance Review in August 2007.



# Business risks:

## Its role in outsourcing decision-making



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From recent surveys carried out by PricewaterhouseCoopers (PwC) and others, it is apparent that CEOs' enthusiasm for using outsourcing as a business management tool remains strong globally<sup>1</sup>.

This enthusiasm is reflected by the media, which continues to carry stories of new outsourcing service suppliers and customers, both large and not-so-large, entering the outsourcing marketplace. News items about existing contract renewals and extensions also abound. It is obvious from the overall picture presented by the press that the CEOs' keenness for outsourcing is driving (or in some cases is being driven by) these critical industry trends:

- The number of service providers and service advisors is increasing rapidly (the latter provide advice to customers and sometimes to service providers but do not generally enter into service delivery contracts);
- The number of countries hoping to attract outsourcing business is also rising (awareness is growing that perfect English is not a requirement for many business processes); and
- The complexity of outsourcing activity undertaken by organisations is increasing.

Taken together, these trends have one inescapable consequence for senior managers – outsourcing decision-making is getting more difficult.

<sup>1</sup> See for example PwC's 10th Annual CEO Survey 2007 and PwC 2007 Global Outsourcing Survey

# Business risks

To a large extent, the trends are the result of a changing view within organisations of the range of benefits outsourcing can deliver and the way in which these benefits can be realised. While manufacturing, logistics and IT outsourcing contracts have been commonplace for many years, the range of business functions being outsourced is increasing rapidly. Sales and marketing, product research and development, corporate legal support and human resources management are all being outsourced today, even though they may have been considered “core functions” in the not-so-distant past. Organisations are also increasingly likely to outsource several business functions concurrently (possibly using the same service provider). They may also enter into multiple contracts with different service providers for one business function (multi-sourcing).

What has brought about this shift in thinking? Outsourcing decision-makers are becoming increasingly aware that while defining business functions as “core” and “non-core” may sound good, it is a highly subjective process and therefore difficult to carry out meaningfully. Senior managers are now making function-by-function outsourcing decisions based on careful analysis of the business benefits and associated business risks likely to arise from outsourcing particular business functions in particular ways (scenarios). The old reliance on the arbitrary classification of business functions in terms of their supposed strategic importance (i.e. “core” or “non-core”) for outsourcing decisions is slowly but surely disappearing.

This change in thinking is being driven by the growing realisation among CXOs and their senior managers that direct cost savings is not the only benefit that outsourcing can confer. Commonly cited non-monetary outsourcing paybacks are:

- Improved timeliness (better time-to-market for new products, for instance);
- Reduced management workload (for example, removal of overlapping organisational elements at business-unit level);
- Better governance (customer can use contractual mechanisms to enforce the use of business controls); and
- Enhanced business knowledge (customer gains access to up-to-date expertise).

CXOs are also realising that outsourcing solely for cost reduction purposes can readily be undertaken by their competitors, leaving competitive landscapes almost unchanged. This awareness is encouraging innovative organisations to create their own competitive high ground by establishing outsourcing contracts or combination of contracts

# Business risks

that deliver cost reduction in conjunction with other, more “hard-to-copy”, business benefits.

Therefore (in theory at least), any business function is now a possible candidate for outsourcing. Given that, how are business managers supposed to select business functions to outsource and decide how they should be outsourced?

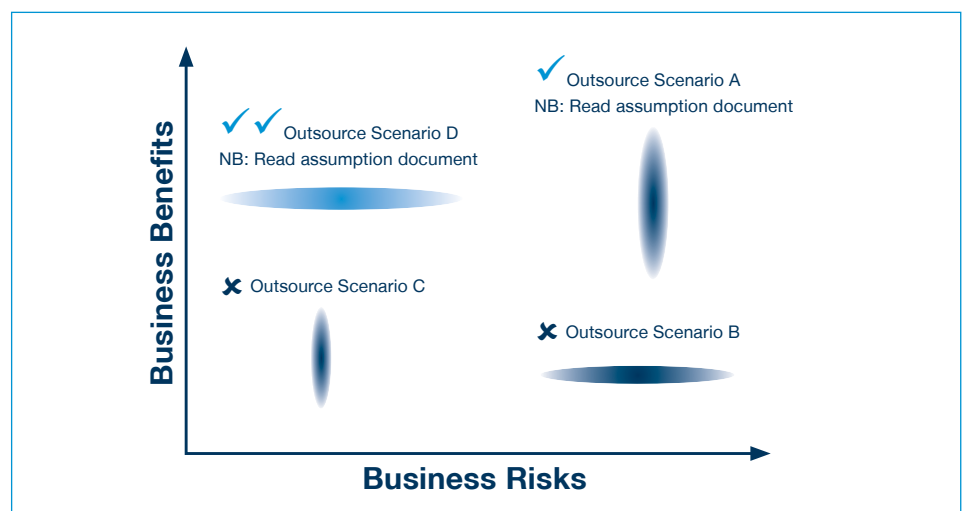
One iterative approach to the problem could be:

- Identify potential outsource scenarios (the business function being investigated, the suggested hosting country, service provider, infrastructure arrangements and expected tax regime, etc.);
- Evaluate the business benefits and risks associated with each scenario;
- Rank each scenario in terms of its evaluated business benefits and risks; and
- Repeat the cycle, refining scenarios and benefit/risk analyses.

The ultimate iteration should yield two outputs:

- An outsource scenario that senior management has fully assessed and approved, and presumably intend to contractualise; and
- An “audit trail” of the assumptions and critical decisions made by senior management during the course of the selection process.

Chart 1: Charting business benefits and business risks

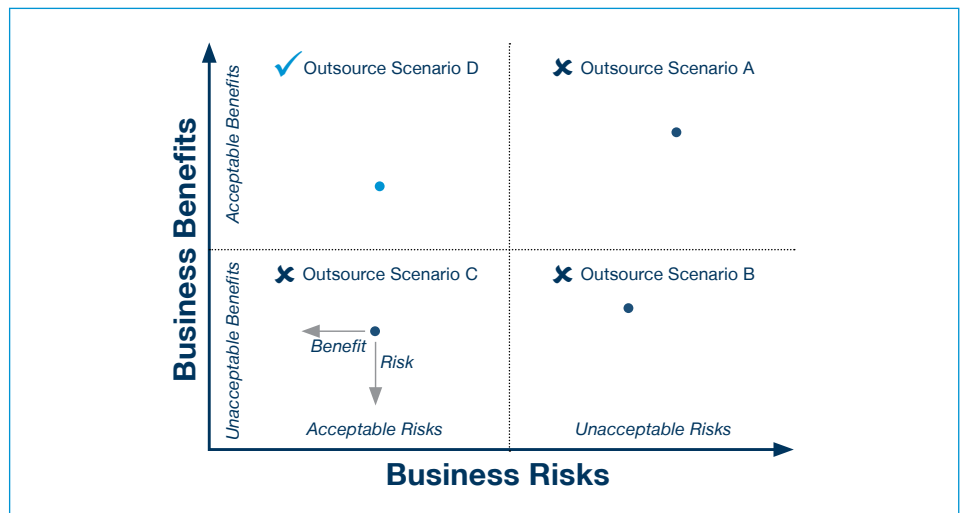


# Business risks

Getting to this point is not easy. Conceptually, the relationship between the various scenarios investigated and their business benefits and business risks can be visualised as a classic “window pane” diagram (Chart 1). Here *Outsource Scenario D* is the “winner”, as it has “acceptable” business benefits and business risks. The other scenarios are all “unacceptable” because of their benefit/risk profiles.

In practice, this representation of the outputs of the selection process is liable to be quite misleading. The principal danger lies in attempts to quantify data that is by nature qualitative, such as non-monetary business benefits and some types of business risks (for example, security breaches or intellectual property thefts). It is frequently observed that quantification can shroud common sense, i.e. numbers are sometimes accepted with blind faith by managers, simply because they are not aware of the assumptions being made when quantification took place.

Chart 2: Charting business benefits and business risks



A more realistic representation is shown on the right. Here the “clouds” for each scenario highlight the inherent imprecision of the data being considered. *Outsource Scenario D* is still the preferred option, but *Outsource Scenario A* is a feasible alternative (business risks are greater than for *Outsource Scenario D*, but benefits may be greater in some sets of circumstances).

It is obvious that the identification and quantification of business risks is central to outsource scenario-ranking. This being so, how should managers go about these tasks? To understand the steps involved, it must be remembered that every business risk has to be defined in terms of probability of occurrence and the impact when it actually occurs.

# Business risks

It must also be remembered that business risks can impact any aspect of an organisation's operations, with new risks arising as political, social and technological changes occur. In its *Uncertainty and Risk Analysis Guide*<sup>2</sup>, PwC suggests that the way forward is through one or more risk identification workshops, in which brainstorming sessions are conducted. More recent PwC experience is that considerable amounts of business risk literature is available on the Internet including extensive "laundry lists" of specific risks. Other experience indicates that stakeholder analysis can highlight likely groups of risk (value net analysis has proved useful in this area). In its *Enterprise-wide Strategic Risk Management Framework*, PwC suggests that CXOs keep the following groups of risks in their view for the complete lifecycle of any outsourcing contract:

- Political and country risk;
- Cultural risk;
- Operational risk including information security risk, process controls risk and business continuity risk;
- Contractual and regulatory risk; and
- Other hidden risks.

Notwithstanding the sources of business risk, or the methods by which they are identified, it is critical that the risks are assembled into a risk register. This should contain the following information:

- The generic risk category the risk falls into;
- A description of the specific risk;
- An assessment of the impact of the risk, using a uniform approach throughout the register (this should be consistent with risk assessments used elsewhere in the enterprise);
- An assessment of the probability of the risk; and
- A quantification of the risk in terms of probability and impact.

All of these require considerable effort. This may be a reason for getting help, especially in the initial stages of scenario-ranking. Senior managers should carefully consider where "the-need-to-know" applies both within their own organisation and in the wider outsourcing marketplace. ■

This article was first published in CIO Asia in November 2007.

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2 PwC UK publication, April 1999



# Clamp down on corruption



Chan Kheng Tek  
Advisory Partner

Bribing foreign officials to do business may be common in Asia, but it is by no means a phenomenon Asia faces alone.

A global provider of power made illicit payments to government officials in Nigeria, Angola and Kazakhstan to secure contracts and government business. A leading military and intelligence contractor funded the presidential election campaign of the incumbent country they were operating in to win business. Yet another established outfit bribed staff of government-controlled personnel with cash kickbacks and gifts in the name of “doing business” in some Asian countries.

When operating beyond one’s domestic country – a common, if not imperative practice for global businesses today – can you get away with such forms of corruption? These days, not easily, or not at all.

The United States (US) is on the war path to clamp down on corrupt practices and the rest of the article calls out to Singapore-based companies, Asia-based outfits and all other foreign companies listed on US exchanges to sit up and stay tuned as it appears that as long as you have a presence in US – regardless of your country of origin – you are affected.

# Clamp down on corruption

## The long arm of the US Foreign Corrupt Practices Act

The US Foreign Corrupt Practices Act (FCPA) was enacted 30 years ago in 1977 during the post-Watergate years. People familiar with the origins of the legislation attribute it to several reasons ranging from US Congress' distaste for the corrupt practices of companies to concerns over possible threats to US national security when corrupt practices by companies bring about the destabilisation of foreign governments at both the economic and political level. Notwithstanding this, until the last few years, enforcement proceedings by the Securities and Exchange Commission (SEC) and the Department of Justice (DOJ) were largely unheard of in the US, let alone in this part of the world.

However, in recent years, US-based companies such as ABB Vetco Gray, Titan Corporation, Schnitzer Steel Industries Inc as well as foreign ones like Statoil ASA have faced the full wrath of the SEC and DOJ with penalties and disgorgement of profits running into tens of millions for FCPA violations. Enforcement activity is expected to increase with DOJ and the Federal Bureau of Investigation warning of "increased vigilance" in pursuing FCPA cases. Gibson, Dunn & Crutcher LLP, a US law firm, had in its July 2007 update to clients stated that there are nine new enforcement actions in 2007 and approximately 100 companies that currently have pending FCPA investigations<sup>1</sup>. Extracts from a speech made by Assistant Attorney General Alice Fisher on 16 October 2006 drives home the point<sup>2</sup>:

*"Do we care about the FCPA? Is the FCPA relevant in today's global business climate? Is enforcing the FCPA a high priority? The answer to all of those questions is yes. Prosecuting corruption of all kinds is a high priority for the Justice Department and for me as head of the Criminal Division. That includes public corruption, corruption in the procurement process, and the Foreign Corrupt Practices Act."*

## Schnitzer Steel Industries, Inc.<sup>3</sup>

Schnitzer Steel Industries Inc. (Schnitzer) is involved in the business of recycling ferrous metals and a manufacturer of finished steel products. From at least 1999 to 2004, Schnitzer had paid cash kickbacks or made gifts to managers of government-controlled steel mills in the Far East to induce those managers to purchase scrap metal from the company. In

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<sup>1</sup> The FCPA Enforcement Explosion Continues: Nine New Enforcement Actions in 2007 and Approximately 100 Active Investigations, 26 July 2007- <http://www.gibsondunn.com/practices/publications/detail/id/626/?pubItemId=8532>  
<sup>2</sup> Prepared remarks of Alice S. Fisher, Assistant Attorney General, US Department of Justice, at the American Bar Association, National Institute on the Foreign Corrupt Practices Act, 16 October 2006 [http://www.usdoj.gov/criminal/pr/speeches/2006/10/2006\\_4810\\_10-16-06AAGFCPASpeech.pdf](http://www.usdoj.gov/criminal/pr/speeches/2006/10/2006_4810_10-16-06AAGFCPASpeech.pdf)  
<sup>3</sup> U.S. Securities and Exchange Commission Litigation Release No.20174/ June 29, 2007, SEC v.Si Chan Wooh, Case No. CV-07-957 ST. (D. Or. Filed June 29, 2007), <http://www.sec.gov/litigation/litreleases/2007/lr20174.htm>

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addition, the company also paid bribes to managers of private steel mills in certain Asian countries and improperly concealed those payments in its books and records.

Schnitzer entered into a settlement agreement with the DOJ and SEC. As part of the settlement, they agreed to pay a total of US\$15.2 million comprising of fines and disgorgement of profits. Schnitzer also agreed to appoint an independent compliance consultant to review its compliance programme and monitor the implementation of new internal controls related to the FCPA.

## Statoil ASA<sup>4</sup>

Statoil ASA (Statoil) is a public company organised under the laws of Norway and is headquartered in Norway. Statoil explores for and develops oil and gas resources around the globe, and has American Depository Shares that trade on the New York Stock Exchange (NYSE). Statoil entered into a US\$15.2 million contract with an offshore intermediary company owned by a third-party located in England in exchange for advice on securing oil concessions in Iran. Funds under this contract were allegedly used to pay bribes to an Iranian official to assist Statoil in obtaining a contract to develop an oil and gas field in Iran.

Statoil entered into a settlement agreement with the DOJ and SEC. As part of the settlement, Statoil agreed to pay a total of US\$21 million comprising fines and disgorgement of profits. Statoil also agreed to the appointment of an independent compliance consultant who will review and report on Statoil's FCPA compliance.

## How Singapore and Asia are affected

The two key provisions which gives FCPA its teeth is what is commonly referred to as the "anti-bribery" provision and the "books and records" provision. The anti-bribery provision make it illegal for any "issuer", "domestic concern", director, officer, employee, or any shareholder acting on behalf of an issuer or domestic concern from making payments of money or anything of value to any foreign government official or foreign political party in order to obtain or retain business or secure any improper advantage. The term "issuer" is defined to include any business entity (whether US or foreign) that is registered under Section 12 or is required to file reports under Section 15(d) of the Securities Exchange Act of 1934. Foreign companies which are listed on US exchanges are therefore included as "issuers" under this statute. The term "domestic concern"

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<sup>4</sup> U.S. Securities and Exchange Commission Press Release: SEC Sanctions Statoil for Bribes to Iranian Government Official, 2006-174, <http://www.sec.gov/news/press/2006/2006-174.htm>

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includes any US citizen and any business entity organised under the laws of a US state or that has its principal place of business in the US.

The books and records provision requires issuers to make and keep books, records and accounts, which, in reasonable detail, accurately and fairly reflect the transactions and disposition of the assets of the issuer and to devise and maintain a system of internal controls to provide reasonable assurance that transactions are authorised and recorded accurately in accordance with generally accepted accounting principles.

## Management's call to sit up

There are several implications within these provisions which ought to make management of certain Asian entities sit up and take serious notice if they haven't already. Firstly, there are quite a few companies in Asia including Singapore-based companies which are caught under the definition of "issuer" or "domestic concern". Further, there are large numbers of US "domestic concerns" with subsidiaries in Singapore and quite a few of these also act as Regional/Asia Headquarters. There are also Singapore and other Asian-based entities with subsidiaries in the US which are caught under the "domestic concern" definition.

Secondly, some people may have the misconception that even if there is an FCPA violation, the SEC and DOJ will spare individuals and go after the relevant corporate entity. Not so - it is quite explicit in the anti-bribery provision that a person acting on behalf of the issuer or domestic concern can be held personally liable, and the SEC and DOJ have not shied away from individual enforcement actions. In fact, the number of individual enforcement actions has increased significantly over the last year or so and some of the individuals prosecuted face not only monetary penalties but prison time as well. Management teams who run the relevant entities (who may or may not be US citizens) should therefore be mindful that the long arm of the US SEC and DOJ could see individuals being extradited to face criminal charges in the US for FCPA violations. In *United States vs Viktor Kozeny et al.* Kozeny, a foreign national, was indicted for his role in a scheme to bribe government officials in Azerbaijan. He was arrested in the Bahamas and is now appealing against his extradition orders<sup>5</sup>. Management's lack of knowledge of a transaction which violates the FCPA may not be sufficient to avoid liability as they may be held accountable for what they reasonably ought to have known.

The above provisions coupled with the fact that in quite a few Asian countries corruption may be considered a necessary "cost" of doing business, makes FCPA violations a very real and serious issue in Asia.

<sup>5</sup> *United States v. Viktor Kozeny, Frederic Bourke, Jr. and David Pinkerton* (CR No 05-518) Southern District of New York, 6 October 2005.

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This issue is even more acute for entities that do business in certain countries where many commercial setups are state-owned enterprises or linked to the government in one way or the other, which essentially means that their employees could very well be considered “foreign officials”.

## Better safe than sorry

Arising from the various “settlement” agreements with the SEC and DOJ, in particular, the United States vs Metcalf & Eddy<sup>6</sup> and United States vs Monsanto Co<sup>7</sup>, legal experts have issued guidance about what is expected of organisations when it comes to FCPA compliance obligations. Some of the key obligations include:

- A “clearly articulated” corporate policy
- Assignment of responsibility for compliance to one or more senior company officers
- Establishment of an independent committee to review contracts retaining agents and consultants
- Due diligence procedures for potential agents, consultants, and business partners
- Procedures designed to inhibit discretion of corporate authority to persons at risk of making payments
- Regular training, including training of agents, consultants, and other representatives
- An effective reporting system for company employees to report possible violations
- Appropriate disciplinary mechanisms for employees violating policies
- Anti-bribery clauses in all contracts with consultants or business partners, including periodic certifications, prior approval of any subcontractors, and termination clauses for violations
- Books and records, and internal accounting requirements identical to requirements imposed on “issuers” under the FCPA

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<sup>6</sup> See for example “International Alert – New FCPA Consent Agreement Addresses Travel and Entertainment Expenses, Imposes Far-Reaching Compliance Requirements” by Kathryn Cameron Atkinson, John Davis, Homer Moyer, Jr. of Miller Chevalier 10 January 2000, <http://www.millerchevalier.com/Publications/search/detail.aspx?fcid=471>

<sup>7</sup> US Department of Justice Department of Justice, Criminal Division and Monsanto Company, Deferred Prosecution Agreement, <http://www.usdoj.gov/dag/cftf/chargingdocs/monsantoagreement>.

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- Periodic FCPA audits of the operations, including detailed financial audits, audits of selected agents, consultants, and joint venture partners
- Periodic reviews of the compliance programme by outside law firms or auditors

As the SEC and DOJ have increased their scrutiny of “issuer” activities abroad, it is essential that companies take heed of what is expected of them. It is no longer sufficient to employ “passive” measures such as inclusion of statements within corporate ethics policies. To avoid FCPA issues, a proactive approach to identifying risk areas, implementing strong internal accounting controls and compliance monitoring is required. This approach must extend to subcontractors, vendors, agents and business partners, and current best practices suggest that audit rights and FCPA compliance certification be written into contracts with these third parties.

The above may seem like “overkill” from a business/operations perspective not to mention the significant costs of implementing such a programme and monitoring compliance. However, this is nothing compared to the cost of being caught out on the wrong side of the law.

## Buyers beware

Given the severe penalties imposed for FCPA violations, organisations should be mindful that even if their own house is in order they could very well inherit someone else’s FCPA problem when they embark on cross-border mergers and acquisitions activity particularly in this part of the world. To minimise such risk, it is critical to consider an FCPA compliance review of the target as part of the pre-acquisition due diligence. As an illustration of how serious this issue can be, in two such cases (Lockheed Martin Corp’s proposed acquisition of Titan Corporation and General Electric Co.’s acquisition of InVision Technologies, Inc) the deal was either aborted or substantially delayed due to FCPA violations discovered during the pre-acquisition due diligence.

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In Lockheed's case, pre-acquisition due diligence conducted by Lockheed uncovered various FCPA violations by Titan. Voluntary disclosures were filed with SEC and DOJ. Lockheed and Titan subsequently amended the acquisition agreement which provided that, as a condition for completion, Titan either obtain written confirmation that DOJ considered its investigation resolved and that they did not intend to pursue any claims against Titan, or Titan enter into a plea agreement with the DOJ and complete the sentencing process. A new deadline was set for completion but this was not met and the acquisition agreement was terminated. On 1 March 2005, Titan pleaded guilty to three felony counts of violating the FCPA and agreed to pay a total of US\$28.5 million in penalties<sup>8</sup>.

In GE's case, the acquisition of InVision was substantially delayed when FCPA violations were discovered during the due diligence exercise. Voluntary disclosures made to SEC and DOJ triggered an investigation by the authorities. As part of the resolution process with the government, InVision entered into a Non-Prosecution Agreement where they agreed to certain conditions in exchange for a promise that the government will not prosecute them for these violations. They also paid penalties totaling approximately US\$1.9 million. GE entered into a Letter Agreement with the DOJ where DOJ agreed not to take action against GE subsequent to the acquisition, subject to certain conditions such as, among others, integrating InVision into GE's FCPA compliance programme and retaining an independent consultant acceptable to the DOJ to evaluate the efficacy of GE's efforts in the integration process<sup>9</sup>. The acquisition was completed in December 2004.

There is no explicit requirement within the FCPA that organisations conduct FCPA due diligence. However, even if we were to forget (for a minute) the severity of the potential penalties, an FCPA due diligence can and should be viewed as part of the organisations overall risk management process to weed out unethical business practices and take full control at the target. From the SEC and DOJ perspective, such actions would be viewed in a positive light and would go a long way in the organisations dealings with the authorities. In the above two cases, had the due diligence not been done and the violations discovered post-acquisition, the purchase would have been a nightmare and the impact crippling.

<sup>8</sup> U.S. Securities and Exchange Commission Litigation Release No.19107/March 1, 2005, Accounting and Auditing Enforcement Release No.2204/March 1, 2005, Securities and Exchange Commission v. The Titan Corporation, Civil Action No.05-0411 (D.D.C)(JR) (filed March 1, 2005), <http://www.sec.gov/litigation/litreleases/lr19107.htm>

<sup>9</sup> U.S. Securities And Exchange Commission, Litigation Release No. 19803 /August 15, 2006, SEC v. David M. Pillor, Case No. C-06-4906-WHA (N.D. Cal. filed Aug 15, 2006), <http://www.sec.gov/litigation/litreleases/2006/lr19803.htm>

# Clamp down on corruption

## Caught in the Act

### **United States vs ABB Vetco Gray, Inc<sup>10</sup>**

ABB Ltd (ABB) is a global provider of power and automation technologies. Subsidiaries in Nigeria, Angola and Kazakhstan made illicit payments amounting to US\$1.1 million to government officials in those countries. In Nigeria, improper payments were made to officials of a state-owned agency to secure oil and gas projects there. In Angola, improper payments were made in the form of training trips for engineers of a state-owned oil company to secure contracts. In Kazakhstan, improper payments were made to a government official in order to secure government business.

The subsidiaries pleaded guilty to two felony counts of violating the FCPA and paid total penalty (fine and disgorgement) of US\$16.4 million. ABB also agreed to retain an independent FCPA compliance consultant.

### **United States vs Titan Corporation<sup>11</sup>**

Titan Corporation (Titan) is a leading military and intelligence contractor with sales derived mainly from contracts with US military, intelligence and homeland security agencies. Some of Titan's subsidiaries were in the business of developing and constructing wireless phone systems for developing nations. Titan paid US\$3.5 million to fund the re-election campaign of Benin's incumbent president so that it would enable the company to develop a telecommunication project in Benin.

Titan pleaded guilty to three felony counts of violating the FCPA and agreed to pay total penalties of US\$28.5 million. It also agreed to retain an independent consultant to review and further implement its FCPA compliance procedures.

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<sup>10</sup> U.S. Securities and Exchange Commission Litigation Release No.18775/ July 6, 2004, Accounting and Auditing Enforcement Release No.2049/July 6, 2004, Securities and Exchange Commission v. ABB Ltd, Case No. 1:04CV1141[RBW](U.S.D.C.,D.D.C.), <http://www.sec.gov/litigation/litreleases/lr18775.htm>

<sup>11</sup> U.S. Securities and Exchange Commission Litigation Release No.19107/March 1, 2005, Accounting and Auditing Enforcement Release No.2204/March 1, 2005, Securities and Exchange Commission v. The Titan Corporation, Civil Action No.05-0411(D. D.C)(JR) (filed March 1, 2005), <http://www.sec.gov/litigation/litreleases/lr19107.htm>

# Clamp down on corruption

## Worth the authorities' wrath?

With such serious implications, Asian managers of “issuers” and “domestic concerns” ought to take a step back to consider if their organisation’s compliance systems are sufficiently robust to prevent and detect FCPA violations. As mentioned, the standard for an acceptable compliance programme is now a much higher one which requires a proactive approach to compliance monitoring not only within one’s own organisation but also the agent, consultant, vendors and business partners.

Yes there is a high cost in establishing, implementing and maintaining an effective FCPA compliance programme and yes the cost may very well include the cost of turning away business and losing market share. As Dean Body from the DOJ puts it, “if the only way for a company to conduct business in a particular location is to do so illegally, then the company probably should not be doing business there”<sup>12</sup>. Such costs are much more palatable than the cost of incurring the wrath of the SEC and DOJ. Asian managers will be wise to keep faith with the old adage of “better safe than sorry”. ■

This article was first published in The Business Times on 2 and 3 October 2007 in two separate articles titled “Clamping down on corruption” and “FCPA rules: Better safe than sorry” respectively.

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<sup>12</sup> “Chiquita Under the Gun – After Disclosing Payments to Colombian Terrorists, Company Officials face Legal Jeopardy” by Laurie P. Cohen, The Wall Street Journal 2 August 2007



# Creating a win-win situation for Singapore-based oil rigs



Ho Mui Peng  
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With 80% of the global market share, Singapore is currently the leading producer of oil rigs and looks set to continue holding on to its number one position. Besides Singapore's capabilities in designing and building oil rigs "on-time on-budget", a key factor which encourages rig owners to hold their rigs from a Singapore base is our attractive tax holidays for rig owners/operators which are similar to that available to ship owners/operators.

As a growing number of oil rigs are being built, owned and operated by Singapore companies, Singapore-based oil rig owners/operators will increasingly be faced with financing and foreign tax exposure issues when they deploy their oil rigs globally.

# Creating a win-win situation for Singapore-based oil rigs

## The issue of financing

In recent years, the bond market, especially in the New York, London and Norwegian capital markets, has become increasingly popular as a funding option for capital-intensive oil rigs. Given Singapore's position as the world's leading oil rigs producer, there is an opportunity here for Singapore to become one of the premier financing hub for the industry.

Withholding tax costs associated with the financing of oil rigs from overseas borrowings can increase a company's business costs if the overseas lender insists on interest to be paid free of withholding tax. Currently, Singapore imposes withholding tax at 15% on interests incurred on overseas borrowings, unless a lower rate applies for certain tax treaties or a waiver is obtained.

Singapore does provide for withholding tax exemption (subject to certain conditions being met) on interest payable on bonds issued in Singapore through qualifying financial institutions operating here. However, this exemption only applies to bonds issued before 31 December 2008.

Besides bond issues, rig owners can also tap on competitive term loans from foreign lenders and apply for a waiver from withholding tax on interest payment under the approved loan incentive. This is awarded on a case-by-case basis, depending on the merit of each application.

Singapore oil rig owners/operators can take advantage of the Maritime Finance Incentive (MFI) as well, which is gaining popularity within the shipping industry and is available to oil rigs. Under this incentive scheme, owners are able to sell their rigs to a fund or trust set up for this purpose and to subsequently lease them back for their operations. The funds raised from the sale can then be used to repay their construction loans. This is an attractive financial incentive for oil rig owners, particularly if they have financed the rig construction costs through high-yield bonds.

## The issue of foreign tax exposures

Notwithstanding the tax holidays awarded in Singapore, the foreign tax bills of Singapore-based oil rig owners/operators could potentially represent a significant business cost if their rigs are operated in a high-tax country. Foreign taxes arise primarily because oil rigs, by virtue of being operated within the territorial waters of a host country for a period of time (unlike ships), would normally be considered a permanent establishment (PE) in the host country and hence be a taxable presence.

This is a pertinent issue which could affect the bottom-line, as although tax treaties would normally protect an operator from tax in a host country

# Creating a win-win situation for Singapore-based oil rigs

on his operating profits, this would only be the case provided he does not have a PE there through which his business is carried out. The definition of PE differs from country to country but can usually be found in the respective foreign country's local tax laws, as well as the relevant tax treaties concluded between Singapore and these foreign jurisdictions.

In view of this issue of foreign tax exposure, tax treaties with special provisions on offshore activities come into play. Oil-rich countries typically have these special provisions on offshore activities in their tax treaties with treaty partners relating to income derived from offshore natural resource exploration and exploitation activities. With this provision, a person carrying on offshore activities in the host country, in connection with the exploration or exploitation of natural resources situated in the host country, will be treated as carrying on a business in the host country through a PE, so long as the activities are carried out for at least 30 days within a 12-month period (typically, even a short-term exploration drilling contract lasts for a few months).

It is interesting to note that Singapore has very few tax treaties with special provisions on offshore activities relating to income derived from offshore natural resource exploration and exploitation activities. What some Singapore tax treaties do provide are specific provisions on when a PE would be created in the offshore country under the following circumstances:

- Substantial equipment is being used in that foreign country (e.g. Singapore/Australia treaty)
- Installation or structure, or drilling rig or ship is used for the exploration of natural resources for more than a certain period of time, typically six months
- The provision of services, including consulting services by the company's employee or other personnel, where such activities last for more than a certain period of time, typically six months

If the Singapore-based company has a PE exposure in a host country, the profits attributable to the PE would be subject to the prevailing corporate tax in that country. Such foreign taxes paid will not be claimable in Singapore so long as the rig owner/operator enjoys a tax holiday in Singapore. Overall, a significant number of oil rig owners would still prefer to own their rigs through Singapore as the Singapore tax incentives awarded do help them focus more on managing their foreign tax exposures.

## Possible win-win situation

To attract more oil rig owner/operators to be based here, there is certainly scope for Singapore to do more to assist them in managing their tax exposures.

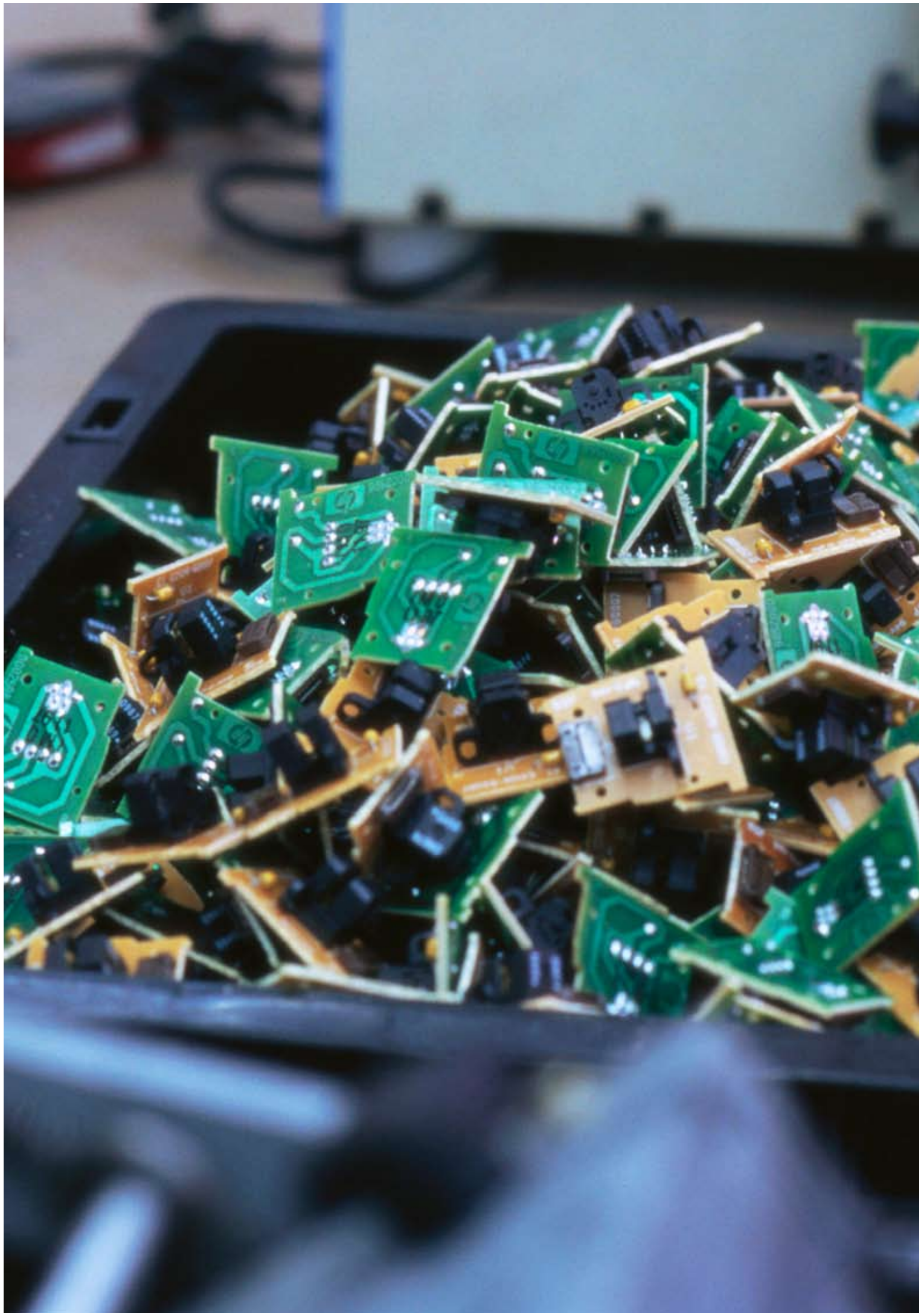
# Creating a win-win situation for Singapore-based oil rigs

For instance, on the financing front, withholding tax exemption on interest for approved bonds issued in Singapore could be extended beyond 2008. And as Singapore's rigs are increasingly being deployed in far flung places, Singapore could negotiate more tax treaties with oil-rich countries which we presently do not have any tax treaties with, especially the South American and West Africa countries. Where possible, such treaties should protect a Singapore-based oil rig owner/operator from tax in a treaty country if their rigs are used in the host country for a short period (e.g. less than six months) to enable them to fully enjoy the tax holidays secured in Singapore.

Undoubtedly, the management of global taxes will remain a key focus for the oil rig industry players in the booming years to come. As Singapore continues to improve the width and depth of its financial markets and enhance the overall tax environment, we can look forward to Singapore becoming a key financing and operating base for the global offshore oil and gas industry. ■

This article was first published in The Business Times on 10 October 2007, titled "A win-win for S'pore-based oil rigs".





# Exploiting intellectual property in a globally converging world



Greg Unsworth  
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Industry Leader

Intellectual property (IP) is now the most critical component of value creation for companies around the globe. This is especially true for technology companies whose business models are IP-based almost by definition. While IP is the livelihood of every technology company, a great deal of that livelihood is freely available in today's converging global markets. Given this reality, how are today's leading technology companies dealing with this challenge? Litigation isn't necessarily the answer, particularly in emerging markets like many of those in Asia. The need to collaborate, accelerate research and development (R&D), and develop global supply chains further complicates the issue. As a result, we are seeing the focus of leading technology companies shifting to effective management of IP with a view to maximise value rather than relying on legal and other protective measures.

These findings are borne out in a recent online survey undertaken by PricewaterhouseCoopers (PwC) of almost 200 technology executives worldwide. The survey considered the challenges that technology companies are facing at a time when innovation and discovery are moving at breakneck speed, and the identification and exploitation of IP assets will determine their future success.

# Exploiting intellectual property in a globally converging world

Consistent with the global findings, leading Asian technology companies recognise that IP management is essential for protecting and sustaining competitive advantage. According to the survey, IP management is even more important to companies based in Asia-Pacific (89%) than it is to companies in North America (84%) or Europe (73%). Although IP is an ever-more important asset class, technology executives are not confident that their companies are getting the most from their IP strategies. Despite an overwhelming view of the importance of IP, over two-thirds of executives believe their IP management is too often treated as a legal issue (a view particularly prevalent among North American and Asian respondents). Others view this approach as out-of-date and an approach which will not work in today's emerging markets.

More than one-third of small companies in another recent PwC survey (2006 Licensing Competitiveness Study) fail to receive all the revenue due from their licensing agreements. Approximately 40% of those that suspected leakage estimated levels of 10% or more, and almost one-quarter estimated more than 20% leakage.

Reasons causing non-compliance for technology companies include differences over contract interpretation and lack of effective controls by the licensee. Other areas of concern include IP theft and the failure of licensees to report all sales containing IP included in licence agreements. For software providers, the lack of an effective software asset-management program and the unintentional over-deployment of software by end-users is a common problem.

While a worldwide IP market is a promising idea, it is many years from becoming a reality. What should be done in the meantime? The survey identifies a number of priorities for technology companies.

- Firstly, it is vital to create closer links between business units and R&D activities. This leads to a more accurate valuation of existing IP assets as well as a tighter alignment of fundamental research with the realities of customers and markets.
- Companies need to treat their IP as a portfolio. Business units, IP professionals and R&D can then collaboratively and continually review the portfolio for potential gaps. These portfolios will be primarily focused on emerging opportunities.
- Furthermore, companies need to do more with their portfolios of protected technology. Centralised inventories of IP can also often be marketed to others, resulting in significant incremental income streams.

# Exploiting intellectual property in a globally converging world

- Companies need to revisit their processes for determining which, when, where and how they will protect their technologies. Is a patent the correct approach or is a copyright all that's needed? (A copyright provides the exclusive right to license or make copies of a work, while a patent, granted by a government, provides the exclusive right to manufacture or sell an invention.) Should patent protection be global in nature or will a regional patent be sufficient?
- Companies should also review their approach to emerging markets. Is IP being created in offshore research centres and, if so, how is it being protected? Are licensees paying their fair share or does the company need to increase its compliance activities? Is sensitive IP being exposed to emerging markets and, if so, do commercial reasons justify the risk?
- Finally, each company needs to ask itself: are we moving as fast as we can? Many executives believe that while patents are important, any company that looks exclusively to patents to preserve its value will soon have little of value to preserve.

While the global findings were broadly consistent for Asian companies, there is a particularly greater challenge in managing and capitalising on IP in emerging markets, where effective IP regimes may not yet be fully developed.

Given an effective regulatory environment, good IP protection mechanisms available and an appropriate tax system for effective IP management, Singapore has the opportunity to further develop its attractiveness as an IP hub in Asia for companies to hold and manage their global and regional IP portfolios from. In developing their regional IP strategy, companies need to carefully consider the appropriate structure and approach to manage their portfolios and balance this with an effective level of compliance activities for the markets they wish to operate in. Companies should also give sufficient consideration to the potential tax issues that may arise in IP planning and structuring.

Leading technology companies have recognised the continued importance of IP as a core strategic asset. They have little choice but to develop an effective IP strategy in order to stay competitive. They need to shift their focus from litigation to managing and enhancing the value of IP. The challenge for many technology companies is to capture, measure and maximise the value of their IP while ensuring that adequate measures are in place. Those that have yet to recognise this risk being left behind. ■

This article was first published in The Business Times on 22 November 2007.



# Going for growth in Asia:

Will the banking boom in Asia continue?



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Will the surge of mergers and acquisitions (M&A) activity seen in 2006 in the banking industry in Asia continue? Yes – at least for the next five years. Buyers, from both within and outside Asia, including strategic and financial buyers continue to be attracted by the high levels of growth in the region to invest across the banking industry. However, with a limited supply of quality assets, there is an increasing risk of overpaying.

# Going for growth in Asia

## Asia's long-term future is bright

Why are buyers so bullish about banking in Asia? According to PricewaterhouseCoopers (PwC) economists<sup>1</sup>, the banking sector will grow significantly faster than gross domestic product (GDP) in the “E7” emerging economies of China, India, Brazil, Russia, Indonesia, Mexico and Turkey. Further, total profits from domestic banking in the E7 could be around half those in the G7 (US, Japan, Germany, UK, France, Italy and Canada) by 2025 and larger than in the G7 before 2050. The projections are based on an analysis of developments in G7 and E7 banking markets since the 1950s, which highlights the tendency of the banking sector to grow faster than GDP as economies develop.

The new projections for the banking market, using projected market exchange rates, suggest that total domestic credit in China could overtake the UK and Germany by 2010, Japan by 2025 and the US before 2050. India could also rise from relatively low levels today to emerge as the third largest domestic banking market in the world by 2040 and, in the long run, could grow faster than China. Indonesia is also a strong candidate for a rapid expansion of its banking sector over time with domestic credit expected to grow 70 times between 2004 and 2050. Restructuring of the E7 economies should also create major opportunities for private equity firms.

However, while the E7 banking markets will become ever more important in the global banking sector, the report predicts that institutions that do not develop strong positions in these markets will find it difficult to maintain the same growth rates of assets and profits as those that do.

The survey has forecasted that continued interest in banking opportunities in Asia is likely to lead to continued high levels of deal activity in the E7 markets, albeit with the normal short-to-medium-term cyclical variations over time. M&A will encompass consolidation activity “in-market” as local banks acquire one another, foreign banks enter the E7 markets, and banks from the E7 expand internationally through acquisitions.

## The more immediate trends

The surge of M&A activity seen in Asia's banking industry in 2006 is likely to gather force over the next five years as firms both within the region and from the West continue to look to Asia as the “home of growth”. The impact of this focus on Asia is already being felt in the form of intense competition for a limited supply of quality assets, higher prices and the spread of activity to more countries across the region – and indeed to

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<sup>1</sup> Banking in 2050: How big will the emerging markets get?

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more sub-sectors of financial services. Based on data from M&A Asia, M&A in the financial services sector (including insurance) skyrocketed by 66% to US\$64.5 billion in 2006 from US\$38.8 billion in 2005.

A recent PwC survey conducted by the Economist Intelligence Unit (EIU) on Financial Services M&A activities in Asia<sup>2</sup> highlighted a number of trends in M&A activities in Asia in the banking industry:

## Price has become a concern

Half of all survey respondents cited high pricing, a significant rise when compared to almost one-third (32%) of respondents in 2005, as the principal barrier to undertaking M&A activity from a company point of view – a clear sign that competition for deals is intensifying. Rising prices have, however, brought more deals on to the market – the number of respondents citing lack of attractive targets as a barrier to M&A dropped from 52% in the same survey in 2005 to 34% in 2007. Concerns about value for money will undoubtedly lead some organisations to put more emphasis on organic growth plans.

From your company's point of view, what are the principal barriers to undertaking M&A deals? Select up to three.

High pricing of M&A deals	50%
Lack of attractive targets	34%
Uncertain regulatory requirements	23%
Lack of capital	17%
Resource constraints within management team/inability to recruit senior managers for new operations	15%
Potential exposure to reputational risk	13%
Poor shareholder value	13%
Compliance issues	11%
Competition restrictions	10%
Lack of information on target organisation	10%
Lack of market understanding of M&A deals	9%
Organisation unable to accommodate further change	9%
Poor track record of M&A success	6%
Concerns over language difficulties/potential cultural issues at target	6%
Don't know	6%
None of the above – there are no significant barriers	5%
Other, please specify	0%
<b>Total</b>	<b>100%</b>

Source: Financial Services M&A – Going for growth in Asia, PricewaterhouseCoopers 2007

<sup>2</sup> Financial Services M&A – Going for growth in Asia, PricewaterhouseCoopers 2007

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## **Financial services institutions are casting the net wider**

Both China and India remain crucial markets for financial services companies looking for growth and, barring radical shocks, are likely to remain so for years to come. However, other markets are beginning to compete for capital and attention: Taiwan and Malaysia are considered ripe for consolidation, while others such as Vietnam, Indonesia and Pakistan are attracting those interested in emerging economies.

## **Liberalisation is less of a driver**

Regulatory liberalisation is considered less of a driver of M&A in part because there are signs of regulations easing across the region, particularly in smaller markets. Indeed, regulatory pressure to restructure or merge in some markets, such as Thailand, is acting as a positive influence and considered a more significant driver than in previous year. Asia's financial services industry is learning to live with the current regulatory environment, or at the very least, putting more emphasis on growth.

## **Coming out on top**

Competition for deals in the financial services sector in Asia is expected to intensify and prices are likely to be driven ever-higher as a result. How can companies navigate this environment and come out on top?

## **Examine prices carefully**

As prices rise and previously unavailable targets suddenly show interest in selling, the temptation to pay more than in normal circumstances will be greater. With today's relatively high prices, it is more important than ever for buyers to weigh deals carefully in the context of strategic goals and to fully price synergies. For example, China and India, for all their imperfections and still unfolding regulatory regimes, are simply too large an opportunity to ignore and conventional methods of pricing will often need to be tailored to fully reflect the overriding strategic objectives and the opportunity cost of deferring an investment decision. In most cases however, growth assumptions should be critically analysed—any number of global shocks, from a global economic slowdown to political turmoil to a major natural disaster could throw growth prospects off track, further increasing the risk of over-paying.

## **Find a balance between organic growth and M&A**

Some people believe that organic growth is an extremely important strategy for achieving most corporate goals, and it is likely to increase in importance as prices rise. M&A, while providing opportunities for

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rapid growth, is distracting and often poorly executed—and carries even more risk in an over-heated market. While gaining an early toehold in an emerging market through the acquisition of a minority stake will almost certainly pay future dividends, with today's relatively inflated prices, it will be necessary to carefully weigh the benefits and drawbacks in the context of each individual market.

## **Be prepared for competition from regional players**

While the largest Western financial services companies have provided the most competition for Asian assets in the past, regional companies, notably from Japan and China, are expected to take a very active role in the market in the coming years. This is already beginning to happen in the insurance sector and the trend has implications for the nature of competition. Japanese companies, for example, take a different approach to valuing assets and are generally willing to wait longer than their Western counterparts for a deal to pay off.

## **Build capability and capacity**

The enormous shortage of human capital in Asia's financial services sector is a major inhibitor of growth—both organic and inorganic. The shortage is not confined to Asia and likely to worsen as institutions from emerging markets begin to compete for talent. Clearly, strong management will become an increasingly important source of competitive advantage and those companies that have prioritised the development of their management team will be best placed to capitalise on growth opportunities.

## **Outlook**

Interest in Asia's financial services sector will only increase, going forward. Asian institutions, having grown rapidly in recent years, are now seeking to expand beyond their borders, posing a new form of competition for traditional players, namely Western institutions. For example, Japanese institutions are beginning to expand their footprint to a size that is commensurate with their asset and customer bases. The strategies of Chinese institutions for the rest of Asia have yet to become clear, but they too have the scale to become regional, and perhaps one day, international, players. Singapore banks are already active in the region and there is the prospect of more players emerging.

Adding to the frenzied environment is the prospect of further opportunities opening up – as barriers to foreign investment in the financial services sectors of India and Malaysia are lowered after 2009 and 2010, respectively.

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As prices continue to rise and the already scarce supply of quality targets begins to look overpriced, more institutions will opt to put emphasis on organic growth and collaboration. But organic growth alone is unlikely to be enough to bring the kind of rapid expansion many are looking for, or to offer an effective reply to the aggressive plans of the world's financial services giants.

Although growth might be shifting in terms of key markets, Asia is still the "home of growth". When compared to Europe or the US, entry into the Asian market presents more of a challenge as the environment is less conducive to control deals, which in turn increases the risks if you are not able to find the right partner. Although this risk in Asia remains high, the growth potential will continue to present compelling opportunities.

To explore these factors in more detail, see our recent publication "Financial Services M&A – Going for Growth in Asia 2007", available for download at [www.pwc.com/financialservices](http://www.pwc.com/financialservices) ■

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# Simplification and sourcing initiatives in Asia:

Achieving improved after-tax cash flows



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There is a common but flawed perception that the immediate benefit of strategic simplification and sourcing initiatives is, first and foremost, cost savings. In reality, revenue growth, increased innovation, and research and development are other crucial objectives. Leveraging simplification and sourcing enhances the discovery and mobilisation of distinctive capabilities that allow companies to unleash their full potential. Today, successful companies adopt streamlined operating models that leverage core competencies and resources to develop distinctive and innovative value propositions. Companies focus on a manageable range of activities that create unique value for customers while sourcing support functions externally.

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## Value-added support from service providers

Technology service providers have recognised the increasing strategic importance of simplification and sourcing, and are evolving their service offerings to address these emerging organisational needs.

To support clients in their value chain and operations restructuring efforts, many providers are expanding their capabilities and platforms to offer more value-added business consulting and transformation solutions beyond the traditional functional and informational technology (IT) services. In certain specialised areas, service providers have developed economies of scale, scope and knowledge intensity that hardly any organisation spreading its activities over an entire value chain could achieve effectively.

As service provider offerings gain sophistication, companies are increasingly utilising competencies of such specialised providers while understanding more effectively how to leverage their own capabilities. The success of such initiatives has been mixed as many buyers jump onto the outsourcing bandwagon without a clear understanding of their own sources of competitive advantage; without performing the appropriate due diligence in terms of best providers, control systems and locations; and without the proper structures for tax and legal purposes.

Senior management charged with operations efficiency should avoid a piecemeal approach focused on short-term cost savings. The remaining article highlights the importance of a strategically aligned and holistic approach to simplification and sourcing, and presents a framework that organisations may adopt.

## The emerging model

Multinational companies are restructuring their organisations to integrate and refocus a collection of stand-alone businesses on their core sources of competitive advantage while centralising and outsourcing other activities which local operating units have neither a critical strategic need nor specific specialist capabilities. Today, this emerging trend is the most apparent in Asia.

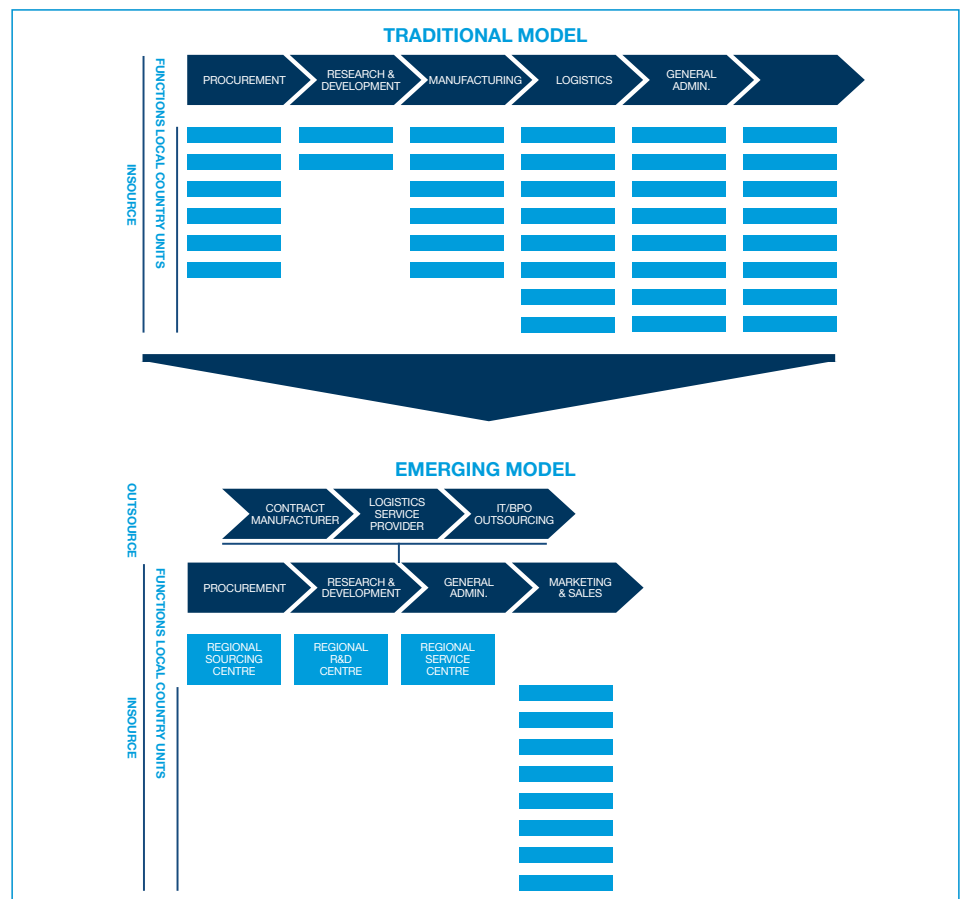
After years of disparate organic expansion and acquisitions, senior management is seeking ways to accelerate growth and reduce operational inefficiencies imposed by unrealised synergies and the proliferation of processes, technologies, organisational structures and facilities in each new market.

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Activities such as procurement, IT, finance, accounting, human resources and other support activities tend to be handled separately in each country. As a result, redundancies, diseconomies of scale, incompatible systems and diluted management controls have become a widespread phenomena across the region. However, as globalisation, rapid technology innovation and service provider sophistication evolve, senior management is beginning to look for ways to reduce complexity and gain operational efficiencies.

Companies need to rigorously assess each of the functions across their value chain to determine which ones have sufficient scale and differentiated skills. For most multinational companies looking to excel in Asia's growth markets, this means focusing local operations on building relationships with end-customers and distribution channels, and developing unique local market insights to adapt global solutions to local needs. Diagram 1 shows how companies can transform their business models.

Diagram 1: Transforming a localised business model into a regional one



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Non-strategic support functions previously carried out by each individual country and business unit are either pooled in regional, in-house shared facilities or a relationship is established with one of the many dedicated third-party service providers in the marketplace. Increasingly, these outsourcing relationships, particularly with technology providers, are moving from transactional relationships to more strategic ones. Common technology applications, consistent processes and standardised definitions of similar roles and responsibilities all reduce complexity and promote effective coordination and decision-making.

Third-party service providers are accelerating this development by upgrading their own capabilities and platforms and offering more value-added business solutions beyond infrastructure and functional activities.

Senior management usually leads and manages such restructuring initiatives from lean corporate centres that focus on critical activities and operations. Within Asia, such regional headquarters are often positioned in locations such as Singapore, Hong Kong and Shanghai which provide effective hub infrastructure and offer tax advantages.

## Strategic alignment

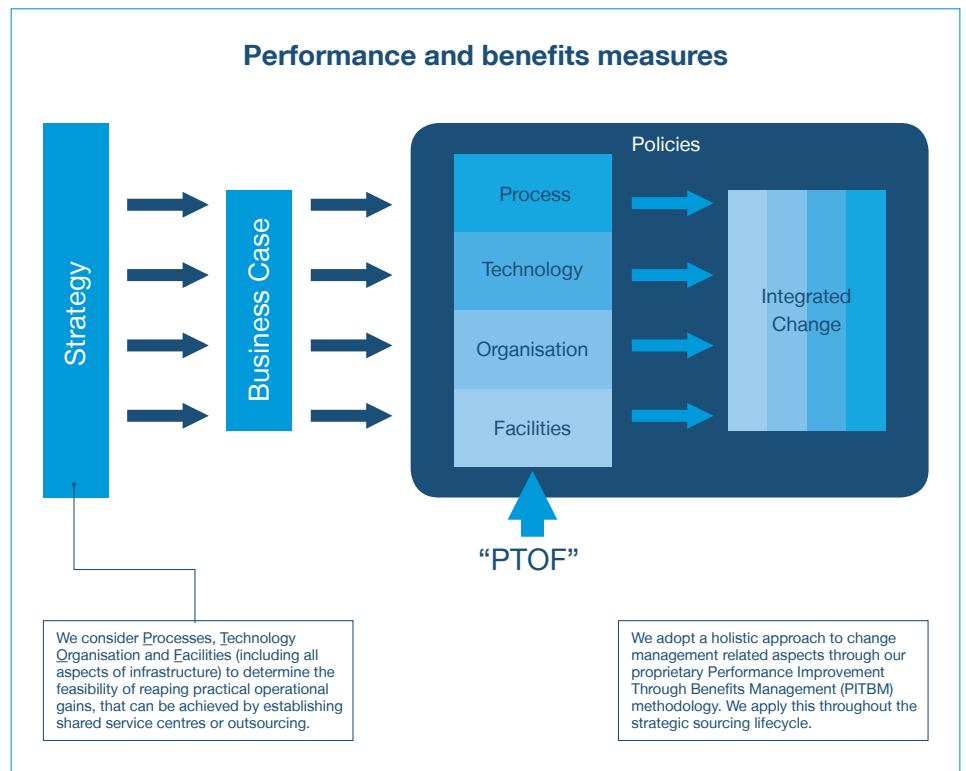
Any new regional business model that is not synchronised with the overall corporate structure and strategy is unlikely to be successful. Senior management needs to spend sufficient time to review their overall corporate strategy as well as understand their company's sources of competitive advantage and levels of complexity necessary to sustain and enhance such core capabilities. Paradoxically, oversimplification may curtail growth and innovation.

One approach is to disaggregate the value chain across all elements, locations and processes. The disaggregated "as-is" business model should then be benchmarked against a minimalist structure with maximum centralisation and standardisation. Each added level of complexity across Processes, Technology, Operations and Facilities (PTOF) should be checked for strategic and operational relevance. If an additional unit of complexity does not yield a tangible advantage over the simpler alternative, management should consider refining the particular unit (Diagram 2). Simplified alternatives may entail unbundling processes and transferring them to captive regional shared service centres or manufacturing facilities or outsourcing activities to specialised IT or service providers.

Deciding whether to keep an activity in-house or to outsource depends on whether the organisation can achieve a sustainable advantage by performing the activity internally cheaper, better or faster on a continual

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Diagram 2: Our approach is holistic and focused on benefits realisation – Linking corporate strategy with simplification and sourcing



basis. The activity should not be outsourced if cost, quality or speed is critical to the customer and if the organisation excels at performing the activity. Companies too often assume that because an activity seems integral to their business, the activity has to be kept in-house.

Today, it is recognised that in a dynamic and open marketplace, companies are constantly in competition with all potential suppliers of each activity in their value chain. Hence, companies should assess their identified core competencies – strategically and activity-wise against other potential suppliers on an ongoing basis and decide what is best for the company.

Service providers are continually developing and enhancing their capabilities and delivering sophisticated business consulting and transformation services, design and engineering and other value-added services. Many activities currently considered as sources of strategic competitive advantage may tomorrow be performed more efficiently by a specialised service provider. Outsourcing frees up critical resources in the organisation to perform real value creating activities.

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## Leverage technology service providers and platforms

IT and business service providers have recognised senior management's dilemma in trying to stem a proliferation of complexity in the wake of globalisation and continued technological advances.

This is partially a result of the mass build-up of disparate technology platforms and systems either in-house or through mergers and acquisitions. Service providers are offering a broader range of more sophisticated capabilities to help organisations reduce complexity and achieve standardisation. IT companies in particular have broadened their horizons beyond infrastructure and technology, and are offering a full suite of outsourcing services, including:

- Software application development and maintenance
- Bespoke R&D and design services
- Hardware/software maintenance and network administration
- Business process outsourcing
- Systems integration
- Technology consulting
- Business transformation outsourcing (BTO)

BTO in particular is attracting more attention where an organisation outsources a business process to a dedicated service provider with the specific intent of having the service provider apply specialist knowledge to enhance the process and collaborate in a risk and reward sharing partnership. Outsourcing helps to leverage internal technical capabilities and tap the rapid response and innovative capabilities of specialised technology providers.

As providers and platforms become ever more sophisticated, outsourcing can provide the buyer with greater flexibility and quality, especially in the purchase of rapidly developing new technologies.

Technological advances have also lowered transaction costs, allowing inputs to be transported, stored and coordinated effectively from external sources. Providers can both have more depth in resources and sophisticated technical knowledge, and support specialised facilities for higher quality than the buying company could achieve alone. Outsourcing can also help a company spread the risk of technology developments across a number of suppliers.

## Minimise cash tax costs

Shareholders eventually attain value created from complexity reduction and strategic sourcing exercises in Asia through improved after-tax

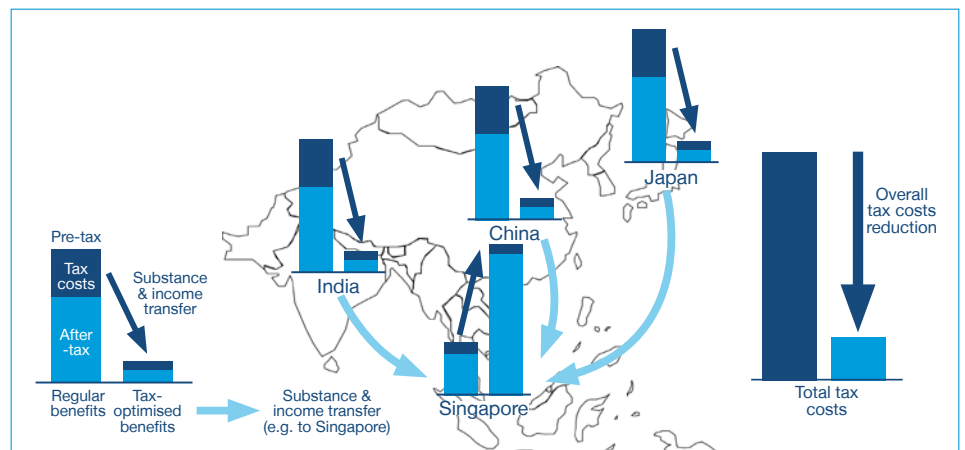
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cash flows. Senior executives should therefore work towards minimising effective taxation simultaneously with relevant operational efficiency and revenue growth gains. Aligning the emerging regional business model with a tax-advantaged structure by centralising strategic functions, knowledge and entrepreneurial risks along with all resulting taxable income in a tax-favoured jurisdiction should be an imperative rather than a consideration.

As the source of competitive advantage in Asia shifts from the ownership of assets and resources across the region to the efficient management of a network of in-house and outsourced capabilities, companies should make sure that they structure transition as tax-efficiently as possible. Too many companies restructure their Asian operations without proper attention to cash tax costs. As a result, additional profits generated from a regional restructuring exercise are eventually exposed to high effective tax rates of between 30% and 50%, either in regional locations like Japan, China or India or at corporate headquarters in the US or Europe.

Locations such as Singapore and Hong Kong, for instance, can provide excellent advantages for locating a strategic management centre. For example, Singapore's Economic Development Board grants multinational companies generous tax incentives for transferring strategic knowledge-based activities to the city state. New regional corporate centres, whose strategic resources drive a multinational's complexity reduction and strategic sourcing initiatives for Asia out of Singapore, can negotiate preferential tax rates for all additional income of as low as 5% or 10%. This represents significant tax savings for the companies, as shown in Diagram 3. The new regional business model with a strategic corporate centre and specialised lean internal operating units or external outsourcing relationships is ideal for efficient tax planning.

Diagram 3: Leveraging business restructuring for tax cost minimisation



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Instead of arbitrary on-paper tax planning that is increasingly scrutinised and challenged by tax authorities, tax-advantaged regional business transformations generally have the necessary substance. The tax perspective should therefore be considered simultaneously from the start together with all strategic and operational aspects.

The early consideration of taxation and other legal matters is not only critical from a tax planning perspective, but also to avoid any exposures to eventual tax audits, assessments, and related penalties that could severely reduce the efficiency and revenue growth gains from the regional business restructuring.

## Managing and leveraging complexity

Complexity brought about by globalisation impacts companies positively as well as negatively. Managing complexity means looking for harmonisation and standardisation to remove redundancy and reap efficiency. Leveraging complexity can also mean stimulating innovation and growth. To maximise shareholder value in Asia today, organisations need to excel at both managing and leveraging complexity.

Managing complexity successfully through effective sourcing and structuring initiatives can act as the much needed catalyst for renewal and change within the organisation and stimulate fresh thinking. A holistic approach that is strategically aligned and tax-efficient is crucial to position the company for sustainable growth and operational excellence in the world's fastest growing markets. ■

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