

DRAFT

CENTRAL GROUP RESEARCH EXPENSES

In 1976, at Hot Springs, the companies present agreed that their contributions to central group research expenses would be on the basis of a percentage of net turnover. This percentage would ensure, as near as possible, full allocation of relevant expenses when applied world wide.

For 1977/78, the percentage calculated was 0.15%, equating to a 99% allocation of the relevant expenses. For 1978/79, it was apparent that expenses had risen faster than net turnover and to achieve a comparable percentage recovery the rate would have to be 0.20%. In an attempt to avoid annual revisions a three year projection was made which indicated that if 0.21% were used in 1978/79 it could be maintained until 1980/81.

The expectation at the time of the projection was that inflation would be no higher than 15% p.a. and that the exchange rate would remain at about £1 = U.S.\$ 1.977. The alternative was that if inflation reached as high as 20% the exchange rate would fall to £1 = U.S.\$ 1.800, the basic assumption being that sterling would depreciate as inflation increased. In either situation it appeared that 0.21% was a valid rate of contribution.

In the event, the position in 1978/79 was that a projected over recovery of some £165,000 finally became an under recovery of £81,000. The turn round in this instance was due to the unexpected strengthening of sterling to £1 = U.S.\$ 2.25.

109881848

The position in 1980 shows a marked difference from the 1978 projection. Recoverable research expenses have increased 22% (against a U.K. inflation rate of 20%) in comparison with 1979 while a higher exchange rate reduces the sterling equivalent of group net turnover. Assuming an exchange rate of £1 = U.S.\$ 2.25, the result would be an under recovery of £943,000 against the £30,000 projected.

If recoverable research expenses increase in 1981 by a further 20% (in line with U.K. inflation) and the exchange rate is £1 = U.S.\$ 2.22, our current forecast is that contributions at 0.21% would leave the centre with a substantial under recovery of £1,634,000. Comparable under recoveries for 1982 and 1983 would be £1,945,000 and £2,395,000.

As the above indicates it is now very difficult for us to maintain the 0.21% basis through 1981, although BAT stood by its earlier agreement to absorb the shortfall of £943,000 in 1980. In order to reinstate the position where recoveries approximately equate to forecast expenditure, the contribution rate would require to be increased to 1981 0.27%, 1982 0.28%, 1983 0.9%.

It is apparent that a percentage rate of contribution for R & D recoveries cannot at present accommodate satisfactorily the unknown variable factors although the principle of relating a company's contribution to research expenses in the proportion that their net turnover bears to the group as a whole is not in question.

109881849

A further problem is that for some companies, where exchange controls and taxation matters are increasingly more difficult the use of a percentage creates a situation which requires renegotiation whenever a change occurs. This situation often requires that supporting documents be provided, which causes additional problems where forecast, and not actual, figures have been used. In addition, we are always vulnerable to attacks by the U.K. Revenue authorities if we are clearly not recovering expenditure incurred.

At this time, therefore, companies are being asked to agree to a formula which, while retaining the existing principles, will be based initially on provisional figures but with a final adjustment to actual over at the year end. This will be supported by an open-ended legal agreement that will state the formula, but not figures, thus hopefully obviating the need for annual approval by the Authorities.

The operation of the proposed procedure is that at the end of each year company and group net turnover values are taken from the consolidated accounts for subsidiaries and the advices by letter for associates and related to actual recoverable research expenses by the following formula:-

$$\text{Research Expenses} \times \frac{\text{Company's Net Turnover}}{\text{Group Net Turnover}} = \text{Contribution}$$

A copy of the type of agreement we have in mind is attached. We will, where required, give supporting details of the values used.

109881850

To try to contain the increase in central group research expenses in the U.K. the Board is investigating whether some research at an agreed cost could be carried out in overseas companies, who would notify their relevant expenses to us. These expenses would be then added to those of the centre before the calculation of company contributions in accordance with the formula. Any company who had participated in central research would then receive a credit for the value of work done.

In conclusion, I would add that all the above proposals have one object in view, namely that of ensuring that research vital to our industry's future progress is not placed in jeopardy by a contribution procedure which must inevitably lead to unacceptable shortfalls at the centre. Equally important is that we move to a procedure that is ultimately tied to current actual expenses and net turnover so that existing timing differences and forecasting errors are not unfairly borne by either the centre or companies.

ACC/JAH

9/7/80

109881851

APPROXIMATE NET TURNOVERS £ MILLIONS

A.	1980	1981	1982	1983
Other Subs. & Assoc.	1,008	1,201	1,386	1,552
Brazil	249	275	305	341
B. & W.	570	588	638	687
IMASCO	132	138	145	153
Germany	296	313	332	345
AMATIL	95	100	105	110
	<u>2,350</u>	<u>2,615</u>	<u>2,911</u>	<u>3,188</u>

1,342
570

RECOVERY AT 0.21% £'000's

B. Other Subs. & Assoc.	2,116	2,522	2,909	3,258
Brazil	523	578	641	716
B. & W.	1,197	1,235	1,340	1,443
IMASCO	277	290	305	321
Germany	622	657	697	725
AMATIL	200	210	221	231
	<u>4,935</u>	<u>5,492</u>	<u>6,113</u>	<u>6,694</u>

FORECAST R. & D. RECOVERABLE £'000's

C.	5,878	7,126	8,058	9,089
----	-------	-------	-------	-------

RECOVERY AT FORMULA £'000's

D. Other Subs. & Assoc.	2,521	3,273	3,837	4,424
Brazil	623	749	844	972
B. & W.	1,426	1,602	1,766	1,959
IMASCO	330	376	401	436
Germany	740	853	919	984
AMATIL	238	273	291	314
	<u>5,878</u>	<u>7,126</u>	<u>8,058</u>	<u>9,089</u>

INCREASE D-B £'000's

E. Brazil	100	171	203	256
B. & W.	229	367	426	516
IMASCO	53	86	96	115
Germany	118	196	222	259
AMATIL	38	63	70	83

109881852