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CORPORATE RESEARCH FORUM

October 2013

Developing Commercial Acumen for the HR Function

"Commercially astute executives have an ability to foresee what may be round the corner. They are able to anticipate market and competitor trends. It's about showing foresight as well as insight."

Sir David Varney, formerly a Managing Director of Shell UK, Chief Executive of British Gas and Chairman of O2.

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Developing Commercial Acumen

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Gillian Pillans and John Kind

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Mike Haffenden

Foreword

HR often has to justify itself over its role, its output and its added value. In some cases this is deserved as we become involved in unsubstantiated opinion, fads and fashions, are reluctant to use data or are unable to evaluate our initiatives.

This report is written from the viewpoint that we believe that HR functions can make a substantial contribution to improved organisation effectiveness and business strategy. However, to do this HR professionals have to be business people as well as HR people. We have to be able to ask searching questions, analyse situations, develop and implement improvement plans and be able to assess their effectiveness in business, not HR terms.

The problem is, it is not easy to become 'commercial'. Far more than merely being financial, it is a fusion of inquiry, attitude, knowledge, experience and skills. It is about challenging and constantly improving the status quo – starting with an understanding of the problem, not force fitting the solution.

This report is short and practical, summarising the views of experienced practitioners and senior business leaders on what commercial acumen is and how it should be applied.

It's not definitive but is a start!

It is not intended to be read as an abstract. To optimise its usefulness read it and apply to your own circumstances and situation.

Mike Haffenden
Director, Corporate Research Forum

Gillian Pillans

John Kind

About the authors

Gillian Pillans

Gillian has worked as a senior HR practitioner and OD specialist for organisations including Swiss Re, Vodafone and BAA. Prior to her HR career, she was a management consultant with Deloitte Consulting. She is also a qualified solicitor.

John Kind

John is a Learning and Development Consultant specialising in commercial and financial skills. He has an MBA from the Manchester Business School and an Honours Degree in Economics. He has nearly 30 years' experience of developing and presenting workshops to a wide variety of clients worldwide including BAA, Babcock International, BP and Standard Life. John is a Visiting Professor in the Department of Executive Education at the University of Strathclyde Business School and an Honorary Professor of Teaching and Learning at Winchester Business School. He is the author of 'Financial Games for Training' published by Gower.

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The Branch Manager of a leading supermarket chain in Winchester
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About CRF

Founded in 1994, the Corporate Research Forum (CRF) is a membership organisation whose international focus is on research, discussion and the practical application of contemporary topics arising from people management, learning and organisation development. CRF has become a highly influential focal point and network for over 100 members representing a cross-section of private and public sector organisations.

- Its annual programme of research, events and publications fully reflects members' interests, in addition to the annual international conference. Side meetings and interest groups are also initiated to meet challenges that members might have.
- Contributors are acknowledged experts in their field with a worldwide reputation as leaders and innovators in management thinking and practice.
- Sharing and collaboration among members is a key feature of CRF's activities. We actively encourage networking at all events, and especially through member lunches and HR director dinners.
- The Forum is led and managed by highly regarded former HR professionals who have a passion for delivering excellence in the leadership and development of organisations and people.

CRF's goal is to be valued for excellence, rigour, relationship building and providing an independent view which, together, lead to measurable improvement in members' people and organisation performance.

For more information on CRF please visit www.crforum.co.uk or contact Richard Hargreaves, Commercial Director at +44 (0) 20 7470 7104 or via e-mail at richard@crforum.co.uk

INTRODUCTION

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What are the characteristics of consistently successful businesses? Is it the ability to innovate and to launch a regular flow of new products and services? Is it the ability to attract and retain high quality talent? Is it about creating new markets and to increase market share?

Of course, all these factors are critical. But in the business world, the defining criterion is companies' ability to achieve superior financial performance and to deliver outstanding shareholder returns especially in the longer term over, say, 5 and 10 year periods.

Such results do, of course, need to be accomplished by demonstrating high levels of environmental, ethical and social conduct as governments and other important stakeholders such as customers and investors pay increasing attention to issues of corporate governance and regulatory compliance.

Standards of financial performance

In the UK in early April 2013, the Financial Times Index of leading shares (the FTSE-100, those 100 companies with the most valuable stock market values) was at 6,250, nearly 10% higher than 5 years ago. The most valuable FTSE-100 company at this time was the bank, HSBC, with a stock market value of £126.5bn.

Businesses such as Compass, the world's largest contract caterer (number 30 in the FTSE-100 list with a stock market value of almost £15bn), have seen their share price increase by more than the 10% achieved by the FTSE Index. Compass's has risen by more than 150% during the past 5 years.

A number of other FTSE companies have 'outperformed'. They include Associated British Foods (number 31 in the FTSE-100 list with a stock market value of £14.7bn). It's a diversified group operating in segments such as Agriculture, Retail (Primark) and Grocery (Twinings tea and Ovaltine). Its share price has increased by 112% over the past 5 years, eleven times greater than the rise in the FTSE-100 index.

By contrast, well known businesses such as Kodak and Nokia, the Finnish manufacturer of 'smart' handsets have not performed nearly as well. Kodak filed for bankruptcy protection in the United States in 2012. The Nokia share price has fallen significantly in the past 18 months as competitive pressures intensify. Shareholders have lost most, if not all, of their investment.

In the UK, since January 2013, businesses such as HMV, Jessops and Blockbuster have all gone into administration following financial difficulties. They face highly uncertain futures with serious consequences for customers, employees and shareholders.

The financial markets are demanding. They do not appreciate profit warnings and unpleasant surprises. In their eyes, a company is only as good as its **next** set of results, not the last set. This pre-occupation with financial performance and 'returns' should come as no surprise. Companies, large and small, need to be profitable. They must generate cash to invest and to finance their expansion plans. Shareholders, as the owners of the businesses concerned, expect consistently higher levels of dividends to be paid.

Quoted companies

In the case of businesses with a stock market listing ('quoted' companies), their principal investors or shareholders are fund management groups, insurance companies and pension funds. These stakeholders invest to increase their wealth in order to finance their pension liabilities and to attract additional funds to reinvest in their portfolios.

This is borne out by the findings in PricewaterhouseCooper's (PwC's), annual CEO survey (see reference in the Reading List). In 2012, CEOs expressed an overriding concern to deliver superior financial results and 'value' for their shareholders.

Talent pools

Developing an increasing pool of commercially astute executives is becoming, therefore, a more pressing priority. As the PwC report makes clear, talent shortages are inhibiting growth plans. One in three CEOs expressed concern that 'talent gaps' are restricting their companies' ability to innovate effectively.

Talent constraints have impacted costs - but also factor in lost opportunities
Q: *Have talent constraints impacted your company's growth and profitability over the past 12 months in the following ways?*

Base: All respondents (1,258)
Source: PwC 15th Annual Global CEO Survey 2012

For the HR function the stakes are high. It means improving its effectiveness to attract, retain, motivate and develop the talent its businesses require. It could not have a more fundamental and important responsibility. However, in many organisations there are doubts about HR's business knowledge and judgment and the relevance of some of its activities.

This leads to the focus of this report – what can and should be done to make executives, at all levels and in all functions, 'fitter for business'?

Commercial acumen

The differentiating factor between companies who 'outperform' and those who don't is the degree to which they demonstrate **'commercial acumen'**.

Accordingly, this report sets out to:

- **Define** 'commercial acumen'.
- **Explain** why it is such an important factor in achieving business goals.

- **Identify** the knowledge, skills and behaviours that demonstrate 'commercial acumen'.
- **Provide** checklists, tools, techniques and references to stimulate the development of 'commercial acumen' both at individual and organisational levels.
- **Highlight** case studies and good practice to demonstrate 'commercial acumen' in action.

The HR Function

The HR Function, in particular, is criticised for its lack of 'commercial acumen'. A recent report by KPMG and the Economist Intelligence Unit (see Reading List) revealed that HR has much to do to improve its commercial credibility and expertise.

The survey found that:

- Only 25% of respondents considered that their HR function excelled in important areas such as the sourcing and retention of talent.
- Less than 20% of respondents considered that HR demonstrated its value to the business.
- Only 1 in 4 respondents considered that HR was capable of supporting their company's strategies.

In which of these areas do you think your company's HR function excels? Select all that apply.

Source: Economist Intelligence Unit study as commissioned by KPMG International: Rethinking Human Resources in a Changing World, 2012

For these reasons, we devote specific attention to what HR professionals should do to support their boards and line management teams to achieve their commercial objectives.

How to use this document

We bring together evidence and insights from interviews with 'top' executives and leading HR practitioners. We also highlight a number of useful tools, some developed by CRF and others developed by experts in the relevant field. In many cases we have only provided a taster, and further information can be found by consulting the sources in the Reading List or online.

The Appendices contain a number of resources and tools which are referred to in the report, as well as a Glossary of Business and Financial Terms, which explains terms used throughout.

WHAT IS COMMERCIAL ACUMEN?

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We define 'commercial acumen' as the set of skills that enables individuals, departments, functions and teams to deliver excellent performance for a business or business unit so that:

- Its revenue or sales increase.
- Its profitability improves.
- Its cash generation gets better.
- Its shareholder value is enhanced.

We interviewed a number of senior executives to understand their views on commercial acumen and the qualities that differentiate strong commercially-oriented executives. They highlighted the following features:

- Commercial acumen is an orientation or lens through which executives approach problems and situations; the ability to **analyse a situation and work out what needs to be done**.
- **Foresight** - the ability to anticipate market and competitor trends to see the 'big picture' as well as the detail.
- Putting the **business first** and the function within which you work second.
- A constant emphasis on **continuous improvement**.
- A firmness of purpose, **resilience** and follow-through once decisions have been made.
- An ability to **persuade** others that the proposed actions are 'right'.

Leading expert in developing commercial capability, Kevin Cope, lists five key capabilities in his book *Seeing the Big Picture: Business Acumen to build your Credibility, Career and Company* (see Reading List).

1. See the 'big picture' – how the key drivers of the business relate to each other, work together to produce profitable growth, and relate to the job the individual does.
2. Understand important company communications and data, including financial statements.
3. Use individual knowledge to make good decisions.
4. Understand how individuals' actions and decisions affect key company measures and the objectives of the organisation's leadership.
5. Effectively communicate ideas to other employees, managers and executives.

The Executive View

We interviewed a number of senior executives to ask their views on the qualities that differentiate professionals with 'commercial acumen'. Here are some responses:

'They have a much greater external orientation. They develop insights into the external trends affecting their business. These trends are not just economic and financial, they are political and social as well'.

'Commercially astute executives have an ability to foresee what may be round the corner. They are able to anticipate market and competitor trends. It's about showing **foresight** as well as insight. Not having this capability can have serious consequences; look at what has happened to HMV and Kodak'.

Sir David Varney, formerly a Managing Director of Shell UK, Chief Executive of British Gas and Chairman of O2

'They are entrepreneurial so opportunities are identified, explored and analysed. If we didn't have commercially astute executives at DLA Piper, we wouldn't have completed our transatlantic merger in 2005 and we wouldn't be the brand that other firms like to keep an eye on'.

'They see the big picture as well as the detail. They want to influence decisions, they understand how our firm works and how it makes money. They welcome challenges. They're decisive, bold and courageous. Sometimes the most commercial solution isn't always the most popular one'.

'They have well developed instincts about what the client wants and being able to assess whether or not these wants will drive profitable growth. They're intuitive and can 'sniff out' bad business'.

Sir Nigel Knowles, Global Co-Chief Executive, DLA Piper

Profile – Key Characteristics of Commercially Astute Professionals

Our research highlighted a combination of personal characteristics, thinking styles, knowledge and experience that distinguish commercially minded professionals. They are summarised below:

Personal Characteristics

Commercially-oriented attitude	• Shows an interest in business and a curiosity regarding the business world generally. Devotes time to learning about business through reading, research and internal and external networking. • Understands the commercial profile of the business sector within which the company or organisation competes. • Can explain the ways in which the business makes money/adds value – its business model including where it has competitive advantage.
Executive mentality	• Able to see the 'big picture'; understands how different parts of the business operate together to deliver results and how business and financial metrics reflect the company's performance. • Able to discern patterns amongst a wide variety of trends and brings them together to produce profitable outcomes. • Understands how their function and its day-to-day decisions, affect the overall performance of the business. • Understands what other functions do and how they interact.
Being a commercial leader	• Sets clear, agreed and quantifiable objectives. • Makes sound business decisions. • Resilient; prepared to take tough decisions in the best interests of the business. • Makes things happen. Converts talk into action. Follows through. • Measures and monitors performance. Addresses failure to achieve results. • Sets and maintains high professional standards.

Skills and Knowledge

Analysing the business situation	• Able to size up the business situation and identify what needs to be done. • Can devise performance improvement plans. • Can prepare and present a convincing business case for a longer term project.
Financial skills	• Understands the key financial metrics that are used to measure business performance. Can explain what they mean and how they interact. • Able to interpret financial results to determine financial strengths and weaknesses, and develop an appropriate course of action.
Delivering business results	• Able to prepare budgets and longer term business plans. • Achieves budgeted results. • Can use project management methodologies such as 'Goal Directed Project Management'. • Understands and can apply suitable business process improvement methodologies such as 'Lean Thinking'. • Understands risk management, and aware of trends in business ethics, corporate social responsibility and corporate governance and the implications for the business.
Negotiation and selling	• Good negotiating and deal-making skills. • Able to sell and gain buy-in to plans and proposed actions. Displays excellent influencing skills.

How 'commercial' are you?

Appendix 1 contains a checklist for assessing the extent to which you have the mindset, knowledge and experience required to act as a commercially astute executive, and where you may have gaps in your knowledge and experience. In the following chapters, we highlight tools that you can use to address any skills gaps, and the options available to develop commercial experience.

The Executive View

'It's being decisive once judgments have been made, including an ability to convince colleagues that the proposed actions are right'.

David Walton, formerly Chief Executive of Stannah Stairlifts

'It's showing a balanced mix of entrepreneurial skills on the one hand and well developed analytical and 'risk assessment' capabilities on the other'.

'It's being clear about objectives and how to achieve them. But to do so flexibly in case circumstances should change'.

'It's about having a strong sense of ethics, to behave well, to operate with integrity. This will help to set the tone in your organisation and influence the values that you wish to emphasise'.

Tim Stevenson, Chairman, Johnson Matthey

'It's a lens you look through. It's not just about understanding the financials, but being focused on good commercial outcomes for the business'.

Amanda Baldwin, VP HR EMEA, McGraw Hill

'There's an element of knowing it when you see it, but for HR commercial acumen is about being able to engage in a conversation in a way that's connected to the business'.

Des Pullen, Group HR Director, Associated British Foods

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In the previous chapters we defined what commercial acumen is, identified the characteristics of commercially astute HR professionals and suggested the knowledge that HR people should possess. In this chapter we expand on the 'Skills and Knowledge' section of the Profile in the previous chapter. We describe key skills areas such as financial literacy in more detail, and identify useful tools and models that can be used to improve your understanding of business. We have grouped these skills and knowledge according to the four areas of 'Skills and Knowledge' identified in the profile:

1. Analysing the business situation.
2. Financial skills.
3. Delivering business results.
4. Negotiation and selling.

3.1 Analysing the business situation

Before delving into financial metrics, it is important to understand the big picture within which a business operates, and be able to size up a situation to identify what needs to be done. It is important that:

- Decisions are taken following thorough analysis of relevant data.
- The principles of cause and effect are considered, i.e. will the selected option lead to the desired outcome?
- Clear objectives are set.
- It is well understood why a particular solution is suitable for the business context in which it is to be applied.

Good commercial managers seem to know instinctively what will work and what will not. However, it is useful to have a framework for developing ideas and checking all factors have been considered. There are many tools available which can be used to help you develop insights into what is going on within your business, its customers and competitors, and to shape a successful action plan. The following tools are useful, and are explained in more depth in Appendix 2:

1. *Diagnostic questionnaire*. Developed by CRF to assess your understanding of your business and work out where you need to ask questions or find out more.
2. *Business Model Canvas*. A strategic management template which can help develop new businesses, or understand existing businesses better.
3. *Porter's Five Forces Model*. To diagnose the nature of competition in the market and identify appropriate strategic options.
4. *BCG Matrix*. Used to assess the competitive strength of your business's different products and services.

5. *SWOT Analysis*. Identify the strengths, weaknesses, opportunities and threats faced in any business situation and how they can be managed.
6. *Pareto principle*. Can be used to work out where maximum gain can be made for least effort.
7. *PESTEL Framework*. Identify the political, economic, social, technological, environmental and legal factors which might influence a particular strategy.
8. *McKinsey's 7S Model*. A tool to assess the internal health of a business and work out what needs to be realigned to improve performance. This can also be used to identify how change in one area of the business might affect other aspects of the organisation.

3.2 Financial Skills

Being commercial requires the ability to understand and interpret financial information. It is not necessary to be an accountant but it does require the motivation to learn the 'language of business', to become financially literate, to engage with the finance function and to understand their views.

It means:

- having the ability to 'read' financial statements and to be conversant with the most important financial performance indicators – how they are calculated and what they mean – to identify the business's financial strengths or weaknesses
- to be an active contributor when financial issues are being discussed and business decisions are being made (as opposed to sitting on the sidelines and not becoming involved in the arguments, conversations and debates)
- to use financial information and financial indicators and to apply financial knowledge as the basis for identifying performance improvement opportunities (what 'story' are the 'financials' telling us and what are we going to do about it?).

Financial objectives

As explained in the Introduction, the fundamental financial objective for any business is to create 'value' and to keep doing so. For a quoted company, this means achieving superior share price performance (relative to appropriate benchmarks like the performance of the FTSE 100) and increasing dividends. Dividends are an important element of value since, over time, they account for about 50% of the value that companies create.

Businesses do not, of course, have complete influence over their share price performance. The stock market can be fickle. It is a market like any other market. Many financial and non-financial factors influence the share price such as the state of the economy, government policies and the possibility of a company being taken over.

Well managed companies concentrate on those aspects of their financial performance which they **can** control.

They focus on two financial objectives:

1. To be increasingly **profitable** which means earning acceptable returns on revenue or sales (improving profit margins) and earning acceptable returns on investment (amounts spent on acquiring short and longer term assets). Assets are what a company owns such as buildings, plant and equipment, raw materials and amounts due from customers.
2. To be and remain in a **sound financial position** so that commitments can be paid for as they fall due such as being able to pay salaries at the end of the month and being able to repay loans on time. The most important challenge here is **cash flow**. Companies get into financial difficulties because they run out of cash and either shareholders and/or lenders are not prepared to provide any more.

The issue of profitability is highlighted in the **Income Statement** or Profit and Loss Account.

The issue of sound financial position and being able to generate positive cash flows is assessed in the **Cash Flow Statement** and the **Balance Sheet**.

It is extremely important to understand that earning a profit and generating cash are not the same thing (this is explained in the Glossary of Business and Financial Terms in Appendix 4).

The meaning of the three financial statements, supported by definitions of financial terms and numerical examples, is also explained in the Glossary.

Financial priorities

There are 10 financial questions that need to be asked and answered:

1. How profitable are our products and services?
2. Overall, how profitable is our business?
3. Is the return on the investment earned by our business acceptable?
4. How long does it take before we get paid by our customers?
5. How long do we take to pay our external suppliers?
6. How well do we manage our stocks – raw materials, work-in-progress and unsold finished goods?
7. Are we generating enough cash to meet our commitments, to invest for the future, to repay loans, to service interest charges and to pay dividends?
8. Are we converting profit into cash flow fast enough?
9. Are we investing for the future, for example in R&D, infrastructure and people?
10. Are our borrowings at an acceptable level? Are they manageable? Can we afford our interest charges or financing costs?

Case Notes

One of our interviewees was a Branch Manager of one of the leading supermarkets in the UK. The KPIs against which his performance is measured are a good example of how financial and non-financial metrics combine to give an overall picture of the health of the business. These include:

- Branch sales.
- 'Store accountable' profit (sales less the costs the branch manager can control such as labour costs and promotional expenditure.
- Shrinkage – loss or theft of stock.
- 'Training Commitment Index' – measuring whether all learning and development initiatives in the budget are delivered.
- 'Mystery Availability Check' – measuring the availability of items in store.
- 'Talk Back' score – extensive feedback from branch staff about the leadership style of the branch manager.
- 'Mystery Customer Measure' – mystery shoppers regularly visit the store and report on their experience, for example helpfulness of staff, queue times and availability of trolleys.
- 'Licence to Trade' – an extensive health, safety and environmental audit.

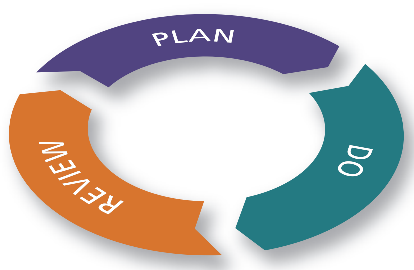
'This means I have to get into a great deal of detail to really understand what's going on in the store. I need to immerse myself in the numbers and analyse them thoroughly'.

The answers to each of these questions can be given by using appropriate financial indicators and, by using relevant benchmarks or standards. The benchmarks are:

- What results do investors expect? For example, what percentage increase in dividends are they anticipating?
- How do the results compare with our internal budgets and longer term business plans?
- Are our results better or worse than in the past?
- Would we be better doing something else with our investment?
- When it's possible to obtain comparable information, how do we perform versus our competitors?

3.3
Delivering Business Results

The ultimate test of commercial acumen is the business results that are achieved, whether they are measured in financial or other terms. Delivering results usually involves an iterative process of Planning, Doing and Reviewing. At each stage in this process there are key skills that need to be acquired, and tools available to assist.



1. Plan

This stage involves developing action plans, setting objectives and targets to be achieved and developing a budget. Hoshin Planning – described in more depth in Appendix 2 – is used by many organisations to convert strategies and plans into actions, with a particular focus on achieving a quantum leap in performance by setting 'breakthrough' objectives. The Business Model Canvas and McKinsey 7S framework described above can also assist in defining the actions that need to be taken to deliver a particular result.

2. Do

Project management is a key skill which is required to ensure that actions are completed in the correct sequence, on-time and on-budget, that responsibilities are well-defined, progress is tracked, and risks that might compromise delivery are identified and managed. Goal Directed Project Management – described in more detail in Appendix 2 – is a relatively simple project management methodology which can be used both for one-off projects and as a general management tool.

"Gaining sales experience is an important pathway to developing commercial acumen."
David Walton, formerly Chief Executive of Stannah Stairlifts.

3. Review

Successful organisations do not stand still or rest on their laurels – they review their performance and make continuous improvements. There are two aspects to this. First, information is needed to evaluate what has been achieved. Financial information – as described in more depth in the previous section – is key to this. However, other quantitative and qualitative information – such as the results of customer focus groups or employee surveys – can be used to identify potential problems before they affect the financial results. Many organisations use the Balanced Scorecard technique to define a broad range of key measures, beyond simply tracking financial measures. The original model – described in more detail in Appendix 2 – covers four perspectives: financial, customers, internal business processes and innovation and learning. However, the model can be adapted to suit individual businesses.

The second aspect of continuous improvement is to work out what changes are needed to enhance business performance, for example by redesigning a sub-optimal business process. Once actions are identified, this then feeds back into the 'Plan' stage of the cycle. Some of the commonly used techniques for continuous improvement include Six Sigma and quality management frameworks such as the Excellence Model, which are both described in more detail in Appendix 2.

Underpinning the Plan-Do-Review process, it is necessary to have a good understanding of corporate governance and risk management techniques, to ensure that results are delivered in a way that protects the company's reputation and in line with corporate values.

3.4
Negotiation and Selling

No business can make money unless it is able to sell its products and services. Similarly, executives need to be able to negotiate well to achieve the best possible deal to maximise profit. Negotiation and selling are therefore two critical skillsets which commercially-oriented professionals need to master. In this section we highlight some useful resources for developing skills in these areas.

Negotiation

Even though we do not necessarily label them as 'negotiations', every interaction at work 'is a matter of give and take, an exchange of benefits and contributions from person-to-person or from group-to-group'. (Chester Karrass, see Reading List). So from the formal across-the-table commercial business negotiation to day-to-day interactions with colleagues, negotiation is a key business skill.

Karrass, who wrote extensively on negotiation skills and trained negotiators, identified five modes of negotiation that the effective negotiator needs to master. He likens them to golf clubs – a good golfer needs to know which club to use under different circumstances, and how to handle each to best effect. Likewise negotiators need to understand the importance of each bargaining tool in the quest for a good agreement, and may indeed deploy different modes at different stages of the same negotiation.

Case Notes (continued)

continuous improvement is also a critical area of focus:

'We strive to do even better by focusing on every single metric under our control. Even small improvements are worth having so there's constant pressure to 'up your game', not least when it comes to comparisons with last year'.

'You won't be an effective commercial manager in our business without a constant continuous improvement emphasis. This means you've got to be on top of the numbers, have an eye for detail and always look for different and better ways of doing things'.

'You've also got to be well briefed about what's going on in the local environment. For example, as a university town, students have a huge impact on our takings and it's essential to be attuned to what they are after'.

1. **The conventional competitive or transactional mode**. This is perhaps the classic negotiation scenario, which is dominant in buy-sell transactions. Each party wants to improve their level of satisfaction by influencing the other to exchange some benefit or consideration for something the other party is prepared to offer. Karrass identifies four rules which can be applied in this scenario to protect your interests while avoiding jeopardising your relationship with the other party:

   Rule 1: Fight the fear of negotiating.

   Rule 2: Leave some room for give and take when negotiating.

   Rule 3: Ask for something in return when you make a concession.

   Rule 4: Give in slowly and in small increments when making concessions.

2. **The collaborative both-win mode**. Through collaboration and open sharing of information, all parties seek to find a way to close the deal in a fair and reasonable way.

3. **The relationship mode**. The focus of the negotiation is to facilitate the resolution of joint problems and integrate the parties' interests. Karrass identifies three basic rules which govern this mode:

   Rule 1: The relationship that exists between the parties affects how they will act in the negotiation and the behaviours, strategies and tactics they employ.

   Rule 2: What one party says or does during the talks affects the attitude and behaviour of the others as talks progress.

   Rule 3: The relationship between the parties affects both the outcome of the bargaining but also the parties' willingness to abide by the agreement and how they conduct future negotiations.

4. **The organisational mode**. This mode rests on the premise that, in any negotiation, there are others – not present in person – who have a stake in the issues in question. Four rules apply here:

   Rule 1: Recognise that others have a stake in the negotiation, whether present or not.

   Rule 2: An important part of preparation involves knowing who the stakeholders are and where their interests lie.

   Rule 3: Build positive relationships with stakeholders before the negotiation, as you will need their goodwill and trust later.

   Rule 4: Communicate with other stakeholders regarding their position on each issue before beginning the negotiation.

5. **The personal issue mode**. Each party to a negotiation brings their own objectives of what they wish to achieve, such as feeling good about themselves or gaining respect in the eyes of their boss. Identifying and taking account of these personal factors in the negotiation is likely to lead to a better outcome.

In all situations where you are using your company's money you have an obligation to get the best deal. Cheapest is not always best. However in buying and selling there is normally a better price or deal to be had than the one that is first on offer. There is often a natural reticence to ask for it but failure to do so is arguably misuse of company resources. Moreover, there is a world of difference between 'Do you think you can improve that a little bit' and 'We would need to see a significant improvement on that offer'. It's not about being rude or disrespectful to suppliers (never) but it's about getting best use of resources.

Rules of Selling

Selling ideas, projects or solutions – as well as products – is a critical business skill, and one which is seldom taught. For many businesses it is the difference between success and failure. Great products, services or ideas that people won't buy are worthless. So we all need to know how to sell. A classic resource on selling skills is 'The 5 Great Rules of Selling' by Percy H. Whiting.

There are five 'rules' which good sales people use to guide their prospect through the stages of a sale, which can be applied equally to the traditional selling situation (i.e. between salesperson and customer) as to trying to sell an idea or project within an organisation:

1. Get your prospect's **attention** by talking to him briefly about something in which he is interested.
2. Arouse your prospect's **interest** by telling him what your product will do to benefit or serve him.
3. Give your prospect enough facts – and no more – about your product and how it will benefit him, to **convince** him he is justified in buying.
4. Arouse **desire** by reminding the prospect that he lacks the benefit your product gives him and that the product will satisfy that lack.
5. **Close** the deal. Get a decision in your favour by weighing the ideas opposed to buying against the reasons in favour of buying. Then ask for the order.

One of the key elements of selling is 'knowing your product'. This universal rule applies to HR and is illustrated as follows:

Knowing your stuff – as in the example below – what it does, what it costs, why it works, how it is used, how it helps and how it is deployed. HR people must know their 'products' inside and out.

"While I was instructing a sales class in Seattle, I asked a coal salesman to give me the talk he used in selling coal.

He answered, "I just say, 'It's a hell of a good coal!' "

"What else?", I asked.

He didn't know anything else – that was all.

I asked, "Does it burn down to a nice, clean ash?"

He thought so, but he wasn't sure.

"Does it form a lot of clinkers?"

He didn't have the remotest idea.

"What about the BTU content?"

He'd never heard of a British Thermal Unit.

I asked, "Is it common banded, splint, cannel, or boghead coal?"

He was sure it wasn't cannel coal.

Finally, annoyed by my badgering, he blurted, "What is there to know about coal?"

What is there to know about coal! Nothing except that coal is one of the most sophisticated minerals know to chemists. Nothing except that more tons of coal are mined in the United States than any other mineral.

I had the matter looked up when I returned to New York. The New York Public Library then listed 3,553 books on coal".

A sales analyst has concluded that in 75% of retail sales, the customer knows more about the product than the salesman.

The Five Great Rules of Selling by Percy H. Whiting

HR people need to know in-depth the characteristics of their products and solutions.

DEVELOPING A COMMERCIAL CULTURE

4

"Every day of the week, the performance of the business is a constant refrain around our people."
Des Pullen, Group HR Director, Associated British Foods.

Case Notes

Des Pullen, Group HR Director at Associated British Foods, finds that the success of his business is partly driven by devolving authority as close to the customer as possible. By pushing responsibility down the hierarchy, people 'live and feel' what the customer needs, and are better able to respond. In ABF, there are some 70 operating companies, each one led by a general manager who is supported by a functional team that typically reports into him/her. The aim is to move people between operating companies so that they build their knowledge, expertise and networks, whilst gaining from different business situations and perspectives. The autonomy of these operating companies is very attractive to those who wish to grow a business.

Similarly, contract services businesses such as Serco succeed by driving down P&L accountability to the level of contract managers who deal on a day-to-day basis with clients. This leads to clarity of objectives and transparency of performance. Performance is measured through monitoring of simple KPIs, which leaves contract managers free to develop ways of delivering services to their customers in the most innovative and cost effective ways possible.

Companies need talented commercial people to prosper. However, good people will only thrive in an environment that allows them to flex their commercial muscles, develop skills and experience, and be rewarded for success. Here, we identify key features of companies that foster strong commercially-focused cultures.

4.1
Drive accountability to lowest possible level

This was one of the most consistent messages from our interviews – make people close to the 'coal face' accountable for results, give them the autonomy to deliver, and do it as early in their career as possible. Accountability tends to drive ownership and commitment to deliver high performance. Holding people accountable for their performance in turn drives better results. This appears to work because:

- They are closest to the customer and therefore best placed to understand and respond to their needs profitably.
- They understand the possibilities, challenges and constraints of business operations and what needs to be done to make things happen.
- They can respond more quickly to market changes without having to go through lengthy approval processes to make a decision.
- It is more satisfying than constantly having to seek approval.

Driving accountability low in the organisation may be an easy statement to make, but can be culturally difficult for centralised, hierarchical organisations that operate on tight command-and-control structures.

4.2
Simple, clear commercial objectives

Successful businesses do not tend to micro-manage what their executives do, but rather set simple, clear objectives and allow managers the freedom to deliver, intervening only when performance is going off track. This can be highly motivating for staff.

One example of this is Babcock International, a FTSE-100 company which is the UK's leading engineering support services group. It is the 'Number 1' support provider to the Royal Navy and offers a wide range of other services such as running the baggage handling systems at leading UK airports. Babcock's shareholder return over the last five years has been approximately double that of other companies in the Support Services sector. Babcock is highly decentralised with four divisions, numerous business units and 25,000 employees. The company uses a small number of financial KPIs such as the size of the order book, revenue growth, operating margin, operating cash flow, cash conversion rate and interest cover to provide tight financial control and operational accountability.

"It's crucial to avoid a blame culture. This means that 'top' executives should encourage initiative and reward well thought out failures." **David Walton, formerly Chief Executive of Stannah Stairlifts.**

4.3
Communication

Regular, open communication of objectives and results across all levels in the organisation is critical to developing a commercially-driven culture. Companies who are good at this are focused on:

- Fostering a culture where customer issues, financial targets and performance are openly discussed. Problems are brought to the surface and people have the opportunity to contribute to solutions.
- Making business leaders visible. Regular communication about what's going on with customers, markets and business performance, through different communication channels and covering the whole workforce.
- Communicating the company's strategy, business model and financial and business objectives widely and sharing performance against plans.
- Making sure communications are cascaded effectively throughout the organisation, especially into support functions who may not have day-to-day exposure to what is going on with customers.
- Promoting a culture where it is seen as important for everyone to be intellectually curious about the business, which in turn means it is taken seriously by all.

4.4
Achieving a balance between freedom and control

Working in a large organisation inevitably involves dealing with a degree of bureaucracy, which can discourage the application of commercial acumen. Being commercial usually involves taking calculated risks, and the more bureaucratic the organisation, the more difficult it can be for people to take 'good' risks. However, the recent banking crisis and LIBOR scandal has shown that a lack of sufficient controls can lead to staff applying commercial acumen for personal gain rather than the best interests of the business, and in extreme cases this can lead to fraud. Organisations therefore need to achieve a balance between having controls that are too lax, potentially putting the business at risk, and being overly risk averse and thus stifling commercial flair.

Case Notes

At Associated British Foods, management teams are encouraged to talk about 'the numbers' at every opportunity. This promotes transparency and brings business performance to life for people across the business. The company also seeks to strike a balance between focusing on short-term financial results while looking to the longer-term performance of the various businesses across the group. Managers are expected to do the right things to ensure the long term health of their business, whilst striving to meet the shorter term commitments they have made in terms of financial performance. It is expected that operating companies within the Group gain some advantage through being part of the Group, therefore it is a critical part of senior management's role to sponsor and enable connections between businesses and across the Group.

PERFORMANCE

5

There are basic words about work that people use every day – like 'manager', 'strategy' and 'job' – which it is easy to assume that everyone understands the same way. In reality, they are subject to quite varied interpretation, which can have significant consequences.

Definition

'Performance' is one of these deceptively simple words – in constant use, but which requires definition and agreement before there is shared understanding.

Performance needs to be defined in context. There are a series of additional words which are twinned with performance that help to fix its meaning. The definition of each of these words also needs careful consideration.

When applied to work (as opposed to, say, artistic performance), the core meaning concerns how and whether an individual, team, organisation – or a product, service or process – achieves **objectives**.

Any manager with commercial acumen must by definition have a deep understanding of what drives both personal and organisational performance – and must be clear about both cause and effect.

Performance objectives

At the heart of debate about performance is how well objectives are articulated, determined and **measured**.

The mnemonic SMART has been widely used as a framework to inject rigour into how objectives are described.

Parameter	Elaboration
Specific	What is to be achieved? Why? Who by? Where? What will success look like?
Measurable	How is success measured? Quantity? Time? Revenue? Cost? Satisfaction?
Attainable	Realistic goals? Sufficient supportive resources? A clear way to achieve goals?
Relevant	Worthwhile, adding value? Fit with other goals? Right time? Right person?
Time-related	What is sensible to achieve by when? What goalposts along the way?

Here are some important additional considerations in framing objectives.

- Quality standards – what does 'good' look like, and similarly what is 'excellent' (exceeds expectations), poor or unacceptable?
- Ethical – is it clear what ethical means? Is there any potential for conflict between internal requirements and societal/legal requirements?
- Motivating – goals that are intrinsically inspiring are more likely to be achieved, and vice versa.

Performance measurement

Measurement runs like a thread through any discussion of performance. Here are some initial points about types of measures.

- KPIs – articulating success measures is eminently sensible, but ensure that these are genuinely 'key', as an excess of KPIs and 'key result areas' (KRAs) will degrade performance.
- Financial – making and saving money generally represents the ultimate indicators of success. However, reliance on purely financial measures tells one little about how success is achieved.
- Behavioural – while historically many managers have ducked the challenge of measuring and managing behaviour, well-governed organisations recognise this is central to performance.
- Risk – in a turbulent world, risk is an increasingly vital area of performance measurement, typically focused on preventing financial, operational and reputational harm. However, identifying and acting on opportunities to 'do the right thing' across all operations is just as important.
- Time – much performance measurement tends to be short-term look backwards. However, real success is ultimately determined in the longer term.

- Stretch (or 'breakthrough') – what goals will require real effort, and/or involve new learning?
- Defining dependencies – what else has to happen to attain goals?
- Accountability – taking responsibility for delivering results, agreeing what happens if not achieved.
- At more senior levels, individuals will set their objectives. Delivering against those which someone else has set is insufficient. NB 'What have you done in addition to what you were expected to do?'

Targets vs goals

Targets are particular types of performance objectives – typically expressed as hard numbers that have to be reached. The advantage of targets is that they impart clarity about 'results' to be achieved. However, in setting targets, there are important things to get right and traps to avoid.

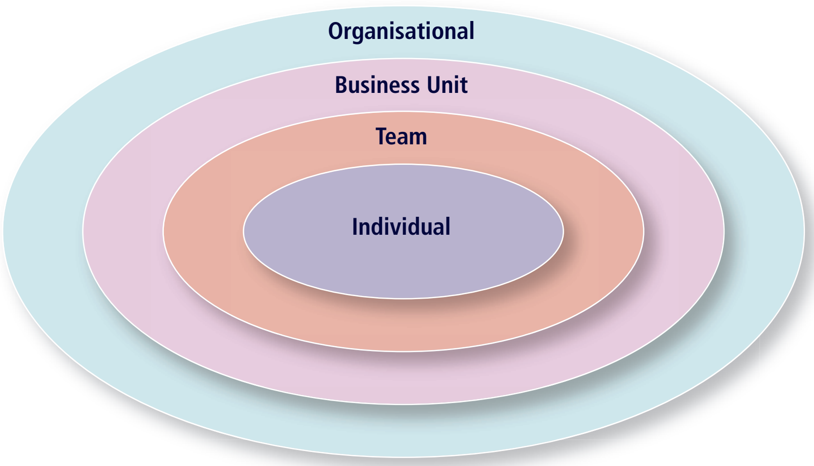
- There are many types of performance achievement that are not best or easily expressed in terms of numbers or as a fixed end-result.
- At the same time, there also many qualitative goals – such as satisfaction or learning achievement – to which numerical goals can be ascribed with effort.
- Targets can be inflexible – they lose relevance when the context changes as well as when they are attained. How good is the process for reviewing and refreshing targets? Just 'hitting your numbers' could mean that in reality you are under-performing.
- Selecting particular targets without sufficient consideration for other factors often leads to perverse results.
- Results-orientation is generally a highly desirable performance characteristic. That said, it has negative connotations if this is interpreted as results without considering all the issues.
- Additionally, it is important also to recognise dimensions of performance such as effort and improvement. It can be simplistic and short-termist to focus just on results.

Much depends on who is setting the target, and how.

- Do those who set objectives really know what is relevant and realistic? Are they providing the necessary resources?
- Is the rationale behind targets robustly conceived and well communicated?
- Imposed targets can be de-motivating, yet clarity can be energising. How do targets look to those who must achieve them?
- Have individuals been involved in devising their own targets? Does this mean they are too soft, too hard or well-balanced?

From organisational to personal performance

Performance need to be considered at different levels in an organisation.



- There should be alignment between objectives and performance standards at different levels in the organisation. While in any complex organisation there can be considerable variation in what people do, effectiveness depends on pulling in the same direction.
- Performance and reward systems often over-focus on individuals. Mostly, performance depends to some degree on team effort.
- People need to feel involved if they are to give of their best. Organisations need to respect bottom-up performance needs as much as they provide direction from above, particularly in knowledge-led organisations where high performance depends on capability at all levels.
- Success generally derives from collectively focusing on achieving a few important things. An excess of targets, objectives and key performance indicators diffuses effort and direction.

Individuals, from CEO to front-line employees, have a mix of personal and organisational objectives.

- Organisational objectives should support achieving collective goals – team, business unit, whole organisation. They can be both qualitative and quantitative.
- Personal objectives should have two dimensions – what contributes to organisational success, and what behavioural goals to strive for to improve both delivery of results and capability for the future. Importantly, personal objectives are often relevant to teams through 'impact on others'.

Extensive research into employee engagement highlights the criticality of everyone feeling they

- are able to make a recognisable contribution to organisational improvement and success
- have a real say in framing their objectives
- are well supported in their work and **development**
- are regularly recognised and fairly rewarded for the contribution they make.

Performance and development

Performance is not just about current activity and results. It also involves building capability for future, sustained achievement.

Performance management and appraisal

'Performance management systems' represent a fraught subject in many organisations. Few employees have a good word to say about performance appraisal in particular. This is mainly a reflection of how common-sense principles are poorly executed.

- 'Performance management' is useful when it represents a clearly expressed methodology to ensure the different elements in supporting performance are coherently orchestrated.
- It involves aligning resources, systems and employees to strategic objectives and priorities.
- In high performing cultures, 'management' is more about facilitating than directing. The role of leadership at every level is to help others to perform and improve.
- The starting point is ensuring that good and poor performance is recognised, and that both are addressed in a fair and supportive way.
- Performance is best appraised by regular discussions (not annual formalities) that focus on support as much as judgement, and are driven by the appraisee as much as the appraiser.

Assessing Organisational Performance

Financial measures dominate in assessing the performance of organisations. One of the most favoured 'measures' is Total Shareholder Return (TSR) which is a composite of dividend payments and share growth.

On its own TSR is not enough. TSR can be inflated if the organisation fails to invest in its people or infrastructure. However, if you don't invest in people, systems, technology, R&D etc., things fall apart and TSR eventually reduces. The question is: 'what is an adequate investment in the infrastructure'? This is a debate to which there is no universal answer, it's a judgement – which is where 'acumen' comes in. Well run businesses have better TSR then those that are less well run, but you must invest in your business and its people for long term viability.

PEOPLE DEVELOPMENT AND COMMERCIAL ACUMEN

6

"It's a feature of large organisations that executives don't get 'proper commercial responsibility' with full 'profit and loss' accountability until quite late on in their careers. Shortening that timescale can only be a good thing." **Sir David Varney, formerly a Managing Director of Shell UK, Chief Executive of British Gas and Chairman of O2.**

Commercial acumen is clearly a highly desirable skill, and it should follow that developing commercial skills is a good thing to do in principle. However, development activities often produce sub-optimal results. In practice most effective development takes place on the job and in a real time context. In this chapter, we highlight different approaches to help individuals and teams develop their commercial capabilities. Whatever combination of approaches is used, there needs to be the opportunity to apply the skills learned in a real-life business situation.

6.1 On-the job experience

Hands-on experience is the most effective way of developing commercial acumen, but companies may be reluctant to place an inexperienced person in a position of commercial responsibility. Experience can be built up gradually over time, perhaps by assigning ownership of a project at the outset, and then over time gradually increasing their responsibility as they move through different functions. Very few people will ultimately be capable of taking on full profit and loss (P&L) responsibility. However, by using different types of experience as described below, people at all levels in the organisation can take on some commercial ownership.

The key is to set clear objectives and development plans and measure that the necessary skills/experience are being developed.

a. P&L responsibility for a business

This is viewed as the best way of developing commercial experience, but may only be practicable for a small number of people within the organisation who have the potential to progress to general management. This involves being responsible for both revenue and expenditure. Organisations such as Associated British Foods push P&L responsibility as low in the hierarchy as possible, and encourage commercial people to broaden out of their functional specialisms early in their careers. Part of ABF's talent strategy is to offer these type of roles in order to attract the type of people into the business who are driven by having the freedom and autonomy to run their own business as early in their career as possible.

b. Managing a cost budget

Focused on the 'expenditure' side of the P&L, this gives managers an opportunity to set objectives and budgets and to manage to plan, reforecasting as necessary.

c. Projects or assignments

Projects, assignments or secondments to other parts of the business can be effective in building experience of key skills such as budgeting, forecasting, objective setting and performance improvement, and developing an understanding of how other functions work. 3-6 months is often enough to give high potential professionals a good level of commercial insight. Many of the people we interviewed had completed assignments in sales, marketing or commercial functions, which they said were key to helping them broaden their understanding of the business.

"Giving opportunities to take profit and loss accountability at an early stage will help consolidate all other learning and pull all the threads of commercial acumen together." **David Walton, formerly Chief Executive of Stannah Stairlifts.**

d. Prepare and deliver a business case or project plan

This gives experience of putting together a business case, obtaining funding for projects, and managing a budget as well as influencing senior management to achieve buy-in to ideas.

e. Get involved in an acquisition or disposal

Acquisitions or disposals offer many opportunities to get involved in commercial activities from due diligence through to integration. Assigning responsibility for delivering the potential business improvements/efficiency gains identified during due diligence can help sharpen commercial skills. For HR, outsourcing projects, TUPE transfers or post-acquisition integration projects provide excellent opportunities to develop skills such as how to evaluate a business, reduce costs and improve service.

f. Develop a performance improvement plan for an underperforming business

An alternative is to develop a strategic plan for a part of the business and take responsibility for some or all aspects of implementation.

g. Gain exposure to customers

This could be through attending sales visits, or being given relationship management responsibility for a particular customer. This can help develop understanding of who the firm's customers are, their needs, and the profitability of different customer groups. Some organisations also get key customers involved in training.

h. Experience in a line role

Functional specialists in areas such as HR or Marketing can enhance their commercial experience and credibility by taking on a line role for part of their career. This provides exposure to the dilemmas and trade-offs involved in running a business.

6.2 Training

Many of the skills, tools and techniques can be learned in a formal training environment, and put into practice on the job. This is particularly true of some of the knowledge-based aspects of commercial awareness set out in the previous chapter, for example interpreting financial statements and ratios and selecting and applying diagnostic models. Online learning is also likely to be effective in delivering some aspects. However, a large part of commercial acumen is about developing the right sort of mindsets and attitudes, and training is unlikely to be sufficient to shift this. It is also extremely important that opportunities are available to apply the learning in real life situations.

Case Notes

DLA Piper, a leading global law firm, has adopted a variety of steps to developing commercial acumen among its staff:

- Starting early through a mixture of experience and training – work assignments, mentoring and secondments.
- A culture of encouraging entrepreneurial behaviour and not punishing mistakes.
- Commercial acumen is tested as a key competency both at trainee recruitment and Partner assessment.
- Broad skills development is offered at important career points by the firm's Career Academy.
- Training for new and experienced Partners – including on pricing and profitability.
- Master classes on specific topics.
- Leadership development to help executives convert the strategic framework into action.
- Coaching.

"Managing a significant cross-functional project such as the launch of a new product can consolidate theoretical learning. The influencing and change management skills developed have wider applicability for commercial acumen." **David Walton, formerly Chief Executive of Stannah Stairlifts.**

Case Notes

Imperial Tobacco is developing an online case study to help sales staff develop their competence in interpreting customer data. As part of their role, sales managers are required to decide what investments to make in sales and promotional activities with key customers, but many lack the skills to analyse and interpret the data available. The tool has been developed by asking the best performers to describe how they go about analysing data and the decision making process. This is being developed into a series of YouTube videos which describe best practice and help sales managers improve their skills.

6.3
Business Simulations

Many organisations use off-the-shelf business simulation tools or tools which have a degree of customisation. However, there was skepticism among our interviewees as to whether they were close enough to real-life business scenarios to be useful. An alternative is to have a commercial expert lead delegates through case studies or scenarios which reflect the types of dilemmas, choices and consequences faced by commercial managers in real-life scenarios.

6.4
Other development options

The recent economic climate has resulted in development budgets being squeezed. It is therefore necessary to find other ways of developing commercial skills without resorting to expensive training programmes. Here are some further suggestions:

- Direct explanation by touchline coaching is often the best method of learning. This could come either from a line manager or a mentor in the organisation.
- Spend time with commercial functions such as Sales or Marketing to understand their business challenges. Consider attending some sales calls to find out more about customers.
- Read the business sections of the press, such as the FT, The Times and The Telegraph. There is especially good coverage at weekends. Quality journals such as The Economist are also good information sources.
- Build networks, both by interacting with high performing colleagues internally and building an external network.

6.5
A Personal Learning Framework

For executives who wish to develop well-rounded business skills, we would suggest the following six steps to guide your personal learning and development:

1. Knowing your subject

Whatever your role in organisational terms it is important to be expert at something. For example, as an HR practitioner, it is necessary to develop functional mastery as set out in the following chapter. Having a depth of knowledge and theoretical underpin to actions taken is essential, as well as understanding the principles of cause and effect and the impact that your actions are trying to achieve.

"I'm a Chartered Accountant but wanted to move into general management so I insisted on getting out into the field to manage a sales force. It was a shock to the system! I had to start from scratch and gain the respect of my sales colleagues." **David Walton, formerly Chief Executive of Stannah Stairlifts.**

2. Knowing your business

All professionals need to understand the ways in which their organisations work. Professional excellence linked to deep understanding of the organisation is more likely to achieve outstanding personal and corporate performance. Use the diagnostic questionnaire and other analytical tools in Appendix 2 to assess whether you are sufficiently knowledgeable about key business areas, whether you would feel confident in discussions about them and how your functional expertise might be used to gain improvements.

3. Knowing business

Apart from understanding your own business, it is necessary to understand business in general, the business and economic environment and the political and regulatory constraints in which the firm operates. It is also critical to understand the measures by which you might gauge your organisation's performance or measure it against another. You can use the checklist in Appendix 1 to evaluate your current level of business understanding and identify any gaps you need to address.

4. Managing or influencing people

Serious business managers recognise that people in organisations are a valuable resource. You need to understand the cycle of people being developed, having clear objectives, receiving positive, accurate and timely feedback and positive encouragement linked to a clear identification of development needs.

Good business managers spend enough time on recruitment to get it right and make sure that decisions are made on facts rather than emotions. They do not shy away from firing poor performers when necessary and have a framework for managing, assessing, developing and motivating people.

5. Constant improvement

Effective managers are never satisfied with the status quo. There needs to be a methodology (such as Six Sigma or EFQM) for improving performance. To accomplish this, good managers need to be constantly analysing situations and looking for opportunities to improve.

6. A personal skill set

Effective managers need to be able to interview, negotiate, run meetings, make presentations, network and scan as this is an essential element in gaining market intelligence. No business operates in a vacuum and knowing what is going on in the broader context is essential.

COMMERCIAL ACUMEN AND HR

7

"HR people like to be called Business Partners but sometimes show little interest in understanding the underlying financial model of their business or organisation. Without this basic knowledge of what drives the operations, how can they expect to support line managers intelligently in the achievement of business goals?" **Andrew Mayo, Professor of Human Capital Management at Middlesex University.**

With the rise of the concept of the 'HR Business Partner' over recent years has come an increasing awareness of the need for HR professionals to be tuned in to the needs of the business they support and make sure that the products and services delivered as part of the HR agenda meet genuine business requirements. However, there continues to be a perception that commercial acumen is in short supply within the HR function, and frustration on the part of senior executives that HR is somehow falling short of the full contribution it could make to business success.

All of the concepts discussed throughout this document apply equally to HR as to other functional areas. However, given the changing nature of HR and the role of the function within the organisation, there are particular considerations which are specific to HR, which are discussed in this chapter.

How does HR need to demonstrate commercial acumen?

a. Start with the business

HR needs to understand the business in which they operate and be clear about the linkages between HR actions and business outcomes. Too often we see HR functions engage in interesting or 'sexy' projects where the impact on business results does not seem to be given sufficient consideration. This can result in the business being hamstrung by bureaucratic people procedures which do not add value. By following a few steps to make sure that business priorities are kept at the forefront when HR plans are developed, HR professionals can avoid this trap and increase their commercial contribution to the business:

- Be familiar with the company's business strategy, current performance and challenges and key financial measures.
- Develop a good understanding of how the organisation's people and capabilities enable success.
- Engage in dialogue with key stakeholders about what they need and how HR can add value, before deciding what to do.
- Ensure there is a clear 'line of sight' (i.e. a demonstrable connection between HR activities such as recruitment or performance management and business outcomes such as sales or profits) from HR actions to markets, customers and business results. Think through the company's value chain and where HR fits. Align HR practices with customer expectations. For example, what contribution can HR make to increasing market share? Showing a 'line of sight' is not easy to do, but by going through the process of assessing whether HR actions genuinely add value, HR can focus resources on commercially useful activities.
- Build in measures as plans are being developed. Measure in business not HR terms. Get buy-in from stakeholders that the proposed measures meet business needs. Communicate results within the HR function and to the wider business.

The Executive View

We interviewed a number of senior executives for their views on how HR can improve its commercial acumen.

'It's the CEO's responsibility to create a learning and development culture. HR should not be seen as a distinct function. It's part of the executive team. HR should implement the 'people' agenda spelt out by the Board'.

'HR shouldn't be silent when senior managers are talking about strategy and their budgets. HR needs to engage, it needs to make a 'business' contribution not just a 'people' one'.

Sir David Varney, formerly a Managing Director of Shell UK, Chief Executive of British Gas and Chairman of O2

'HR needs to build a relationship with the Chief Executive and the Board to show how commercially valuable it would be for the company's culture to develop in a certain way, and demonstrate to 'top' management that HR can help them to promote this change of culture'.

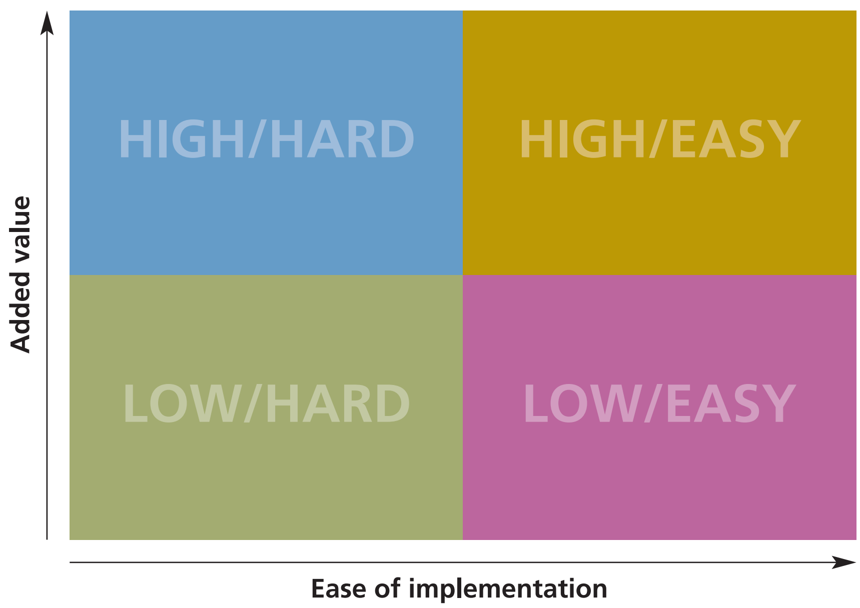
'HR should develop individuals with commercial acumen, who may then be promoted to senior levels. Because these individuals have benefitted from the development guided by HR, they are likely to value HR's input at a strategic level'.

David Walton, formerly Chief Executive of Stannah Stairlifts

- Understand and talk the language of business. Make explicit the link between HR actions and business outcomes. For example, what effect will a specific initiative have on costs, sales, customer service or other key business measures? If in doubt talk about the issues in terms of ££'s!
- Spend time and effort to get close to different functions and understand what their drivers and challenges are. Get out of HR silo thinking and work across functions to bring people and solutions together.

Given the resource pressures that apply equally to HR as other functions, it is necessary to decide what the priority actions should be. We sometimes find HR focused on urgent or fashionable rather than important activities. Critically evaluating all HR activities using the priority matrix below can help prioritise what is business-critical and what can be dropped.

Matrix for priority actions



b. Functional Mastery

Deep expertise in the tools and techniques of HR, and an understanding of their application to business challenges is fundamental to HR. The function can suffer from a perception that much of what it does is 'common sense' or that anyone can easily understand how to develop human capital, which devalues HR's contribution. In our experience this perception is often not helped by HR professionals themselves, who sometimes display a surprising lack of knowledge and expertise of key aspects of the function.

However, there are areas where HR can apply technical expertise in a commercial way to improve business outcomes. Our view is that commercially-focused HR professionals need a properly-equipped toolkit, which they can relate to the challenges of their business, and that this would cover the following areas as a minimum:

- Organisation design and development, including supporting strategic change – models, frameworks and theories.
- Talent and succession planning – definition, process, assessment and development.
- Reward – motivation theory, tax, benefits costs and modelling.
- Performance management – definition, process, motivation theory and measurement.
- Leadership development – theories, development options, adult learning principles and evaluation.
- Consulting and diagnostic skills – a toolkit including some of the techniques profiled here which assist the HR professional in diagnosing organisational problems and coming up with solutions.
- Employment legislation – key rules and regulations in force and development trends.

If HR professionals wish to make a wider commercial contribution, it is important to have expertise and credibility in their own field in order to apply that knowledge to the commercial challenges of the business.

c. Strategy

As mentioned above, it is critical for a commercial HR function to understand and develop plans in line with the business strategy. HR needs to play a meaningful role in strategy development, but this is often challenging as the function can lack credibility or expertise. CRF's 2012 report 'Developing an Effective HR Strategy' covers the topic in detail, however there are some key points we would highlight here:

- HR people need to understand how business strategy is developed and where they can add value. We would suggest that, as well as making a contribution in key functional areas such as talent management, HR can carve out a unique role by identifying and interpreting the potential impact of longer term social and demographic trends, such as ageing population, on the organisation's business and workforce.
- HR needs to provide good information to assist strategy development. Evidence suggests that CEOs are not currently receiving the information they might expect from HR. For example, PwC's 2012 CEO survey showed that CEOs on the whole are dissatisfied with the information they receive in relation to their workforce (see below). PwC found that, in areas such as staff productivity and assessments of internal advancement, two-thirds or more of CEOs were not receiving adequate information. Although the picture was better for more straightforward measures such as labour costs, approximately half were also dissatisfied with the information received here.
- Numeracy and information analysis – an ability to analyse, interpret and present people metrics in context and with confidence.

The Executive View

'HR needs to get out of its ivory tower and engage with those at the 'coal face' especially about what matters to them. HR should talk the language of the business not the language of HR'.

'HR should become 'best friends' with the Finance and Marketing teams – so they develop a working knowledge of our markets and clients and how we make money. They need to understand the impact of their activities on the other parts of the business'.

'The biggest inhibitors to growth are talent and leadership capability. We need HR's input!'

Sir Nigel Knowles, Global Co-Chief Executive, DLA Piper

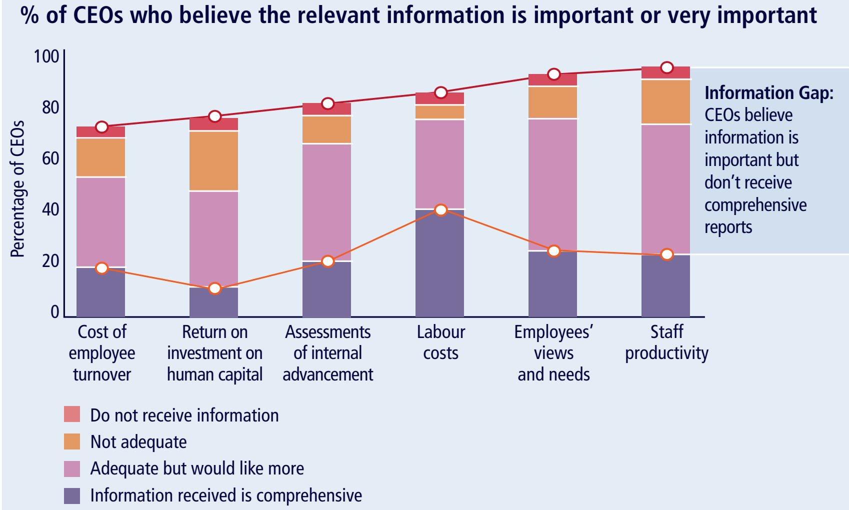
'The Chief Executive sets the tone and, of course, it's HR's job to attend to all the traditional HR pre-occupations. But more than that, HR needs to know what going on in the business, to know the 'pulse' and to be prepared to offer commercially valuable advice'.

'As a Chief Executive, I want my HR Director to be thinking about and focusing on the business. To come in on a Monday morning and say to me, 'Tim, over the weekend, I've been mulling over why this business unit is not performing as it should – profit margins are under pressure, performance is below budget and we're losing market share. I've concluded that the Head of the Unit is not the right person for the job...and here are my proposals for doing something about it'.

Tim Stevenson, Chairman, Johnson Matthey

Talent constraints have impacted costs - but also factor in lost opportunities

Q: *When making decisions, how important is it to have information on each of the following talent-related areas?*
For those areas that are important to you, how adequate is the information that you currently receive?



Base: All respondents (1,258)
Source: PwC 15th Annual Global CEO Survey 2012

- It is critical that HR can link business strategy to HR actions, such as investment in talent. There needs to be a clear 'line of sight' both prospectively, i.e. agreeing what is included in HR's action plan, and retrospectively, i.e. measuring performance and showing links between what HR did and business outcomes achieved. Too often, we find, HR starts by defining what it will do in isolation, perhaps based on what the latest fad is in management thinking, rather than start with the business objectives.

- In some cases HR has carved out a niche as coach or advisor to the board. Here, HR may have a useful role to play in facilitating corporate strategy development and making sure the internal process works well.

- Involvement in corporate strategy development also offers HR an opportunity to improve its understanding of the external business context – how the market is developing, where the key challenges are, and how the organisation is likely to respond. By developing this understanding, HR can take the lead in helping prepare for growth, for example by identifying investments in talent that are likely to drive value, or by measuring whether the organisation is investing enough in talent to drive future growth.

d. Identify People Core Competence

A key aspect of understanding what drives the success of an organisation is to define what is the organisation's core people competence. This links closely to the company's value chain and competitive advantage discussed previously. To what extent are the factors that differentiate the company from its competitors embedded in the qualities, experience and attitude of its people, and in the people processes that underpin the business? If HR can find ways of identifying and enhancing this, this has the potential to have bottom-line benefits.

e. Metrics and measurement

As HR systems and data quality have improved over recent years and analytical techniques have become more sophisticated, HR has an opportunity to take on an increasingly important role in helping shape business decisions. Areas such as demographic and social change, talent shortages and labour costs are mainstream commercial issues and HR can add value to business decisions here, providing they have the right measures, tools and analytical capabilities in place.

In practice this means:

- Focusing on how HR contributes to business measures.
- Becoming better at defining people measures which are important to the business. A measure for its own sakes is meaningless.
- Identifying predictive measures such as potential talent gaps and future trends rather than simply reporting on historical cost and activity metrics.
- Building effective feedback loops between plans, actions and results.
- Communicating regularly and formally to the business in terms of a written report specifying what you have done and what you will do next.
- Providing insight based on data, analysis and expertise rather than opinion-driven assessments to support business actions.

HR can sometimes be obsessed with measurement, but there is a world of difference between **measurement** and **evaluation**. Not everything can be measured, but most things can be evaluated. For example, a beautiful sunset can easily be evaluated, but measured with difficulty. Many HR initiatives can be evaluated by considering: What has been accomplished and at what cost? Given these dimensions, was the initiative worth it?

Critical People Measures

In the context of HR's contribution to overall business performance, there are a minimum number of critical HR measures which should be monitored and reviewed on an ongoing basis with action taken where necessary.

- **Staff numbers or headcount**
  - How many people are directly employed by the organisation analysed by department, level or grade and increasingly by gender and age. The latter two may be tricky but you need to be able to demonstrate lack of bias or equality of opportunity. How do these numbers change year on year?
  - Staff turnover, who is leaving and why, are they in critical groups? How are they replaced, internally or externally? Do you have effective succession planning?
  - Of increasing importance is the same information regarding contractors, consultants, part-timers and outsourced work. The organisation should not be allowed to claim reductions in direct staff masked by increases in indirect or none payroll employees.
  - Rates of non-attendance, where are the areas of concern, what are the reasons, what is being done to ameliorate the situation. Compare over time and with others in the sector.
- **Staff Costs**
  - Staff numbers and headcount are important but the real commercial drivers are costs and these measures need to be expressed in financial terms. It then becomes possible to measure productivity or effectiveness in any number of ways, for example, labour costs as a proportion of total costs, as a proportion of profit or as a measure of individual or departmental productivity.
  - The cost of employing people is not just expressed in salary terms: national insurance, pension contributions, travel, expenses and other benefits all need to be measured and managed.
  - For many organisations commercial decisions are based on global comparisons, and off-shoring and outsourcing are increasingly common. Make sure you know the true labour costs of moving an operation to a different country or of outsourcing to an external provider.
  - Sickness absence costs, as an absolute cost is always an eye opener and expressing these costs in context of the total costs or profit is event better!
- **HR Function Costs**
  - HR needs to be on top of its own cost base. As well as headcount costs, recruitment, consultants, legal and other costs need to be understood, managed and justified to the leadership team.
  - Make comparisons internally (other departments) and externally (other company HR data) and with the right networking you may find that people are prepared to share detail over and above the published headline figures.
  - Training and development costs can easily get out of hand. It is important to evaluate the effectiveness of this investment in terms of impact on the business. This is a difficult but necessary activity. Clear objectives should be set at the outset of a training programme, with a plan for how effectiveness will be evaluated (see box above on the difference between measurement and evaluation).
  - N.B. Don't become too introspective. HR, of course, has to manage its own cost base but fundamentally should be more concerned with the organisations overall people costs.

Take advice about the costs of HR. Developing a good relationship with Finance can help. Always think about costs and benefits, rather than focusing on the latest HR fad.

HR's reputation – and your personal standing - will be enhanced if you are seen to be running a commercially effective operation contributing to the wider business goals.

"HR needs to be able to stand in the shoes of other functions. Otherwise, they can end up sending out information saying 'implement this', without understanding what needs to be done within other functions to make it happen." **Des Pullen, Group HR Director, Associated British Foods.**

f. Cost Management

Every function is under extreme cost pressure today, and this is also true of HR. Commercial HR executives need to be skilled at core financial and budgeting skills such as:

- Understanding costs and how initiatives will be funded.
- Developing a business case to support a course of action.
- Defining a budget and reforecasting as circumstances change.
- Increasing efficiency and achieving more with less.
- Clearly demonstrating tangible returns on investments in what can often be intangible areas such as people development.

g. Environment and future scanning

HR has a key role to play in helping the organisation understand the demographic, social, political, legal and technological challenges it can anticipate in the near and more distant future and help develop people plans to address these challenges. This might include activities such as:

- Developing networks with external academics, consultants, headhunters and specialists in demographic, social, legal and technological changes to help the organisation anticipate trends that might affect its business and workforce. They often have free seminars which are an ideal opportunity to keep up to date and develop your network.
- Understanding the population pyramids of the markets where the company currently operates and may wish to in future, to identify trends and potential talent pinch points. Gather and disseminate population data and trends in key current and future markets.
- Identifying key skill and talent gaps in different markets and developing plans for how to tackle impending difficulties.
- Developing profiles of the current and future workforce, to identify for example where hard-to-train skills are likely to be lost in the medium term through retirement.
- Think through the impact of new technologies such as social media or cloud computing on HR systems, development needs and costs.

h. Communication

We have already identified the importance for HR of talking in the language of business, and adopting business measures to assess and measure its performance. HR people need to think carefully about how they communicate with other parts of the business, and make sure that they prepare and present data in a business-focused way. For example, putting themselves in the shoes of a colleague from another function may help approach a problem in a way that is more likely to achieve buy-in. Another example might be headcount planning. Beginning with identifying the medium-term business objectives and then tracing through what that means for skills and headcount might be a slightly different, and more business-focused way of approaching the problem.

i. Personal and functional credibility

Underpinning all of the above is the need for HR to be taken seriously by the business. HR will be unable to achieve much commercially if it does not have a track record of delivery and if its professionals do not have personal credibility. We would suggest focusing in the following areas:

- Focus on the important, not just the urgent or fashionable.
- Prioritise. Use the matrix on page 40 to identify and focus on the activities in the top-right box.
- Stop activities which are interesting from an HR point of view, but do not make a difference to the business (for example, do competency frameworks or PDPs genuinely add value?).
- Take a 'zero-based' approach to examining all HR activities – build the operating plan from the ground up.
- Do not become so process driven that you lose sight of the bigger issues.
- Develop a track record of delivering results.
- Manage your own function well.
- Develop good relationships with other functions.
- Ask good questions and be prepared to give good feedback – HR has the potential to occupy a unique position, given its independence of other functions.

Intangible assets and the concept of Human Capital

The market valuation of a company – its share price times the number of shares – is what a stock market says it is worth at a point in time. It is never what internal accountants calculate it as, ie the net assets or 'book value' because the market takes other factors into account, as do professional firms when asked to value a company. It is normally the case that the independent valuation is higher than the book value, even for capital intensive organisations, and often many times higher.

These other factors are known as the intangible assets. According to Bill Gates, 'our primary assets, which are our software and software developing skills, do not show up on the balance sheet at all'. In the case of Microsoft less than 3% of its value is accounted for by the tangible physical and financial assets. When a firm is bought by another the price always takes into account these intangible assets – and this gives a problem for a balance sheet. So accountants use the term 'goodwill' for this non-standard asset that has been acquired.

The term *intellectual capital* is often used as an alternative to intangible assets. Intellectual capital is an example of an intangible asset but (wrongly), it is not valued by accountants and treated as an asset in the balance sheet. Other intangible assets like intellectual property (for example, patents and software licences) and lease premiums are valued. The basis of valuation is the 'acquisition cost' to the business. This cost is reduced in value every year. The reduction is called amortisation not depreciation. It is these assets that are the fundamental drivers of growth in an organisation and the last thing one wants is for them to depreciate. The first thinkers to realise the significance of this intellectual capital came from Scandinavia - Leif Edvinsson of Skandia and Karl Erik Sveiby from one of Sweden's most successful publishing companies. They divided intellectual capital into three categories. There have been various extensions made of these over the years but this division remains useful. Unlike the valuation of tangible assets there are no globally standardised approaches to valuing intangibles, except in some small specialised categories, and this remains a challenge for the modern corporate world.

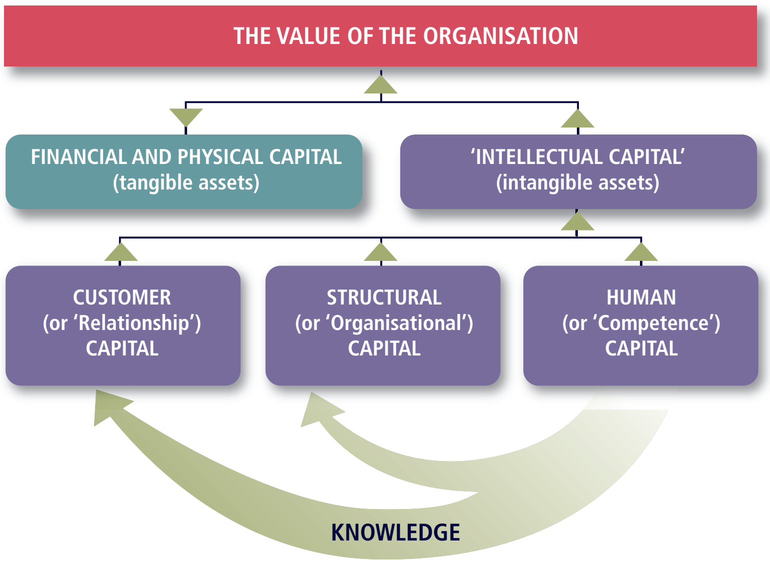


Figure 1 Assets in an Organisation

The Components of Intellectual Capital.

'Structural capital'

- Customer (external structural) capital.

This includes assets which enable and/or stimulate people outside our organisation to work with us, and – in a commercial organisation – to buy from us. It includes customer contracts, relationships, loyalty, satisfaction; market share; image, reputation, brands, distribution networks and channels.

In the public sector, we would talk, for example, about service levels, accessibility, reputation, or the popularity of revenue generating activities.

This is sometimes called relationship capital.

- Organisational (internal structural) capital.

This includes all that relates to internal operations and efficiency. It embraces strategies, systems, methodologies, intellectual property, and operational processes. All the recorded knowledge which exists is here - patents, know-how, databases, software and technology. We would also place here the culture of the organisation.

Most of this is hard to value financially – although patents are valued in (for example) drug companies

'Human capital' (or 'competence capital')

This comes from the people in the organisation – who loan their personal 'human capital', - their individual capability and commitment, their personal knowledge and experience. But it is more than the individuals alone - it includes the way in which they work together, (sometimes called social capital), and the relationships they have both within and without the organisation.

Attempts have been made to value human capital and there are books on human resource accounting. They are not in general use. Current approaches concentrate on identifying and evaluating (rather than financially valuing) those capabilities and talents that are in the front line of value creation.

People – the maintainers and creators of value

When we look at Figure 1 are there any grounds for saying 'people our most important asset'? If we were able to divide the total financial value calculated as attributable to intellectual capital between these three categories, would the largest sum be in the human capital box? Firstly we could not do it. And secondly to do so would miss the point. The 'snapshot' approach of a valuation at a point in time diverts us from the reality of the continuing change and dynamics of an organisation. People can vote with their feet, and structural capital has more continuity and availability. But the truth is that: all intellectual assets are maintained and grown by people and without them will wither away.

Most organisations have some people who are more liabilities than assets. That is, one way or another they cost more than the value they create – or they may even subtract value from stakeholders rather than add it. So the correct statement to make is that 'some people are undoubtedly a most valuable asset'. Whereas all people combined are (in most organisations) our greatest cost.

What does this mean for 'human capital management'?

We can describe 'human resource management' as comprising all the policies, processes and systems needed to effectively manage people as costs. It is a very necessary function. 'Human capital management' however is about managing the asset side of people. It is closely related to 'talent management' – and indeed the above would lead us to define talent as 'people who actively contribute to the growth of intellectual capital, and thereby add value to stakeholders'. This is much more inclusive than the often used definition of 'those with leadership potential'. Note also that it may include many front line people, especially those that interact with customers.

So human capital management comprises the following disciplines:

- *building a talent strategy from the business strategy*
- *workforce planning for core skills*
- *talent definition, identification and evaluation*
- *developing and growing value adding knowledge, skills and competences*
- *motivation and engagement of all, particularly value creating people*
- *partnering with managers to see how their people most effectively maintain and increase other intangible assets*
- *creating a culture and organisation that maximises value creation.*

The 'Top' 10 Issues that the HR Function Should Know About

1. It's essential that HR professionals are really curious about business. If so, they will be able to answer, in detail, the question 'Tell me about your business'. Recruitment, compensation, talent management, learning and development, pensions, succession planning are HR issues in support of the business. They are **not** the business. The real business is external...customers, investors, suppliers, competitors, products and services, markets, regulators, governments and so forth. HR needs to be able to give a comprehensive synopsis of the business environment within which the company or organisation operates and the ways in which competitive advantage is achieved. THEN followed up by the detailed, practical implications for HR.

2. HR does need to be financially literate. Understanding and being able to interpret financial statements, financial terminology and financial indicators should become second nature. If so, HR executives will be able to contribute to business conversations and influence business decisions. They will 'add value' as business and not just specialist HR professionals. It's gaining a reputation as colleagues who can add value whatever subject is being talked about and whatever decision is being made.

3. Apart from being financially fluent, the HR function needs to demonstrate that it is numerate. It is on top of the numbers. This means being very conversant indeed with the KPIs (Key Performance Indicators) or 'People Metrics' that are used to determine the success or failure of a section, team and department. Measuring performance against KPIs, especially in the form of ratios, provides the evidence to highlight strengths and weaknesses. For example, labour productivity using sales and value added per employee and staff retention by expressing resignations as a percentage of headcount.

4. HR should recognise that interpersonal skills – influencing, presenting, negotiating, leading, facilitating – are as important as the 'hard' skills around finance and numeracy. Indeed one of the hallmarks of commercial acumen is a firmness of purpose, a tough mindedness to make things happen, to seize the initiative and to take tough decisions. The head needs to rule the heart by explaining to colleagues and direct reports what they need to hear not telling them what they want to hear. For example, making a departmental manager redundant, weighing up the pros and cons of different courses of action before deciding what to do and taking steps to reduce costs by using less office space.

5. HR needs to improve its business knowledge. Apart from finance, there are several important topics – having a good grasp of business strategy, being conversant with the techniques of project management, knowing what process improvement is all about negotiating and selling. In essence, strategy is doing the 'right' things to achieve competitive advantage. Project management and process improvement (or 'lean' thinking) are all about operational effectiveness, doing things 'right'. Negotiating involves getting the best deal you can with company resources and the ability to sell ideas, concepts, solutions as well as products is fundamental. Being good at strategic thinking enables the HR function to show foresight as well as insight. What's round the corner? What new competitors may turn up? What new trends might revolutionise the role of the HR function? What new technologies may affect the way we work? Project management concentrates on 'excellence in execution' - achieving objectives on budget and on time. Process improvement concentrates on improving efficiency – reduced wastage, less duplication, faster transaction times and so on.

6. HR should practise what it preaches about creativity and innovation – generating, evaluating and then implementing new and better ways of working. This means being at the forefront, having the confidence when it comes to identifying performance improvement opportunities. To be radical, to be bold, brave and courageous in the quest for better and different ways of doing things and not just in HR.

7. HR people should be able to define good performance for both individuals and the organisation and know the factors that influence this.

8. HR people should know how to define human capital and its relationship to structural capital and customer capital. They should also know the difference between tangible and intangible assets.

9. HR should have excellent antennae – to be able to pick up developments, shifts, changes in other companies and in other markets. To act as the radar, to learn from other businesses and to import 'best practice' wherever it is to be found. Relevant networking is not just a nice to do: it is essential.

10. HR's methodology should embrace analysis, clear objectives, a theoretical underpin, an understanding of what things cost, process and project management thorough evaluation and communication. These are fundamental principles of an operating code.

APPENDICES

8

APPENDIX 1: COMMERCIAL ACUMEN CHECKLIST - FIT FOR BUSINESS

This checklist assesses the extent to which you have the mindset required, the knowledge needed and the experience necessary to act as a commercially astute executive. It is based on recent conversations and interviews with a number of Chief Executives and Senior Managers in a variety of different companies and industries.

The Checklist is not designed to be definitive. It is perfectly possible to be commercially astute without receiving a conventional business education. Personality and innate skills can overcome a lack of formal learning and development as the success of well known entrepreneurs like Sir Richard Branson and Sir James Dyson demonstrate. However, they are the exceptions rather than the rule. Most executives develop their business skills 'on the job' supplemented by 'off the job' coaching, mentoring and training.

It is recognised too that you may not wish to move into general management with full responsibility for the performance of a business. You may have an ambition, for example, to become or remain a senior functional specialist such as an HR or Marketing Manager. Nevertheless, showing you know more about business and can contribute as a well-informed business colleague is likely to accelerate your career development and increase your personal reputation.

Therefore, the Checklist can help you to:

- Highlight your own learning and development priorities.
- Identify gaps in your business experience and expertise.
- Provide advice to colleagues who wish to improve their commercial skills.
- Prepare a Training Needs Analysis for your business.

How to complete the Checklist:

Please score each statement on the 1-10 scale by ticking the box that corresponds to the relevant number.

'1' indicates that you **disagree** with the statement concerned. '5' indicates **some** agreement. '10' indicates **total** agreement. It is important to be honest so your profile is accurate! If, for any reason, a statement is 'not applicable' to you or you 'don't know', don't score that particular statement. Move on to the next statement.

Some statements below such as 'I have prepared budgets and financial forecasts' lend themselves to 'yes' or 'no' answers. In this case, score '1' for 'no' and '10' for 'yes'.

A. COMMERCIAL ORIENTATION	Disagree									Agree
	1	2	3	4	5	6	7	8	9	10
1. I read the business press regularly to keep up to date with the latest news and developments.										
2. I am curious. I devote time to learning about business by reading journals like the Harvard Business Review, doing research and networking.										
3. I am familiar with the competitive environment within which my business operates including the political, economic, social, technological, legal and environmental trends which affect our activities.										
4. I can comment on the strengths and weaknesses of our competitors and the ways in which we achieve competitive advantage.										
5. I read the most important parts of our Annual Report (such as the Chief Executive's Review) to gain a greater insight into our commercial objectives and business strategy.										
6. I am clear about the ways in which the business I work for makes money.										
7. I have a working knowledge of the products and services my business markets and sells.										
8. I understand what other functions do in my business and how they fit together.										
9. I have regular contact with my colleagues in other functions.										
10. Through the appropriate channels, I am in touch with our sales force and visit customers.										
11. I am knowledgeable and alert enough to have business conversations with colleagues in other departments and functions. For example, being able to discuss our latest financial results and to assess the impact of a competitor's new product launch.										

B. COMMERCIAL LEADERSHIP	Disagree 1	2	3	4	5	6	7	8	9	Agree 10
1. In conversations and meetings with colleagues, I seek to identify the benefits and costs of particular options before arriving at decisions.										
2. I am familiar with my function's Key Performance Indicators (KPIs) and how they are calculated.										
3. I am good at solving problems/overcoming challenges.										
4. I have the ability to see ahead, to anticipate future developments, trends and new competitors.										
5. I have lots of ideas about the ways in which my business and/or function can make more money and operate more efficiently.										
6. I have received detailed feedback on my leadership and management styles.										
7. Based on the feedback, I've received, I've taken steps to become a more effective leader and manager.										
8. I'm an excellent team player.										
9. Whenever possible, I use technology to help me to increase my personal productivity.										
10. I am 'open' minded so I'm willing to listen to new ideas and different opinions.										
11. I have been involved in the taking of 'tough' decisions in the best interests of my business and/or function.										
12. I make things happen with a clear focus on achieving agreed objectives.										
13. I find that I'm resilient enough to cope with the 'ups and downs' of organisational life.										
14. I have excellent verbal and written communication skills so I can convince colleagues that proposed actions and decisions are the 'right' ones.										
15. I set and maintain high professional standards.										
16. I am an excellent negotiator.										

C. BUSINESS KNOWLEDGE	Disagree 1	2	3	4	5	6	7	8	9	Agree 10
Accounting and Finance										
1. I know what Income Statements, Cash Flow Statements and Balance Sheets are all about.										
2. I know the meaning of important financial terms such as cash flow, Earnings, 'ebitda', equity, net present value (NPV), operating profit and working capital.										
3. I have a working knowledge of the financial performance indicators that my business concentrates on; for example, days sales outstanding, operating margin, return on capital employed and total shareholder return.										
4. I immerse myself in the figures so I really know what is going on in my business/function.										
5. I make an active contribution when our business and financial performance is being reviewed.										
6. I have prepared budgets and financial forecasts.										
7. I'm able to prepare a business case for a longer term project (for example, recruiting additional staff for a new activity) using, if necessary, project appraisal measures like Net Present Value (NPV) and the Internal Rate of Return (IRR).										
8. If my business unit/business is a quoted company (one with a stock market listing), I watch the trends in our share price and read analysts' reports to gain a more informed view of our performance and prospects.										
9. I can comment on the strengths and weaknesses in our latest set of financial results.										
10. I have attended a training programme on 'Financial Skills for Managers'.										

C. BUSINESS KNOWLEDGE (continued)	Disagree 1	2	3	4	5	6	7	8	9	Agree 10
Business strategy, marketing and selling										
1. I am familiar with important strategic management tools and techniques such as Porter's 'Five Forces' model, the Boston Consulting Group (BCG) Matrix, SWOT Analysis (Strengths, Weaknesses, Opportunities and Threats) and the Value Chain.										
2. I have a good working knowledge of the Business Plan for my business or function.										
3. I'm a good strategic thinker with views about the strategy that my business or function is or is not following.										
4. I feel able to prepare a longer term Business Plan for my business or function.										
5. When business plans for my business or function are being put together, I contribute. I make my views known.										
6. I am knowledgeable about the strategies of our competitors.										
7. I have attended a 'Strategic Management' training programme.										
8. I am familiar with important marketing concepts such as market segmentation, the product life cycle, and differential pricing.										
9. I feel able to produce a Marketing Plan for the launch of a new product or the re-launch of an existing one.										
10. I have a working knowledge about 'what it takes' to be a successful sales executive.										
Process Improvement										
1. I am familiar with important process improvement terminology and techniques such as 'Lean' Thinking, Six Sigma, Process Mapping, Cause-and-Effect Diagrams, Flow Charting and Pareto Analysis.										
2. I can identify and map core processes for my business.										
3. I show a strong 'continuous improvement' focus by using Key Performance Indicators (KPIs) relevant to my business/function.										
4. I understand the difference between 'activity' and 'output'.										
Project Management										
1. I have a working knowledge of important project management tools such as Critical Path Analysis, Work Breakdown Structures and Responsibility Charting.										
2. I am familiar with different approaches to Project Management, for example, 'Goal Directed Project Management' and 'Prince 2'.										
3. I have attended a Project Management Training Workshop.										
Corporate Governance										
1. I am familiar with the latest Corporate Governance Codes of Conduct issued by the Financial Reporting Council and the impact it may have on my business and function.										
2. I know all about my business's approach to Risk Management and, when necessary, put it into practice.										
3. I know how to use Risk Management techniques such as a Probability-Impact Grid and Decision Trees.										

D. BUSINESS EXPERIENCE	1 (Disagree)	2	3	4	5	6	7	8	9	10 (Agree)
1. I know how to prepare a business or strategic plan for a business unit and/or function.										
2. I have helped to implement a strategy for a business unit (an activity with full profit and loss accountability).										
3. I have been the Project Manager/Project Leader for a significant cross-functional project such as introducing a new IT system or re-organising a business or function.										
4. I have gained experience selling my business's products and services.										
5. I have managed a sales team.										
6. I have been involved in the preparation of a marketing plan.										
7. I have had responsibility for a budget.										
8. I have led a negotiating team, for example, to solve an industrial dispute or agree a major contract with a new customer.										
9. I have worked in more than one function, for example, HR and Marketing.										
10. I have experience of living and working in countries other than the UK.										
11. I would know how to conduct a due diligence exercise.										
12. I have held a leadership role in a significant 'change management' project(s) such as a re-locating facilities to another country or project managing the re-organisation of a business after it has been acquired.										
13. I have been in a line management role(s) with responsibility for budgets, people and resources.										
14. I have held profit and loss responsibility for a business unit.										
15. My track record of leading and managing a business unit indicates that I have been a success.										

E. SCORING GUIDE

The maximum score for each Section of the Checklist is shown below. You can put your own score next to the maximum score and then calculate your percentage score. For example, the maximum score for 'Commercial Orientation' is 110 points. If you score 78 points then your percentage score is 71%.

	Your score	Maximum score	Your % score
A. Commercial Orientation		110 points	
B. Commercial Leadership		160 points	
C. Business Knowledge			
Accounting/Finance		100 points	
Business Strategy, Marketing and Selling		100 points	
Process Improvement		40 points	
Project Management		30 points	
Corporate Governance		30 points	
D. Business Experience		150 points	
Overall Score		**720 points**	

Interpreting your scores:

For each part of the Checklist, **a score above 75%** indicates that you are in excellent shape. It is now a question of making sure that you continue to develop your commercial skills, for example, by seeking additional and new responsibilities.

Scores between 50% - 75% indicate that there are important gaps in your commercial skillset. You might consider preparing a Learning and Development Plan to address the filling of the gaps earlier rather than later.

Scores below 50% suggest that, in a particular area(s), your commercial skills may be significantly under-developed. If you wish to follow a business career with increasing levels of responsibility, it may be appropriate to prepare a Career Plan so you can take practical steps to improve your overall business acumen.

APPENDIX 2: THE COMMERCIAL MANAGER'S TOOLKIT

1 Diagnostic Questionnaire

The following questionnaire can be used to analyse the 'big picture' within which your company operates and assess your business understanding. If you are unable to answer any questions, it may be necessary to talk to colleagues or conduct research to fill in the gaps.

Business Context

1. What market does the firm operate in? Is the market mature or growing and what are the long-term growth trends? What affects supply and demand? What are the current and emerging markets?

2. Who are the firm's main competitors? What are the firm's strengths and weaknesses relative to the competition?

3. What is the firm's market share? Is this increasing or decreasing?

4. What are the main political, economic, social and technological trends affecting the firm and its industry? Which of these trends have the potential to be highly disruptive, leading to a fundamental reshaping of the industry?

5. How high are the barriers to entry in the industry? Are there potential new entrants? Is the industry consolidating, i.e. firms acquiring each other?

Strategy and Planning

1. What is the firm's strategy? How would you articulate it in a couple of sentences? Is the firm seeking to grow, consolidate, enter new markets, develop new products etc?

2. What is the firm's core (key) competence?

3. What is the firm's competitive advantage, i.e. what is unique about the firm compared to others? Does it have superior products/services, marketing/brands, innovation, ways of dealing with customers etc? Is the firm sales, marketing, manufacturing, technology, innovation or cost-led?

4. Are there major strategy shifts on the horizon? Is the firm making significant investments (e.g. in new products, markets or technology)?

5. What is the firm's process for developing strategy? Who gets involved?

Customers

1. Who are the firm's customers? What products and services do you provide to them? Why do they choose your firm over competitors? Do they also buy from your competitors?

2. What do your customers get that they don't want? What do they want but don't get? What other feedback would your customers provide about your firm?

3. How loyal are the firm's customers? What proportion of customers have dealt with the firm for more than five years? What is the customer turnover rate per annum (i.e. how many do you lose each year)?

4. Does the firm measure the profitability of different customers? Which are the most and least profitable and why?

5. Are the firm's customers the end users of the product? If not, who is the ultimate consumer and to what degree can the firm influence their choice?

Financial and Business Performance

1. What are the firm's key performance objectives and targets? What are the critical financial metrics? How does the City assess the firm's performance? What do the leading City analysts say about the firm?

2. How is success measured in ways other than financial measures?

3. How is the firm performing currently against each of the key objectives and targets? How has it performed over the last five years?

4. How does the firm's financial performance against key metrics compare with competitors?

5. What systems does the firm have in place for measuring performance?

1 Diagnostic Questionnaire (continued)

Costs

1. What are the firm's principal costs? Are they rising or falling, and why?
2. Does the firm have a process for reviewing and controlling costs?

Products

1. What products and/or services does the firm produce?
2. At what stage of the product life cycle are the firm's products/services. Which are growing/mature etc? Does the firm have new products/ services being developed to replace mature and declining markets?
3. What brands does the firm own and to what extent do they drive the firm's performance?

Organisation

1. What is the organisation structure? Why has this design been adopted? What are the respective roles of each part of the organisation (e.g. role of corporate centre vs. operating units)?
2. To what extent is decision making centralised or devolved?
3. What differentiates the firm's organisation structure from competitors and why?
4. What functions have been outsourced and why?

People, Values and Culture

1. What are the firm's values, whether they are articulated or not? Does the reality reflect the rhetoric, i.e. are the defined values those which are practised by senior management?
2. What is the firm's core people competence, i.e. how do the firm's employees drive its success? What do the firm's people need to be good at to support its strategy - is it innovation, customer service, sales etc?

Stakeholders

1. Who are the largest investors in the firm? What % stake do each of the top ten shareholders own? Why do they hold the firm's stock, i.e. what do they aim to achieve from their investment? How long have they held their shareholding?
2. Who are the firm's main suppliers? Are any of them business critical, i.e. the firm would be at risk if they ceased trading, or they would be difficult to replace? How healthy is their financial performance?
3. What other key stakeholders does the firm have to consider and what influence do they have, e.g. government, local communities etc?
4. What is the firm's environmental impact and how does it affect the business?

2 Business Model Canvas

The Business Model Canvas (developed by Osterwalder and Pigneur) is a strategic management template for developing new or documenting existing businesses. As the diagram below shows, the template is used to map a company's value proposition, infrastructure, customers and finances. It can be used as a planning tool to think through all the elements required to deliver a new project, and is sometimes printed out on a large scale allowing groups of people to discuss and annotate the model, such as in a workshop setting.

Key Partners

Who are our Key Partners?
Who are our key suppliers?
Which Key Resources are we acquiring from partners?
Which Key Activities do partners perform?

Motivation for Partnerships:
Optimisation and economy
Reduction of risk and uncertainty
Acquisition of particular resources and activities

Key Activities

What Key Activities does our Value Propositions require?
Our Distribution Channels?
Customer Relationships?
Revenue streams?

Categories:
Production
Problem Solving
Platform/Network

Key Resources

What Key Resources does our Value Propositions require?
Our Distribution Channels?
Customer Relationships?
Revenue streams?

Types of Resources:
Physical
Intellectual (brand patents, copyrights, data)
Human
Financial

Value Propositions

What value do we deliver to the customer?
Which one of our customer's problems are we helping to solve?
What bundles of products and services are we offering to each Customer Segment?
Which customer needs are we satisfying?

Characteristics:
Newness
Performance
Customisation
'Getting the Job Done'
Design
Brand/Status
Price
Cost Reduction
Risk Reduction
Accessibility
Convenience/Usability

Customer Segments

For whom are we creating value?
Who are our most important customers?

Mass Market
Niche Market
Segmented
Diversified
Multi-sided Platform

Customer Relationships

What type of relationship does each of our Customer Segments expect us to establish and maintain with them?
Which ones have we established?
How are they integrated with the rest of our business model?
How costly are they?

Examples:
Personal Assistance
Dedicated Personal Assistance
Self-Service
Automated Services
Communities
Co-creation

Channels

Through which Channels do our Customer Segments want to be reached?
How are we reaching them now?
How are our Channels integrated?
Which ones work best?
Which ones are most cost-efficient?
How are we integrating them with customer routines?

Channel Phases:
1 Awareness
How do we raise awareness about our company's products and services?
2 Evaluation
How do we help customers evaluate our organisation's Value Proposition?
3 Purchase
How do we allow customers to purchase specific products and services?
4 Delivery
How do we deliver a Value Proposition to customers?
5 After sales
How do we provide post-purchase customer support?

Cost Structure

What are the most important costs inherent in our business model?
Which Key Resources are most expensive?
Which Key Activities are most expensive?

Is your Business More:
Cost Driven (leanest cost structure, low price value proposition, maximum automation, extensive outsourcing)
Value Driven (focused on value creation, premium value proposition)

Sample Characteristics:
Fixed Costs (salaries, rents, utilities)
Variable costs
Economies of scale
Economics of scope

Revenue Streams

For what value are our customers really willing to pay?
For what do they currently pay?
How are they currently paying?
How would they prefer to pay?
How much does each Revenue Stream contribute to overall revenues?

Types:
Asset sale
Usage fee
Subscription Fees
Lending/Renting/Leasing
Licensing
Brokerage fees
Advertising

Fixed Pricing:
List Price
Product feature dependent
Customer segment dependent
Volume dependent

Dynamic Pricing:
Negotiation (bargaining)
Yield Management
Real-time-Market

The elements of the canvas are:

Infrastructure

This identifies the **most important activities** in delivering a company's value proposition (i.e. the products and services that distinguish a company from its competitors). For example, organising the logistics to deliver the raw materials required to manufacture a component for an aircraft.

The two other elements of infrastructure are **resources** (the human, financial, physical and intellectual assets required by a company to create value for a customer) and the **partner network** (the internal and external relationships formed by a company such as buyer/supplier relationships).

Customers

This involves identifying the customers that a company seeks to serve. It is critical to focus on specific customer segments based on their different needs so that a company can deliver products and services appropriate to the characteristics of specific segments.

Finances

This describes, for example, a company's revenue stream (the way in which it earns a profit from each customer segment) and its cost structure. Cost structure describes the relative significance of a company's fixed costs (those costs that, in the short term do not vary with the level of activity such as rent and salaries) and variable costs (those costs that do vary with the level of activity such as material and packaging costs).

3 Five Forces Model

Developed by Professor Michael Porter of the Harvard Business School in 1980, the 'Five Forces Model' plays a central role in Porter's theories of achieving sustainable competitive advantage. In deciding which strategy to pursue, executives need to consider the nature of the competitive environment their business faces – Fragmented? Emerging? Mature? Or Global? The five forces in the model determine the intensity of competition in the market – the higher the intensity of competition across the five forces, the lower levels of profit that are available for firms to exploit.

Porter contends that there are a limited number of strategic options:

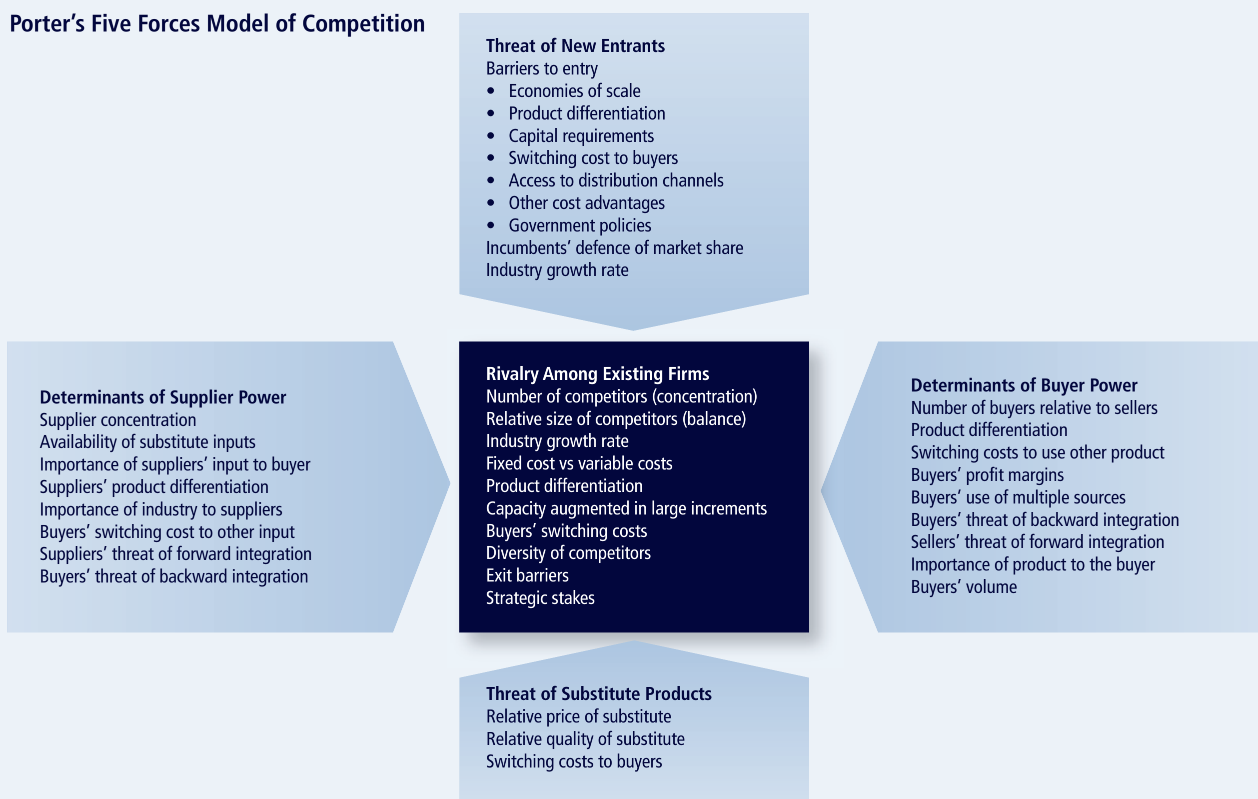
- Pursue a cost leadership strategy with the business delivering the same quality of products and services as its competitors but at a lower cost.
- Seek differentiation where the business offers products and services with unique or unusual benefits that customers want and are prepared to pay more for.

A refinement of cost leadership and differentiation is focus - targeting specific market segments to achieve cost or differentiation advantages.

The attractiveness of the various strategic options can be analysed by reference to the following five competitive forces:

1. Competitive rivalry between existing competitors - the more intense the competition the greater the pressure on prices, costs and profit margins.
2. The bargaining power of suppliers - do suppliers have the 'upper hand' or not? If so, inputs such as labour, raw materials and components will be relatively highly priced and put pressure on profit margins.
3. The bargaining power of customers - do customers have the 'upper hand' or not? If so, they will be in a powerful bargaining position to force down selling prices and margins. For example, look at the relative bargaining power of many food manufacturers selling to a relatively small number of major supermarkets. No surprises - food manufacturers face an uphill commercial struggle.
4. The threat of new entrants - a profitable market will attract new competitors which will make it less profitable in due course.
5. The threat of substitutes - substitutes are new products or services that reduce the competitive advantages of existing offerings. For example, e-books are reducing the market share of traditional books.

Porter's Five Forces Model of Competition

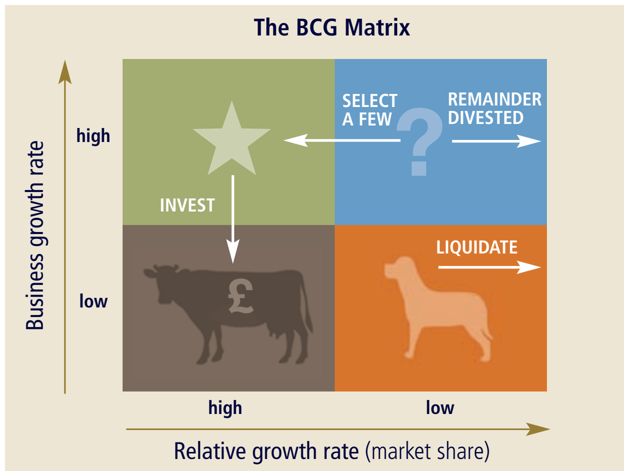


4. BCG Matrix

This is a tool developed by the Boston Consulting Group for assessing the competitive strength of the products and services sold by a business in different market segments. Business units or product lines are plotted on the matrix based on their relative market share and growth rates.

There are four possibilities which can be highlighted in a 2 x 2 matrix, as shown here:

1. The product is a market leader in a high growth segment. This is a 'star' business. Stars often require high levels of investment to maintain their market leading position. Once the market matures, stars have the potential to become lucrative 'cash cows'.
2. The product is a market leader in a segment but which is growing relatively slowly. This is a 'cash cow' business, which can be 'milked' to generate cash without the need for significant investment.
3. The product has a relatively low market share in a market segment with low growth prospects. This business is referred to as a 'dog'. Companies may seek to sell off or cease trading in products or services in this category.
4. The product has a relatively low market share in a market segment which is growing rapidly. This business situation is referred to as a 'question mark'. Question marks consume cash, and businesses must decide whether to invest to convert them into 'stars' which may mature into 'cash cows', or accept that they are likely to become 'dogs' once market growth slows.



The life cycle of businesses tends to follow a particular pattern: beginning as 'question marks', they would ideally develop into 'stars' then become 'cash cows' once the market ceases to grow. At the end of the cycle they would become 'dogs'. Although the real world is rarely this simple, the matrix can be used to assess whether a company has a balanced portfolio with sufficient new products/services in development to replace cash cows as they mature.

5. SWOT analysis

SWOT is a mnemonic to help executives with their strategic thinking. It stands for Strengths, Weaknesses, Opportunities and Threats. What are a business's SWOTs? In what ways can it manage them to improve its performance?

The four factors can be categorised along two dimensions:

- Internal/external - internal features are the company's own strengths and weaknesses. The external features are the company's opportunities and the threats to its future performance.
- Positive/negative - the positive aspects are the strengths and opportunities. The negative ones are the threats and weaknesses.

6. Pareto Principle

The Pareto Principle was developed in 1897 by the Italian economist Vilfredo Pareto. It is usually referred to as the 80:20 Principle. Why? Because a minority of causes, inputs or effort usually lead to a majority of the results, outputs or rewards. There is an inbuilt imbalance between causes and results since 80% of outputs are likely to produce results from 20% of the inputs. It also means that 80% of the inputs are having only a marginal (20%) impact. Pareto analysis can be used to ensure resources are focused where they are likely to have greatest impact.

For example:

- 80% of a company's operating profit may come from 20% of its customers. This information should be used so that efforts are concentrated on the 'vital few' - keep the critical 20% of customers extremely satisfied so the prospects for doing more business with them are increased.
- In a sales force, studies find that the top 20% of salespeople generate between 70% - 80% of sales. This means that a great deal of effort needs to be devoted to retaining them and ensuring that more of the same type of salesperson is recruited. It is also important to identify what the top salespeople do differently in order to identify the factors that account for their success. These observations and insights can, of course be extended to all executives and all roles.
- In a negotiation, 80% of the concessions are likely to occur in the last 20% of the time available. If requests are made at a relatively early stage, neither side may be willing to give way. But if additional requests surface in the final 20% of the time available for the negotiation, both sides may be more flexible. As Richard Koch says, 'impatient people don't make good negotiators!' Koch's book on 80:20 is mentioned in the Reading List in the Appendix.
- In seeking to solve quality problems, a relatively small number of causes will account for the vast majority of the defects or delays.

7. PESTEL framework

The PESTEL framework provides a comprehensive list of external factors which may influence the success or failure of particular strategies. PESTEL stands for Political, Economic, Social, Technological, Environmental and Legal.

Politics highlights the role of governments. Economics refers to macro-economic factors such as exchange rates, inflation and growth rates. Social factors include demographic changes such as ageing populations in many advanced economies. Technological influences refer to innovations such as cloud computing, social media and the use of new composite materials. Environmental stands for 'green' issues such as pollution and waste. Legal covers legislative and regulatory constraints or changes such as health and safety legislation and the new Retail Distribution Review in the financial services sector.

In addition to PESTEL, other external influences are becoming increasingly important such as Corporate Governance and Corporate Social Responsibility including business ethics.

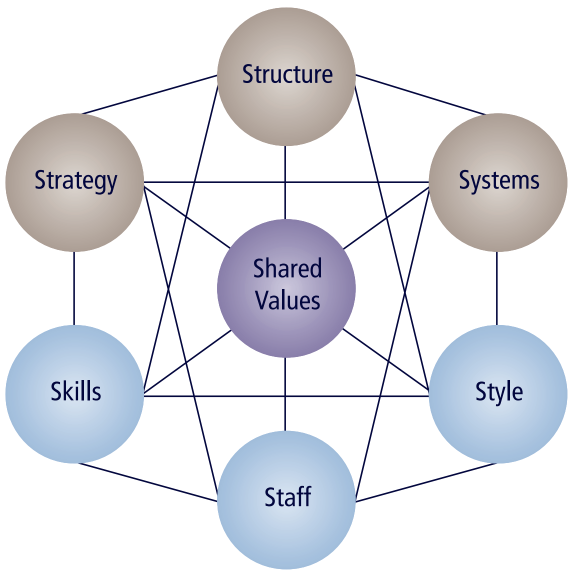
8. McKinsey's 7S model

This is a management model developed by Tom Peters and Robert Waterman (McKinsey consultants) in the 1980s. The 7S's, all of which are interdependent are:

- Structure... the organisation chart.
- Strategy... the business plan to achieve short and longer term objectives.
- Systems... the processes and procedures operating in the business.
- Shared values... the guiding principles that employees share, for example, a 'no blame' culture.
- Skills... the capabilities of the staff within the business .
- Style... the cultural style of the organisation, for example, de-centralised decision making.
- Staff... the personnel categories within the business, for example, sales executives, technologists, accountants and IT specialists.

The model is used to assess and monitor changes in the internal situation of a business. It is based on the assumption that for an organisation to perform well, the seven factors need to be mutually reinforcing and operating effectively. The model can be used to identify what needs to be realigned to improve performance, or to assess what the impact of change in one part of the organisation is likely to have in others.

The McKinsey 7S Model



9. Hoshin planning

This is an approach designed to convert all the discussions and decisions about strategy into action. It is a technique popularised in Japan in the late 1950s by Professor Kaoru Ishikawa. The four elements of Hoshin are:

1. A focus on a shared 'breakthrough' objective involving a quantum leap, such as reducing delivery times to customers by 30%.
2. Communicating the objective to all those who should be involved in achieving it so the improvement objective receives the attention and focus that it deserves.
3. Involving all those who should be active in the planning required to achieve the objective.
4. Holding participants accountable for achieving their part of the plan.

From an HR perspective, any breakthrough must be business focussed, for example, how can HR contribute to increasing sales by 25%? A team effort is required with a clear description of the current situation and the use of a practical problem solving methodology.

10. Goal Directed Project Management

GDPM is a straightforward approach to project management with a focus on identifying and concentrating on the most critical issues that determine the success of a project. There are five major project steps.

1. Justifying the project - the business case.

2. Planning the project.

3. Setting up the project.

4. Implementing the project.

5 Closing the project.

Important techniques in GDPM include:

- Milestone Planning (identifying the major stages of a project preceded by the word 'when', for example, 'WHEN we have chosen the recruitment agency'.
- Identifying the work that needs to be completed to achieve each milestone (the Work Breakdown Structure).
- A Responsibility Matrix...who is responsible for doing what? When?

11. Balanced scorecard

Invented by Robert Kaplan and David Norton in 1992, the Balanced Scorecard seeks to go beyond simply measuring the traditional financial metrics which are common to most businesses and measure four broader factors that have an important influence on business performance.

They are:

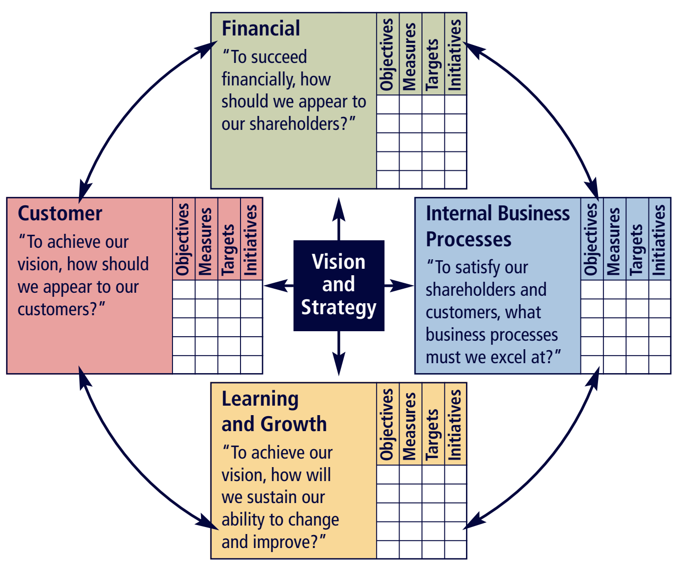
1. Financial; improving profitability and financial position.

2. Customer; acquiring, retaining and satisfying customers.

3. Internal; improving business processes by, for example, 'lean thinking'.

4. Innovation and learning; developing new products and services and using education and training as a competitive weapon and a source of competitive advantage.

The four factors are often set out in graphical form as shown here:



There is no specific reference to 'people' in the Balanced Scorecard. It is worth pointing out, therefore, that the 'people' element transcends the Scorecard since it is **the** essential resource that will determine whether the four factors mentioned will be implemented or not. If financial performance or 'profit' is the principal focus, then financial management only will receive attention.

Accordingly, the Balanced Scorecard takes a wider view because it is only then that companies will achieve goals other than purely financial ones. Furthermore, achieving the financial goals are the outputs. Factors 2, 3 and 4 are the inputs. Without the inputs there will be no outputs!

Many businesses develop bespoke scorecards using measures which reflect the strategy and objectives of their business. It is worth finding out whether your business has such a scorecard, and if so what gets measured and why.

12. Excellence model

Various 'quality frameworks' have been developed over time, including those by W Edwards Deming and Malcolm Baldrige used respectively in Japan and the USA. In Europe the EFQM Excellence Model has been used by over 30,000 organisations to improve their business performance.

The Excellence Model focuses on 'enablers' or 'performance drivers' and 'results' or 'outputs'.

The 'enablers' are:

- Leadership.
- People.
- Strategy.
- Partnerships and resources.
- Processes, products and services.

The 'results' are:

- 'people' results
- 'customer' results
- 'society' results
- 'business' results.

To implement the EFQM framework, the following steps need to be taken:

- Assess performance to identify process strengths and weaknesses.
- Identify process improvement priorities.
- Use practical methods such as the principles of 'lean' thinking to achieve performance improvement such as reducing 'cycle times' (for example, the time taken to recruit a senior executive).
- Introduce ways of thinking that encourage reflection and stimulate continuous improvement.

13. Six Sigma and Lean Thinking

An approach to quality improvement using statistical analysis, originally popularised by Motorola and GE, aimed specifically at reducing defects and variability in business processes. At the Six Sigma level, there are only 3.4 defects per million. Each Six Sigma project carried out within an organisation follows a defined sequence of steps and has quantified financial targets (cost reduction and/or profit increase).

Six sigma projects are often implemented using the DMAIC methodology:

- **Define** the problem and project goals.
- **Measure** key aspects of the process to be improved.
- **Analyse** the data to investigate and verify cause and effect of problems and proposed solutions.
- **Improve** or optimise the process.
- **Control** the future state process to. eliminate defects by continuous monitoring.

Lean thinking is a closely related concept, in that it aims to maximise value while minimising waste. Originally developed as 'lean manufacturing', as a continuous improvement approach designed to improve flow, to eliminate error and to reduce delays, this concept is now applied more widely to services and business processes.

APPENDIX 3:
PEOPLE-RELATED METRICS – FORMULAE

ORGANISATIONAL EFFECTIVENESS		
Human Investment Ratio	£,€	Revenue - (Total Costs - (Compensation + Benefits)) / (Compensation + Benefits)
Profit per FTE	£,€	Profit Before Tax ÷ Total FTEs
Revenue per FTE	£,€	Revenue ÷ Total FTEs
Cost per FTE	£,€	Total Costs ÷ Total FTEs
PAY & PRODUCTIVITY		
Remuneration/Revenue	%	(Compensation + Benefits) ÷ Total Revenue
Remuneration/Total Costs	%	(Compensation + Benefits) ÷ Total Costs
TURNOVER		
Resignation Rate	%	Resignations ÷ Headcount
Resignation Rate by Length of Service: 0-1 years service; 1-3 years service; 3-5 years service; 5-10 years service	%	Resignations within each Length of Service category ÷ Total Resignations
over 10 years service		
Executive Stability Ration	%	Executives with >3 years service ÷ No. of Executives
EMPLOYEE BEHAVIOUR		
Grievance Rate per 1,000 Employees	%	Grievances Recorded x 1,000 ÷ Headcount
Absence Cost per FTE	£,€	Absence Rate x Compensation x 2 ÷ FTEs
DIVERSITY		
Female Diversity	%	Headcount Females ÷ Total Headcount
Female Diversity (Mgmt. & Prof.)	%	Headcount Female Managers & Professionals / Total Headcount Managers & Professionals

APPENDIX 4: READING LIST

Useful Business Publications and Websites

- Financial Times and ft.com
- Fast Company Magazine and fastcompany.com
- The Economist and economist.com
- Harvard Business Review and hbr.org
- seeingthebigpicture.com
- mckinsey.com, bcg.com and boozallen.com
- The leading business schools such as Wharton and Insead also have resources that you can sign up for on their websites.

Books and Reports

Andersen, E, Grude, K, Haug, T, *Goal Directed Project Management: Effective Techniques and Strategies*, Kogan Page, London, 2009

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Koch, R, *FT Guide to Strategy: How to Create, Pursue and Deliver a Winning Strategy'*, FT Prentice Hall, London, 2011

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Lambert, A, Cooper, D, *Managing the People Dimension of Risk*, Corporate Research Forum, London, August 2010

Pillans, G, *Developing an Effective HR Strategy*, Corporate Research Forum, London, January 2012

Rumelt, R, *Good Strategy/Bad Strategy: The difference and why it matters*, Profile Books, London, 2012

Russell-Walling, E, *50 Management Ideas You Really Need To Know, Quercus*, London, 2008

Ulrich, D, Brockbank, W, *The HR Value Proposition*, Harvard Business School Press, Boston, 2005

Rethinking Human Resources in a Changing World, KPMG, London, October 2012

15th Annual Global CEO Survey 2012, PwC, London, 2012

APPENDIX 5:
GLOSSARY OF BUSINESS AND FINANCIAL TERMS

ADDED VALUE

Defined originally as the difference between the selling price of a product or service and the cost of purchasing that product's and service's 'bought-in' materials. Using this definition, it is the wealth created by a company's activities.

This wealth is distributed to employees (payroll costs), governments (taxes), sustaining investment (capital expenditure) and the providers of finance (lenders and shareholders).

Added Value or Value Added is complementary to measures of profit. For example, it is possible to calculate 'value added per employee' and 'value added per £ of research and development expenditure'. Such indicators provide an insight into the relative efficiency or productivity of different kinds of expenditure and resources.

If a company's added value/value added divided by its payroll charges is high relative to its competitors, it indicates superior productivity. It is an important role of the HR function to measure and monitor indicators relating to the productivity of employees and to report such results regularly.

Added value or value added may also be defined as the benefits that differentiate a product or service from another thus creating value for the customer. In this sense, added value is a customer perception producing competitive advantage.

Finally, 'adding value' can refer to the contribution that an executive makes to the success of his/her section, team, department and company. The extent to which value is being added can be measured and monitored by the use of Key Performance Indicators.

AMORTISATION

The reduction in value of intangible fixed or non-current assets such as a lease or intellectual property. This reduction in value is a cost which will be included in the income statement or profit and loss account.

ASSETS

Everything that a company owns or that is due to it. Cash, stocks or inventories and amounts due from customers are examples of current assets. Buildings, equipment, land and machinery are examples of **tangible** fixed or non-current assets. Goodwill, leases and intellectual property such as patents and software licences are examples of **intangible** fixed or non-current assets.

BALANCE SHEET (See the back of the Appendix for an example)

A statement of the financial position of a business at a particular date showing the different kinds of assets and how those assets have been financed. Assets (what a company owns) are financed by liabilities. Liabilities are amounts owed by a business to third parties such as banks and suppliers plus the obligations a company has to its shareholders (called equity). Assets must equal liabilities (i.e. they balance), according to the conventions of double entry bookkeeping.

BARRIERS TO ENTRY

The obstacles that prevent new competitors from entering an industry or market. High barriers to entry benefit existing companies, because they reduce competition, allowing existing businesses to maintain their revenues and profits by keeping prices high for customers. Barriers include high start-up costs such as the need to build factories or develop highly specialist skills or technology, the existence of patents, high costs for customers to switch providers, or onerous government regulations.

BENCHMARKING

A benchmark is a standard of performance which can apply, for example, to defect levels, financial results, production rates, share price performance and staff turnover rates. Benchmarking involves assessing the performance of your own business and comparing it with others. If the others are superior, an action plan needs to be developed to bridge the gap. Such a plan may involve applying the principles of continuous improvement and 'lean' thinking.

BUDGET

An annual business or organisational plan covering:

- revenue and costs
- capital expenditure
- cash inflows and outflows,
- assets and liabilities
- non-financial matters such as headcount and staff turnover

A budget is a commitment to achieve a set of financial and non-financial results during a 12 month period.

BUSINESS MODEL

A business model describes the ways in which an organisation creates and delivers value for its customers and shareholders. For example, selling goods to customers online rather than using agents or distributors. For example, John Lewis business model gives each employee part-ownership of the company, a share of its annual profits and a say in how it is run.

CAPITAL EMPLOYED (See the back of the Appendix for a worked example)

The sum of fixed or non-current assets plus working capital. Capital employed represents the long and short term assets used by a business. The lower the level of capital employed, the more financially efficient a business becomes.

CAPITAL GEARING OR GEARING (See the back of the Appendix for an example)

The proportion of short and long borrowings (debt) in relation to equity. It measures the relationship between the financing provided by outsiders (for example, banks) and the financing from shareholders (equity).

It is calculated by expressing debt as a percentage of equity. The higher the debt/equity ratio, the higher a company's gearing. Debt is normally defined as total borrowings including leases less cash balances and short-term investments such as cash on deposit. The higher the debt-equity ratio, the greater the financial risk because a company will incur higher interest charges and will need to repay higher levels of borrowings. In America, gearing is known as leverage. A gearing ratio of more than about 75% is relatively high.

CASH CONVERSION RATE (See the back of the Appendix for a worked example)

This is operating cash flow expressed as a percentage of operating profit. The higher the figure the better. The cash conversion rate is a measure of the ability of a business to convert profit into cash flow. The target should be at least 100%.

CASH FLOW (See the back of the Appendix for a worked example)

The generation of cash by a business. It is the most important measure of financial health since cash is the 'fuel' that enables a business to trade. Businesses get into financial trouble if cash runs out and they are unable to raise additional funds. There are a number of different measures of 'cash flow' and companies' terminology varies when 'cash flow' is discussed so it's important to clarify the particular definition.

Operating cash flow is equal to 'ebitda' less capital expenditure, plus or minus the decrease or increase in working capital during a period.

If operating cash flow is positive, it means that a business is generating enough cash to meet its day to day commitments; it is cash self sufficient. If operating cash flow is negative, a business is not generating enough cash to support its day-to-day requirements. It is not cash self sufficient and it will need to use its existing cash balances and/or additional borrowings and/or extra funding from shareholders to finance the cash shortfall.

'Free' cash flow is operating cash flow less financing charges and corporation tax. This cash flow is 'free' in the sense that it is available to repay loans and to pay dividends to shareholders.

Net cash flow is 'free' cash flow less loan and dividend payments. It is the cash remaining after a business has met all its commitments.

CASH FLOW STATEMENT (See the back of the Appendix for an example)

A statement explaining the change in a company's cash position between the beginning and end of a financial period.

COLLECTION PERIOD OR DAYS SALES OUTSTANDING, DSO. (See the back of the Appendix for a worked example)

The average length of time taken by a customer to pay a sales invoice. It is calculated by dividing accounts receivable or trade debtors by annual revenue times 365 days to give the average number of days for which the sales invoice has been unpaid. The benchmark is the length of time allowed by the customer's supplier which is usually between 30 – 90 days; the shorter the better because that means cash will get paid by customers earlier.

COMPETITIVE ADVANTAGE

The attributes that an organisation has that allows it to outperform competitors. This may be superior products, better customer service, innovations, technology, or the skills of its people.

CORE COMPETENCE

An idea introduced in 1990 by C. K. Prahalad and Gary Hamel. Core competencies are the collective learning in a business including a deep commitment to working across organisational boundaries. There are three tests to be applied to determine whether a core competence exists:

- It provides potential access to a wide variety of markets.
- It makes a significant contribution to the customer benefits of the end product or service.

- It is difficult for competitors to imitate because, for example, it involves a complex linking of individual technologies and production skills.

There is a view that an important HR role is to focus effort and time on developing an organisation's 'core' people competences. If HR does so, their intervention will act as a catalyst to accelerate the development of 'core' business competences.

COST OF SALES OR COST OF GOODS SOLD

This is the direct cost of the products and services sold to customers such as raw material, packaging and direct labour costs.

COST, REVENUE, PROFIT AND VALUE DRIVERS

A **cost** driver is any factor that affects cost, for example, the number of units manufactured, the number of sales visits made and the number of packages shipped.

A **revenue or sales** driver is any factor that affects revenue, for example, sales volumes, selling prices and the level of marketing costs.

Profit drivers include selling prices, sales volumes, variable costs (those costs that vary in proportion to revenue such as material costs) and fixed or overhead costs (those costs that do not vary in proportion to revenue such as office rent, business rates and interest charges).

Value drivers are factors that increase the value of a product or service by improving the perception of the item concerned thus creating competitive advantage. Examples of value drivers include, advanced technology and brand recognition.

CREDITORS AND CREDITOR OR PAYABLE DAYS

Any person or organisation to whom a company has a commitment. For example, the suppliers of goods for whom unpaid bills are outstanding - called accounts payable or trade creditors. It is an accounting requirement to distinguish between short-term creditors called current liabilities (due to be paid within 12 months) and long-term creditors (amounts due to be paid after one year).

Creditor days or payable days is the average length of time a company takes to pay its suppliers. It is worked out by taking the sum of accounts payable and accrued charges and dividing it by the sum of the cost of sales and operating costs. This figure is expressed as a percentage which is then converted into a 'number of days' by multiplying it by 365 days. If at all possible, cash should be received from customers before cash payments are made to suppliers.

DEBT EQUITY RATIO (see Capital Gearing)

DEBTORS

Amounts due to a business from third parties. The largest item is usually accounts receivable or trade debtors; amounts due from customers.

DEPRECIATION

As a fixed or non-current asset such as a car or plant and machinery is used, its value falls. This fall in value is a cost in the income statement or profit and loss account and it will also be a deduction from the original cost of the asset in the balance sheet. The purpose of depreciation is to write down the cost, less any salvage value, of a fixed asset over its estimated business life. It is a bookkeeping entry and does **not** represent a cash outlay. The most common method is 'straight line' depreciation so a fixed asset is reduced in value in equal annual instalments over its estimated life.

DIFFERENTIAL PRICING

Similar (or sometimes identical) products can be priced differently for different customers, markets or in response to different levels of risk. This allows a firm to maximise profit by offering products or services at different price points, covering all market segments. An example is Easy Boarding offered by EasyJet. The service (a plane journey from A to B) is the same, but a small number of customers are prepared to pay more to board the plane before other passengers and have a wider choice of seats.

DIVIDEND

A discretionary cash payment recommended by the board of directors and approved by shareholders to be distributed pro rata among the shares outstanding. 'Non-cash' dividends can also be paid, for example, when a company issues more shares to the value of the dividend. Dividends are sometimes paid in two instalments – an interim dividend paid during the financial year and a final dividend paid after the end of the financial year.

DIVIDEND YIELD

The annual dividend per share expressed as a percentage of the share price. For leading companies, the average dividend yield is about 3.2%.

EARNINGS OR NET INCOME

The profit after all costs including taxation. It is the 'bottom line'. It is the profit or extra wealth belonging to shareholders before they receive a dividend. The American expression for earnings is 'net income'. The term 'net profit' may also be used.

EARNINGS PER SHARE (EPS)

Earnings divided by the number of issued ordinary shares. Growth in EPS is an important financial performance indicator.

EBITDA (See the back of the Appendix for a worked example)

This stands for earnings before interest, tax, depreciation and amortisation. It is equivalent to revenue less the cash cost of sales and less cash operating costs. Depreciation and amortisation are 'non-cash' costs and are, therefore, excluded from cash costs. 'Ebitda' is equivalent to operating profit plus depreciation and amortisation.

Ebitda is both a measure of profitability and an indicator of the ability of a business to generate short term cash flows from its trading activities.

EQUITY

The financing of a business attributable to and provided by shareholders. Equity can be referred to as net assets, net worth, share capital and reserves, shareholders' funds, shareholders' interest or equity shareholders' funds.

FINANCIAL STATEMENTS

These are the Income Statement (or Profit and Loss Account), Cash Flow Statement and Balance Sheet.

FIXED ASSETS OR NON-CURRENT ASSETS

Assets such as equipment, buildings, intellectual property, land and machinery. They are expected to be used for more than a year. Tangible fixed assets have a physical shape like a building. Intangible fixed assets, such as goodwill, intellectual property and trade marks do not.

FORECAST

A prediction of what the business and financial results are likely to be for a period taking into account:

- Actual performance so far in the financial period.
- Additional information that was not available when the budget was prepared.
- Future actions that were not anticipated at the time the budget was prepared but will take effect during the rest of the budget period, for example, additional cost saving measures.

GEARING (See Capital Gearing)

GOODWILL

The excess paid by an acquiring business over the book value of the equity of the business acquired. For example, if A Limited pays £10m for B Limited and B Limited's equity in its latest balance sheet is £8m, goodwill is £2m. Goodwill is an example of an intangible fixed asset. The figure shown for goodwill has to be reviewed every year.

GROSS PROFIT AND GROSS PROFIT MARGIN (See the back of the Appendix for an example)

The difference between revenue and the cost of sales. It can be calculated for a business as a whole and for individual products and services within a business. Gross profit margin is the gross profit divided by revenue expressed as a percentage. It measures both the profitability and the relative profitability of a business's products and services. There is no, overall gross profit margin benchmark because it varies significantly from business sector to business sector but a retailer, for example, would seek a gross margin of about 60%.

INCOME STATEMENT

See the Profit and Loss account.

INSOLVENT

A business is insolvent when it is unable to meet commitments as they fall due. This will happen when a company does not have enough cash to pay its cash costs and/or when a company's liabilities exceed its assets.

INTANGIBLE ASSETS

Fixed or non-current assets which do not have a physical shape. Examples include brand names, goodwill and intellectual property such as patents, software licences and trade marks.

INTEREST COVER (See the back of the Appendix for an example)

An indicator of solvency - the ability of a business to meet its financial commitments. It is calculated by expressing profit before interest and taxation (the operating or trading profit) as a multiple of the interest charge. It is a measure of the ability of a business to service its financing costs from the profit it earns from its day-to-day activities. The higher the interest cover the more it indicates that the business concerned is better able to afford its financing costs. The lower the interest cover, the less able a business is to service its financing costs. A benchmark for interest cover is 3 – 4 times.

KEY PERFORMANCE INDICATORS (KPIs)

The most important success measures helping a business to define and achieve its objectives. They are quantifiable factors that measure the level of performance. Examples include:

- the percentage of revenue that comes from existing customers
- the proportion of operating profit in a financial period that is converted into operating cash flow (the cash conversion rate)
- the percentage of products returned by customers for a mail order company
- the proportion of revenue coming from new products launched in the past three years.

LIABILITY OR LIABILITIES

Amounts owed by a business to external parties. In a balance sheet, 'total liabilities' means equity (shareholders' financing) plus amounts due to creditors (obligations to third parties like banks and suppliers).

LIQUIDITY

The extent to which a business has access to cash. It is an indicator of the ability to meet short-term commitments. 'Liquid' companies are financially healthy. 'Illiquid' companies are not.

MARKET CAPITALISATION

The stock market value of a company. It is calculated by multiplying the current price per share by the number of issued shares.

MARKET SEGMENTATION

A marketing strategy that involves dividing broad target markets into smaller groups of customers who have different needs. Companies may develop specific products and services to target different market segments, and may use differential pricing across different segments. For example, in the car industry, Toyota has two different brands (Toyota and Lexus) that address different market segments, Lexus being a luxury product and Toyota being a less expensive, mass-market product.

MARKET SHARE

The percentage of an industry or market's total sales that is earned by a particular company or product over a specified time period. Market share is calculated by taking the company's sales over the period and dividing it by the total sales of the industry over the same period.

OPERATING COSTS OR FIXED OR INDIRECT COSTS

All costs excluding the cost of sales, interest charges and taxation. Examples include advertising and promotional costs, business rates, rent, salaries, travel and entertainment, research and development and utility charges.

OPERATING MARGIN

See Profit Margin.

OPERATING PROFIT

Revenue less the cost of sales and less operating costs. It is the profit made by a company from its day-to-day, trading activities. Other descriptions for operating profit are profit before interest and taxation (PBIT), earnings before interest and taxation (EBIT), operating income and trading profit.

OPPORTUNITY COST

The sacrifices involved or the consequences arising from pursuing one course of action rather than another. For example, a decision may be made to build a new factory on land that could otherwise be sold. If the factory is built, the opportunity cost of building the factory equals the sales proceeds from the land if the land had been disposed of.

PERFORMANCE

The standards and measures, financial and non-financial, that are used to assess the contribution of departments, individuals, sections and teams towards the achievement of specific results or objectives.

PRICE-EARNINGS RATIO (P/E RATIO)

The market price of a share divided by the earnings per share to give the number of years' earnings per share represented by the current share price. The higher the P/E ratio, the more attractive a company's earnings prospects are assumed to be. The lower the P/E ratio, the less attractive the earnings outlook. The average P/E ratio for leading companies in the UK is about 16.7 (March 2013).

The P/E ratio is a measure of the relative financial status between different businesses. It is not a true measure of performance because it is influenced by the vagaries of the stock market.

PRODUCT LIFE CYCLE

A marketing concept that describes the typical stages through which a product passes throughout its life. The stages are:

- Introduction – in the early stages, a firm is likely to incur losses as costs exceed sales.
- Growth – the product may now be generating profit, but competition may be intensifying as rival products are launched.
- Maturity – Growth rates are slowing down, but this is the stage at which greatest profits tend to be generated, as sales exceed costs such as investment in product innovations.
- Decline – The product becomes obsolete or superceded by innovations; there are so many competing products that it is no longer profitable.

NB. The product life cycle describes what happens in an ideal world – the reality of business can be very different!

PROFIT

The difference between revenue and the costs incurred during a financial period. In view of the accruals or 'matching' principle, earning a 'profit' is not the same as generating cash. Revenue is recognised in the financial period when goods or services are supplied or when work is done for a customer rather than when the customer pays.

Similarly, costs are incurred during the financial period to which they relate which may not be when they are paid for in cash. Some costs, such as depreciation, do not involve cash outlays at all.

It is important to note that there are a number of different measures of profit such as gross profit and operating profit.

PROFIT AFTER TAXATION

Revenues less all costs including financing costs or interest charges and taxation but before dividends. Also referred to as 'earnings'.

PROFIT BEFORE TAXATION

Revenues less all costs excluding taxation and before dividends.

PROFIT AND LOSS ACCOUNT OR INCOME STATEMENT (See the back of the Appendix for an example)

A summary of the revenue generated less the costs incurred by a company during a financial period.

PROFIT MARGIN (See the back of the Appendix for an example)

A measure of the profitability of revenue. It is defined as the profit before or after interest and taxation expressed as a percentage of revenue. The operating or trading margin is the operating profit or the profit before interest and taxation expressed as a percentage of revenue. The operating margin may also be called 'return on sales'. The average operating margin for leading companies in Europe is 10% approximately.

RETAINED PROFIT OR RETAINED EARNINGS

The profit for the year after deducting all costs and the distribution of dividends to shareholders.

RETURN ON CAPITAL EMPLOYED, ROCE (See the back of the Appendix for an example)

Operating profit expressed as a percentage of capital employed. An acceptable benchmark is about 15%. The ROCE measures the return earned by a business from its trading activities. This return is then compared to the return required by the shareholders and lenders financing the business called the cost of capital. For a business to create 'value', the ROCE should be greater than the cost of capital. The ROCE is a similar measure to return on investment (ROI, see below) or return on assets (ROA).

RETURN ON INVESTMENT (ROI)

An indicator similar to the Return on Capital Employed but, unlike the ROCE, it can be used in a wide variety of business rather than just financial situations. It focuses on management's ability to produce benefits in relation to the resources required to produce those benefits. For example, a project team may estimate that the investment required to introduce a new IT system is £1m. The team estimates that the benefits - faster processing times and reduced headcount - will reduce costs by £150,000 during the first 12 months of the new system's operation. The ROI will, therefore, be 15%. In practice, the challenge in working out the ROI is being able to quantify the benefits, costs and resources applicable to the initiative or project that is being considered.

REVENUE

See Sales.

RISK AND RISK MANAGEMENT

According to the CRF report 'Managing the People Dimension of Risk', risk is an 'uncertain future event which may or may not occur and which, if it does occur, will have an impact on objectives'. Risk assessment is intrinsic to decision making, and has important implications:

- Risks are related to the future and future events.
- Risks are inextricably linked to uncertainty.
- Risk is related to objectives. In order to assess risks, first be clear about your objectives.
- Risks can be both positive and negative. Taking 'good risks' is fundamental to business success, whilst mitigating against negative risks is vital in preserving business health.

There are a number of different kinds of risk, for example, 'operational' risk which covers a wide range of factors which could have an impact on the operations of a business and its ability to function. An example is a major power failure or a serious industrial dispute. 'People' are a key factor which means that operational risk should be managed in ways which ensure that individuals in all functions and at all levels appreciate how risk has an impact on what they do and how they do it.

'Risk management' has two elements. First, raising awareness and gathering information which can be analysed to improve understanding and aid decision making. Second, taking action based on conclusions from the risk analysis – the implementation stage.

SALES

The value of the goods and services provided to customers or the work done for customers during a financial period. It is also called revenue or turnover. It excludes VAT.

SHAREHOLDER RETURN / SHAREHOLDER VALUE / TOTAL SHAREHOLDER RETURN

Shareholder return or creating shareholder value is measured by two factors. The first is the change in a company's share price over a defined period. The second is the dividends received by shareholders again over a defined period. Assume, for example, that a company's share price was £1 on 1 January 2012 and it had risen to £1.15 on 31 December 2012. Assume, further, that a dividend of 5p was paid during 2012 for every share owned. The shareholder return during 2012 is 20%; the increase in the share price of 15p plus the dividend received of 5p to give 20p. This 20p of extra 'value' is expressed as a percentage of the opening share price of £1 to give a return of 20%. When shareholder returns are calculated for longer periods, say 5 years, it is assumed that the dividends received are reinvested to purchase additional shares.

For example:

Share price = 100p at the start of a 12 month period.

Share price = 110p at the end of the period.

Dividend per share received during the period = 5p.

The total gain = 110p less 100p plus 5p = 15p.

15p expressed as a percentage of the opening share price (100p) is 15%. 15% is the annual rate of shareholder return.

SMART

A long-established mnemonic to address quality of objective-setting and KPIs. Generally the letters stand for Specific, Measurable, Achievable, Relevant and Time-based. It can be beneficial to elaborate on what each word means when setting specific objectives, eg discussing degrees of 'stretch'.

SOLVENCY

The ability of a business to meet its liabilities as they fall due.

STOCKS

Raw materials, work in progress, finished goods and supplies. They are normally valued at cost or net realisable value, whichever is lower. The American term is inventory.

STOCK TURNOVER RATE OR INVENTORY TURNOVER RATE

(See the back of the Appendix for an example)

The average number of times each year that stocks are 'turned over'. It is calculated by dividing the cost of sales by average or closing stocks. When calculating the ratio from financial statements, the cost of sales may not be known and the sales figure is used.

STRATEGY AND STRATEGIC PLANNING

There are many views and many definitions! Richard Rumelt, 'Strategy's strategist' according to McKinsey, defines it as:

'Discovering the critical factors in a situation and designing a way of co-ordinating and focusing actions to deal with those factors. A good strategy recognizes the nature of the challenge and offers a way of surmounting it. Simply being ambitious is not strategy'.

John Kay, a leading economist, says that strategy is 'structured intelligent thinking about a business'.

The distinction between 'strategy' and 'tactics' as originally defined by Carl von Clausewitz should be noted, in order to keep strategic focus on higher and longer-term objectives.

Any strategy definition implies the selection of priorities, identifying the factors that create competitive advantage and making appropriate choices.

Richard Koch says that strategy can:

- Help define the different parts of a business and where it needs to do different things to be successful.
- Help to understand the customers' perspective and their purchasing criteria.
- Identify which customers should be cultivated most.
- Indicate where most effort and investment should be concentrated.
- Identify businesses or product lines which should be discontinued or sold.

Henry Mintzberg suggests that strategy formulation should be emergent, continuous and flexible, rather than planned at intervals, given that organisations face increasingly fast-moving, ambiguous and surprising operating conditions. It should be a creative interaction between business aspirations and results. The key to good strategy is sensitivity to market opportunities, the creation of superior products and services and the 'crafting' of strategy at all levels in an organisation.

Finally, while some strategies can be 'secret', it is generally best that they are both communicable and shared with key stakeholders, on whose co-operation or participation the organisation depends. Lengthy, complex and indistinct strategies are hard to remember and to engage with.

TRADING OR OPERATING PROFIT

Profit before interest and taxation (PBIT). It is also referred to as EBIT (earnings before interest and taxation) and operating income. Operating profit is revenue less the cost of sales and less operating costs.

TURNOVER

See Sales.

VALUE CHAIN

The chain of activities a firm performs to deliver a valuable product or service to the market. This can be physical activities (such as converting raw materials into finished goods) or virtual activities (eg. eBay brings together buyers and sellers in a virtual marketplace). The chain of activities should result in greater value added overall than the sum of each individual step in the chain. Companies can perform value chain analysis to identify the ways in which value is created for customers, and how this value can be maximised, for example through superior products or great service. Value chain analysis typically involves three steps:

1. Analyse the activities undertaken by the firm to produce a product or service.
2. For each step in the chain, identify what would add the greatest value for the customer.
3. Evaluate whether the changes identified are worth implementing, and develop a plan of action.

WORKING CAPITAL (See the back of the Appendix for an example)

Current assets such as trade debtors, cash and stocks less current liabilities such as trade creditors, bank overdrafts and accrued charges. Working capital is the investment a company makes in its short-term assets. They are the assets needed to operate on a day-to-day basis. Working capital is likely to fluctuate depending, for example, on the level of revenue and seasonal requirements. The aim is to keep working capital as low as practicable. By doing so, a business will generate more cash flow.

For business units which are part of a larger group, a narrower definition of working capital is often used – current assets less cash less current liabilities excluding borrowings. This is called operating or trading working capital because it focuses on those factors such as trade debtors and trade creditors which a local management team can control. For example, by reducing trade debtors and stocks and taking full advantage of the most favourable credit terms available from suppliers, working capital will fall and cash flow will be improved. If working capital management is lax, trade debtors and stocks go up so customers will take longer to pay, stocks will increase and payments to suppliers may be made before they have to. This means that working capital will rise and cash flow will get worse.

ZERO-BASED BUDGETING (ZBB) AND THE ZERO-BASED APPROACH

ZBB involves preparing a budget without reference to the previous year's budget. It challenges the status quo and assumes that the budget for a business, department, section or team should be prepared starting from scratch. A 'zero based' approach is radical thinking and action not inhibited by the existing situation.

Worked Examples

- Income statement
- Cash flow statement
- Balance sheets
- Three financial statements; how they link together
- Financial performance indicators;
  a. Profitability
  b. Working capital management
  c. Financial position

Global Services Limited

Income statement for the 12 months ended 31st March 2013

	£m
• Revenue	60
• Cost of sales	(15)
Gross profit	**45**
• Operating costs	(28)
Operating profit	**17**
• Interest charges	(7)
Profit before tax	**10**
• Tax	(5)
Profit after tax (earnings)	**5**

Note that (a) operating costs include a depreciation charge of £5m, (b) the dividend paid during the year was £3m which means that the retained profit for the year was the earnings of £5m less the dividend of £3m to give £2m.

Cash flow statement for the 12 months ended 31st March 2013

	£m
Operating cash flow:	
• 'ebitda'	22
• Capital expenditure	(15)
• Increase in working capital	(4)
Operating cash flow	**3**

Notes:

a. 'ebitda' = revenue – (the cash cost of sales + cash operating costs)
= £60m – (£15m + £28m - £5m of depreciation)
= £22m

This £22m is the equivalent to the operating profit of £17m plus the depreciation of £5m to give £22m.

b. Capital expenditure is the cash spent on fixed or non-current assets during a financial period. In the case of Global Services, it is £15m. Looking at Global's balance sheets you will notice that the fixed assets are stated at £105m at the end of March 2013 and £95m a year earlier. However, the £105m is after deducting depreciation of £5m. So before that deduction, the figure is £110m. The cash movement is £110m less £95m = £15m which is the capital expenditure during the year.

c. Operating working capital, £m

	2012	2013
• Trade debtors	20	22
• Stocks	13	17
	33	39
• Trade creditors	(4)	(6)
	29	**33**

The operating working capital has increased by £4m during the year. This is bad news for cash flow since, overall, Global Services is having to finance an extra £4m in short term assets.

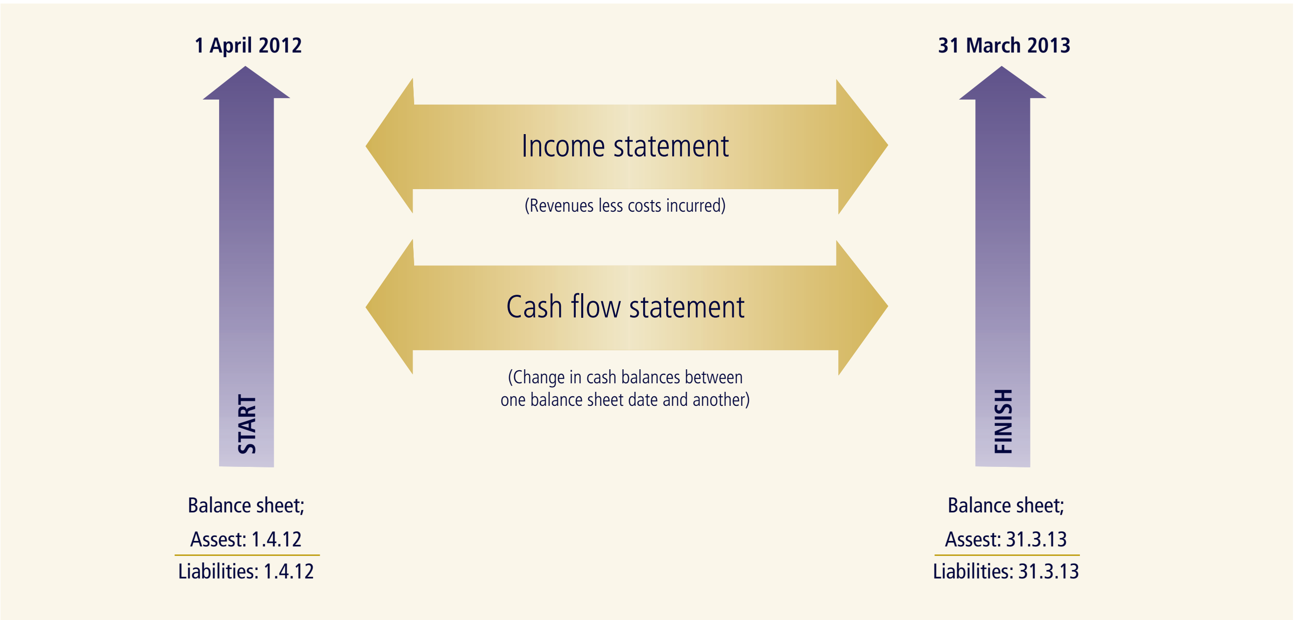
d. From the balance sheets, you will notice that Global Service's bank overdraft has increased by £7m. How can this be explained? See below:

	£m	£m
• Operating cash flow		3
• Dividend paid	(3)	
• Tax paid	(5)	
• Extra long term borrowings	5	
• Interest charges	(7)	
Non-operating cash flows		(10)
• Total cash shortfall		(7)
• Increase in bank overdraft needed to finance the cash shortfall		7

Balance sheets years ended 31st March 2013

	2012 £m	2013 £m
Fixed or non-current assets	95	105
Current assets:		
• Trade debtors/accounts receivable	20	22
• Stocks/inventories	13	17
Total assets	**128**	**144**
Financed by:		
• Share capital	100	100
• Retained earnings/profit	1	3
• Equity	101	103
Current liabilities:		
• Trade creditors	4	6
• Bank overdraft	-	7
Long term liabilities:		
• Borrowings	23	28
Total liabilities	**128**	**144**

Three financial statements; how they link together



Financial performance indicators for Global Services Limited year ended 31 March 2013

a. Profitability

- Gross profit margin = gross profit expressed as a percentage of revenue = £45m ÷ £60m x 100% = 75%.
- Operating profit margin = operating profit expressed as a percentage of revenue = £17m ÷ £60m x 100% = 28.3%.
- Return on capital employed = operating profit expressed as a percentage of capital employed (fixed or non-current assets + operating working capital) = £17m ÷ (£105m + £33m)= £138m x 100% = 12.3%.

b. Working capital management

- Days sales outstanding / collection period = accounts receivable or trade debtors ÷ revenue x 365 days = £22m ÷ £60m x 365 days = 134 days (too long!).
- Stock or inventory turnover rate = cost of sales ÷ year end stocks expressed as a multiple = £15m ÷ £17m = 0.88 times.

  This is equivalent to an average stock holding period of 0.88 x 365 days = 322 days (too long!).
- Cash conversion rate = operating cash flow expressed as a percentage of operating profit = £3m ÷ £17m x 100% = 17.6% (too low!).

c. Financial position

- Interest cover = operating profit ÷ interest charges expressed as a multiple = £17m ÷ £7m = 2.4 times.
- Debt-equity or capital gearing/gearing ratio = total borrowings less cash balances expressed as a percentage of equity = short term borrowings of £7m + long term borrowings of £28m = £35m – cash balances which are zero = £35m ÷ equity of £103m x 100% = 34%.

CORPORATE RESEARCH FORUM

CORPORATE RESEARCH FORUM

Corporate Research Forum
One Heddon Street Mayfair London W1B 4BD United Kingdom
T + 44 (0) 20 7470 7104   **F** + 44 (0) 20 7470 7112
www.crforum.co.uk   enquiries@crforum.co.uk   @C_R_Forum