THE INSTITUTE OF CHARTERED ACCOUNTANTS IN ENGLAND & WALES

The Institute of Chartered Accountants in England & Wales

Faculty of Finance and Management

Finance & Management

JUNE 2000 Issue 64

formerly FINANCIAL FOCUS

Isn't making money enough?

Digby Anderson deplores the corporate 'mission statement'

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Feedback

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June 2000 Issue 64

Faculty reaches 10,000 members

We are pleased to announce that the Faculty has reached its target of 10,000 members. This makes the Faculty of Finance and Management the largest of the Institute's faculties and we expect the growth to continue.

Elections – a new committee face

One new face has joined the Faculty's committee following the uncontested annual elections – and two committee members have been re-elected.

Kevin Bounds and Lois Bentley were re-elected for a second term of three years.

The new committee member is Paul Edwick, who has been running Lucy Locket, a privately owned fashion accessory wholesale business, since 1994.

This design-led company sells mainly into the UK market with most of the production coming from the Far East. Customers include Harrods and John Lewis, as well as high street multiples. Turnover is currently in the £1-2 million range.

Prior to the fashion industry Paul spent eight years in the home improvements industry. His time was spent dealing with operational, IT and management issues, as well as a mainline financial role. He qualified with a small London practice and then moved to Arthur Andersen for six years in the audit division, where he specialised in retail and publishing companies. (See Faculty face – page 12).

Annual meeting – a reminder

Members should make sure the Faculty's annual meeting is in their diary for later this month – Tuesday 20 June at Chartered Accountants' Hall in London, starting at 6.15pm.

This will be followed by a lecture by Dr Veronica Hope Hailey of Cranfield School of Management on 'Human capital – human performance – human resources – what's happening to people in our organisations today ?'.

For further details, see page 11.

Directory of Expertise

It is time for the annual revision of the Directory of Expertise. The directory is a searchable database on our website.

With the growth of Faculty membership, there are many new members who may wish to add their names to the directory.

You don't have to be an authority to be included, simply willing and able to talk to fellow Faculty members on areas where you have practical experience.

This way, we can all help one another, rather than re-inventing the wheel. To participate, please complete the application form included in this mailing and fax it or mail it back to us. Access to the database is restricted to Faculty members, so you will not be exposed to nuisance calls.

If you are already in the directory and your data are still correct you need do nothing. Please note that the address data are not linked to the Institute Database. Many members use a work address for the directory and home address for Institute mailings.

If you want to see how it works, log onto the website at www.icaewmembers.co.uk and click on the directory link.

FACULTY OF FINANCE AND MANAGEMENT

ANNUAL GENERAL MEETING

TUESDAY 20 JUNE, 2000 — 6.15PM

CHARTERED ACCOUNTANTS' HALL, MOORGATE PLACE, LONDON EC2

FOR FULL DETAILS – SEE PAGE 11

Working on the other side of the fence

Peter Woodlock, formerly in practice, reveals what he has learned since being on the 'other side' as finance director of a high tech electronics company, and what he would now do differently.

It is perhaps a truism, but accountants in practice should always remember that they are providing a service to clients and, therefore, that they should approach the job in exactly the same way as any other provider of products or services.

This involves putting the client first rather than purely 'listing' the services that it is felt that client requires. Given that basic premise, it is essential to:

- put the client first;
- anticipate and know client expectations;
- meet and exceed those client expectations;
- ensure the service is provided right first time;
- reduce the costs of poor quality; and
- reinforce good staff performance.

This article will deal with some of these issues and offer advice as to the 'dos and don'ts' for practising accountants dealing with current and potential clients. However, its content is not aimed exclusively at practitioners.

As the main decision maker in the purchase of financial and accountancy services could well be an accountancy colleague in the role of proprietor, financial director or management accountant, this article should be relevant to the majority of readers.

What do clients need?

The client, unless a very small business, is not normally going to require the traditional services provided by accountants – preparation of accounts and basic tax work – thanks to the rapid advance of technology especially in software products. Even if all or some of these services are required the need is normally met by part time staff, bureaux, self-employed book keepers etc.

For larger limited companies there will be the statutory audit. However, it is well known that audit work unless of a specialised nature, is now very competitive and often provided as a loss leader to gain other services of a more lucrative nature. It is still perceived by the client as a necessary evil, despite the reassurances given by accountants that the audit adds value by a deeper independent insight into the business. And in reality the costs of providing audits are so tight (unless undertaken very efficiently – and that depends on the ground work undertaken by the accountant prior to the audit) that this aspect, which could be of practical use to the client, tends to be overlooked.

And what do you want to provide?

The point here is that the accountant must be clear what section of the market place the firm wishes to service and the client business clear as to what services it requires. It should also be noted that buyers of accountancy services are much more aware now that they do not have to use just one accountant – or an accountant at all – for all their business needs. This is particularly true of book-keeping, payroll and management account services, as well as computerisation advice for accounting software.

Tax advice, audits and general accountancy advice can be provided by small to medium sized firms while specialist advice such as buying or selling businesses or insolvency problems could be brought in as and when required.

Other attributes that will be important in the suitability of a provider and recipient include geographical area, size, and clients in similar businesses.

Establish commonality

Assuming that these preliminary issues have been thought through by the parties, it is of utmost importance to establish with the client not only what it is that client wants from the accountant but also how they wish to work together. In establishing this commonality, the practising accountant should bear in mind some of the prejudices that clients have of the profession.

The common complaints are:

- arrogance;
- use of technical jargon;
- stating the obvious;
- lacking vision;
- charging for phone calls;
- not sufficiently explaining the nature of costs, or what has given rise to a charge; and
- open ended fee structures.

It should be pointed out that these are common complaints against professionals as a whole, and that sometimes the problem lies with the level of fees being charged, and the explanation for them, rather than with the service.

The customer comes first

To avoid such pitfalls, remember that the customer comes first. Listen carefully to the needs or perceived needs of the business and be prepared to suggest that some or all the requirements could be better met by another provider – this will gain respect.

Above all, question thoroughly the history, the proprietor's vision of the business and the problems faced.

Make suggestions as to how value can be added to the business:

- appropriate costing systems;
- methods of reducing overheads;
- comparisons with businesses in the same business sector;
- availability of grants and cheap, flexible sources of finance; and
- use of contacts.

Don't say:

- you need to improve your gross margins;
- you need to raise your prices;
- you are in the wrong business; or
- you have too many employees.

They may all well be true – but there is a very good chance that the client knows this already.

By taking this overall approach a sense of compatibility and understanding should emerge which is paramount if this relationship is going to work.

Open discussion of fees and structure of service

Once the problems have been defined and the services to be provided agreed upon, the question of fees and how the service is to be structured must be discussed openly. The majority of accountants still charge on an hourly basis but this is no excuse for being unable to give fixed fees.

The vast majority of other services and products are at agreed fees or prices, and most people would not dream of entering an open cost agreement. There are certain cases that are difficult to cost, for example litigation cases, but even here it can be argued that the accountant, with experience, should be able to give a fair estimate of costs.

A suggestion would be to offer a range of fee options:

- three star – a high monthly fee but covering all meetings, telephone calls, help line, proactive advice on the subjects agreed upon at the initial meeting. Ongoing business sector information. No hidden costs;
- two star – a more modest fee covering a limited number of meetings and specified service; and
- one star – a basic fee for essential services. No meetings. Limited contact.

Listen to clients, or be prepared for other sectors to take over the work

It is imperative to take a realistic view of clients' needs and demands and be prepared to be flexible. If the profession does not take heed and listen to customers, it is the writer's view that work that has been traditionally the domain of accountants will move to other sectors.

It has probably been noted by accountants in industry and commerce that at least one of our major banks has, after extensive market research, decided to take this approach with current and potential customers – and it is proving to be an efficient marketing tool. Part of the service offered covers the consultancy advice the majority of accountants value most in dealing with client affairs.

Staff training is also important – not only in the technical knowledge that is essential to provide the required service but also in dealing with clients on a personal level. Ensure they are aware of the services and method of working agreed with the client, that they give appropriate and timely information and advice and – above all – avoid asking for information that should be available from that held on file.

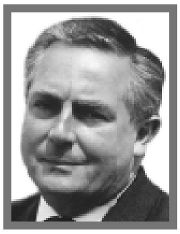
It should be remembered that many proprietors of businesses, financial directors, and other purchasers of financial based services want to share their problems and to seek second opinions. Accountants in practice are in a unique position to provide this with their knowledge and network of expertise and also to act as co-ordinator for a range of services a client may require. By taking account of the matters referred to in this article long term satisfying working relationships can be forged and retained.

Peter Woodlock is a Faculty member. After training at the London office of one of the major accountancy firms he was in practice in Bristol for a number of years both as a sole practitioner and as a partner in a six-partner firm. He is now financial director of one of his former clients – a high tech electronics company based near Cambridge.

The comments made in this article are entirely the author's own views, and not necessarily those of his company.

Mission impossible

Why do companies feel they must have mission statements? Isn't making money good enough, asks Social Affairs Unit founder director **Digby Anderson**.



What is the purpose of the for-profit corporation? The obvious, if modest answer is to make profits and give return to shareholders who have risked their money in it. But here is another, grander answer: "a good business should be a force for good in everything we do".

Who would make such a utopian claim? Perhaps some starry-eyed modern day Candide in search of the best-of-all-possible-worlds? No, in fact, it is BP Amoco. Everything? BP Amoco's directors have clearly mistaken themselves for God.

Unfortunately, BP Amoco is not the only company tempted to megalomania. Inspect the missions, visions and welcomes to our world of today's leading companies and you find an orgy of trendy, vacuous and sometimes even leftist terms. One Monsanto statement runs to 13 closely printed pages. Favourites are words such as sustainable, integrity, highest ethical standards, healthy environment, equality of opportunity, quality of life, empowerment, being in step with society, being a good citizen, good practice, acting responsibly, our social obligations, people as our greatest asset and, inevitably, diversity and partners. The whole world and his dog appear eligible for partner status.

Widgets plc

To whom it may concern

We aim to be good citizens, keeping in step with society and offering – through integrity and good practice – sustainable equality of opportunity so as to improve the quality of life and facilitate the empowerment of people, who are our greatest asset. We act responsibly to meet our social obligations together with our partners who, like us, espouse diversity and the highest ethical standards in the interests of achieving a healthy environment. Blah blah blah blah... and sometimes we try to make money for our shareholders.

The first casualty of these grandiloquent claims and promises is the obligation to shareholders. It is usually mentioned. But in the rush to show how the corporation serves everyone, any particular one – notably the one to whom the chief obligation is owed – can look like just one of many.

There are honourable exceptions. HSBC bluntly announces its task is to give its 17,000 shareholders a good return. When it does talk about values, it doesn't mean the happiness of seals but a strong capital and liquidity base. Yet even HSBC can't resist a little mantra about "the development of each local community". McDonald's is another exception. Right in the middle of its statement, it says: "Our efforts to increase market share, profitability and customer satisfaction have produced high return to shareholders, a compound annual return of 21% over the past 10 years."

But these, as I've said, are the exceptions. And the companies that are giving vent to all manner of cliches are causing all manner of problems. One of them is ethics. Ethics is not about glorying in extravagant aims but making tough decisions when priorities conflict. Nor is ethics about the incantation of supposedly ethical words such as integrity, or fashionable but now meaningless ones such as community. And corporations should not claim credit for effects they never intended. Successful corporations may create employment and customer satisfaction but that is a by-product of their search for profit and shareholder return. They, like anyone else, deserve no moral credit for the accidental – even if frequent – by-products of their behaviour.

Moral shallowness

The moral shallowness of the mission statements is a grave matter. It is in the interest of corporations that the public understands capitalism and the real benefits it has brought.

The inflated and ethically illiterate rhetoric does not help that understanding. Indeed it may lead to people expecting things of companies that they neither can – nor should be expected to – deliver.

Worse, there are currently all manner of anti-business activists who care little for capitalism and nothing for shareholders who are demanding that stakeholders (including themselves) be represented on company boards. The language of the mission statements may well assist them. Indeed some of it was learned from them.

Cynics will say that the mission statements are just public relations. But they are bad public relations. There will be a public stink when actual company behaviour is shown by the media to be at odds with the vision. In the interim, the statements may well cause damage within the firm.

Once the mission is enthroned and the vision agreed in the company, demands will arise that – in another cant phrase – compliance is ensured. The policies and practices of each department will be inspected to check that they comply. Empires will be built, careers made and bureaucracy spawned out of mission-led behaviour. If the mission itself is inflated, unrealistic nonsense, then actual nonsensical, unrealistic behaviour will shortly follow.

The above article first appeared in The Wall Street Journal Europe, and is based on Digby Anderson's report, 'Good companies don't have missions', published by the Social Affairs Unit, price £6.50 p&p. (Details about companies reflect their statements at the time of writing that report.) For copies of the report contact the Social Affairs Unit, 314-322 Regents Street, London W1R 5AB; or telephone 020 7637 4356.

Dr Digby Anderson is founder director of the Social Affairs Unit. He is author and contributing editor of a number of books and reports including 'Faking it: the sentimentalisation of modern society', and 'What has ethical investment to do with ethics?'. He is also a regular contributor to newspapers and periodicals.

ANBAR ABSTRACTS

A selection of abstracts from various sources with comments by the abstractor.

29AJ402 Touting with clout (accountancy services)
Smith S, *Accountancy* (UK)
Mar 2000 Vol 125 No 1279: p54
(2 pages)
● *Discusses how accounting firms can obtain extra business and looks at the critical success factors identified in a recent UK comparative survey of more successful and less successful firms. Stresses the importance of keeping existing clients happy, offering them extra services and obtaining referrals from them. Points out that not enough firms review the reasons for failure to win a pitch or master marketing techniques; and briefly describes the strategy adopted by one successful firm. Credits = 2.*

29AJ111 Corporate responsibility audits: doing well by doing good
Waddock S, Smith N, *Sloan Management Review* (USA)
Winter 2000 Vol 41 No 2: p75
(9 pages)
● *Seeks to demonstrate that a responsibility audit may narrow the gap between the values expressed in the mission statement and current business practice. Cites the outcome of beta testing for a responsibility audit process where eight companies identified measurable performance improvements by adopting responsible management practices. Argues that showing positive bottom-line impact is necessary to overcome managers perceptions of a trade-off between profitability and socially responsible business practice. Outlines the measures and audit methodology associated with responsibility audits, emphasizing the need to consider the stakeholder perspective and to benchmark against their expectations as well as best practice. Focuses on the four areas of quality management systems, environmental practices and energy conservation, human resources and human rights and community relations. Observes that, despite its potential as a core business strategy to improve profitability, few companies have yet adopted this approach. Credits = 3.*

29AG180 A factor lifeline (asset-based financing)
Smith S, *Accountancy* (UK)
Feb 2000 Vol 125 No 1278: p36
(2 pages)
● *Reports continuing UK growth in the use of factoring and invoice discounting, noting that whole-package asset-based financing (lending against all assets) is also beginning to take off. Compares this approach with more traditional financiers (ie banks), and sees it as a potentially useful method for larger, well-controlled companies with high stock and debtor levels (eg manufacturers, retailers) or seasonal cash flows; and for management buyouts and buyins as a way of reducing the need for venture capital funds. Sidebars the experience of one UK company in the paper industry which used asset-based finance from a US bank to finance an acquisition. Credits = 2.*

29AE585 Turning vision into reality
McCann M, *Management Accounting* (UK)
Jan 2000 Vol 78 No 1: p36
(2 pages)
● *Recognizes the importance of vision and strategy in business success but reports that less than 10% of strategies are effectively carried out. Suggests that use of the balanced scorecard can improve strategic understanding and considers problems of implementation. Identifies three key roles in the implementation team (architect, executive sponsor and key advocate), explains how to select objectives and describes how the balanced scorecard should be incorporated into management. Warns of pitfalls (eg closely copying other organisations) but believes that 'only when vision becomes reality can true success be achieved'. Credits = 2.*

The balanced scorecard – what & why?

In his address to the Faculty's half-day conference in Huddersfield, **John McKenzie**, director of consulting, sales and marketing at software and consultancy firm Armstrong Laing plc, described the role of activity based management (ABM) in improving the efficiency of the balanced scorecard approach.

One of the reasons many companies' attempts to implement the balanced scorecard (BSC) fail, John McKenzie contended, is that they have not asked themselves the basic question 'What are we doing to enrich our understanding of the business?'. They haven't done the work to find out what really drives their organisation.

In his view, the aim of the BSC is to help establish a set of clearly defined corporate goals that provides a reference point for the entire organisational performance measurement system, and to assist the coherent alignment of measures throughout the enterprise (at business unit, divisional, and departmental level).

The idea is to integrate strategy (in terms of customer relationships, core competences, organisational capability and R&D) with the BSC's indicators of how to reach the strategic goals (through identification of cause and effect relationships and performance drivers, and linking these to the financials). "However", he said, "in many cases things fall apart at the 'cause and effect' level, because management has not properly identified what drives performance."

Many companies, he went on, fail to match action to strategy. The ideal is goal congruence. Here, not only is the corporate vision clear and simple, with major goals set and a strategy established, but the employees understand the strategy and goals, and individuals know what they are supposed to do to help attain them.

However, this ideal is seldom realised. Instead of goal alignment, the board may be united on its aims, but these have not been driven down through the ranks.

Additionally, not all the relevant elements of the BSC (Figure 1 {a}) may be being measured, the result being a somewhat unbalanced scorecard with elements of the blueprint missing (Figure 1 {b}).

'Profitability' measurement may be missing in any real sense because although the organisation measures overall profit, it has no idea which customers, products and channels of distribution are profitable. Similarly, if the areas of 'value add' are not clearly identified, nor those of operational inefficiency, the business clearly cannot identify the areas which represent waste where costs can be cut while maintaining or improving service.

In fact, McKenzie said, the direct processes of most businesses – those that involve production, and tangible or physical processes – are fairly well understood and efficiently run. It is the indirect ones – marketing, R&D, order processing, financial management etc – which are poorly understood and controlled. Thus the indirect overheads often drift and grow, characterised by excess bureaucracy and low levels of customer satisfaction, yet involving large amounts of non-value added activity.

Indeed, he observed, most businesses' attitude to apportioning indirect costs, is to take the total remaining after direct costs and "slap it on with a knife, spreading it like butter over direct processes, products and customers". There is, he said, a much better system for discovering these indirect costs.

FIGURE 1 FINDING THE BALANCE

a) Elements of the balanced scorecard

Financial
- Sales
- Shareholder wealth
- Costs

Business process
- Innovation
- Operational efficiency
- Service
- Value add

Customer
- Market share
- Acquisition rate & cost
- Retention rate & cost
- Satisfaction
- Profitability

Growth & learning
- Employee competencies
- IS capabilities
- Motivation
- Empowerment

b) The 'unbalanced' balanced scorecard

Financial
- Sales
- Shareholder wealth
- Costs

Business process
- Service

Customer
- Market share
- Acquisition rate
- Retention rate
- Satisfaction

Growth & learning
- IS capabilities

What drives or causes cost?

Before expanding on how activity based costing (ABC) can help in identifying the drivers of cost, McKenzie provided a brief summary of the management terms it employs (see Figure 2 on page 8).

Traditional view of costing

McKenzie suggested that many traditional costing methods companies use to allocate indirect costs (direct labour, machine time, direct cost ratio) are 'precisely wrong'; they pro-

FIGURE 2 ABC MANAGEMENT TERMS

Term	Definition	Example
Function	an area of skills supporting one area in the business	accounts receivable
Activity	a series of related tasks carried out repeatedly	chasing customers for late payments
Driver	an event or factor which causes an activity to be performed	unpaid invoices
Process	a series of activities required to achieve an outcome	invoice processing

duce a precise figure, but one which does not apply cost as it is really incurred, ie through the drivers of product, customer, or related service costs.

ABC, on the other hand, comes up with a costing that is approximately right, by posing the pertinent questions 'What do we do? What drives that activity? Who or what is causing the driver?', of all activities, prompting often quite shocking answers.

For example, McKenzie said, it is not unusual to discover that your favoured customers are also the least profitable, because you are always prepared to go that bit further for them at no extra cost. Similarly, customers of seemingly equal importance (turnover, annual order size etc) can represent very different cost if they have differing levels of activity drivers - eg Customer A orders weekly, and thus in order processing terms costs four times the monthly order-placing Customer B. Also, if A is a consistent late payer, the activity costs of invoice chasing must be factored in.

In fact, a mere 20%-30% of all possible drivers in a business will account for around 90% of its costs. So identifying the key drivers is crucial.

Once the activity driven costs in the business have been identified, it is possible to look at the profit and loss account in a different way. The 'ABC contribution' – comprising of the customer, service/product and channel/ distribution-driven costs – can be deducted from revenue, and the difference between that figure and the bottom line profit or loss, gives the level of unabsorbed or 'sustaining' costs. In other words, the true overhead costs. In the vast majority of cases this will be much smaller than the usual amount traditionally allocated as 'overheads'. Focusing on reduction of these is a sure way to boost profits without affecting service or quality.

Business does not exist to service such 'un-absorbable' costs. What's more, said McKenzie, they can now be benchmarked, and tracked, so companies should be looking both at competitors and at their own past performance, to see if their own unabsorbable costs are reducing in relative and absolute terms.

How ABC can be used to cut such costs

McKenzie emphasised that ABC can only ever be as good as the user's identification and allocation of its own drivers. He went on to provide case studies demonstrating where it had helped unearth wastage otherwise invisible to management.

Product profitability

One study, of a leading UK manufacturer of speciality foods, looked at the profitability over 406 products. It emerged that only a small proportion of products were profit-making while the remaining 70% produced "a long boring tail of individually small but cumulatively significant losses".

The investigation as to contributory factors showed that the vast majority of the profitable products were bought in while the vast majority of the loss-makers were made in-house. As a result of these findings, and benchmarking itself against other food manufacturers, the company decided to streamline operations through re-engineering its processes, cutting out the worst loss-making lines, and freeing up capacity. The moral behind this story, McKenzie emphasised, is that "one should never lose track of the life cycle of a product's profitability. Loss-makers should be only those with legitimate reasons, such as new brands with start-up expenses. All your established products should be profitable cash cows."

Budgeting as the main planning tool

These days, McKenzie pointed out, budgeting – almost totally based on the financials – is regarded as the organisation's main planning tool. And for many companies it is used as a means of finding more creative ways to "swing the cost-cutting axe", the focus being on cutting cost rather than identifying its cause.

The ABC model, however, provides invaluable information about the activities performed in the organisation, how they are performed, and their drivers. Logically, there then follow only two ways of cutting those costs – reducing the unit cost of a driver, or decreasing the driver volume (eg encouraging customers to make less frequent orders for the same overall amount).

This, of course, is only possible if you measure driver performance as a matter of course. So, using activity based budgeting:

- resources are linked to the level of forecast activity, and to the efficiency of that activity;
- the volume of major activity drivers is used as the basis of budgeted cost; and
- efficiency improvement is measured and forecast as a reduction in the unit driver costs.

This is more relevant to management. Budgeting becomes a question of looking at the key drivers and asking what will happen in the coming year to impact on them. It is then possible to extrapolate from today's driver volumes and unit costs to those expected in the year to come, having built in increments where those will be inevitable. In this way the concept of zero-based budgeting – so attractive when mooted 25 years ago, but difficult to implement – becomes a reality.

Cost occurs horizontally, throughout the business

The common mistake of failing to focus on the drivers of cost is compounded, McKenzie added, by companies generally looking at cost vertically, when it is actually incurred horizontally throughout the business.

They look at cost as a result of undertaking functions, when it is in fact built up throughout a process.

Such a process is a succession of activities, each having inputs from previous activities and providing outputs to the next activity.

Thus the order fulfilment process shown in Figure 3 involves activities in five departments. And in any department, something could go wrong – eg customer errors, input errors, damage to goods, and more.

What companies need to focus on, he continued, is the fact that correcting such errors adds no value for either the customer or the business. Processes can therefore be improved by cutting as many non-value added and support activities as possible, and making the remaining value-adding ones as efficient as possible.

Value-adding activities

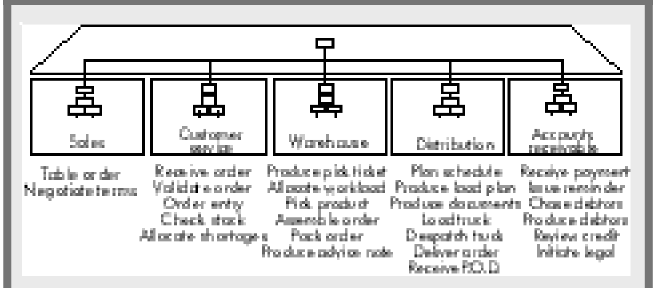
Examining how to identify which costs should or should not be cut, McKenzie proposed four types of corporate activity:

1. *customer value added (CVA)* – when the organisation gets something right first time, to the customer's benefit;
2. *business value added (BVA)* – activities which the customer will not appreciate immediately, but which bring longer-term improvements – eg research and development;
3. *non-value added (NVA)* – those which do not add value (even though they may produce customer satisfaction, in that rectification is swift) – eg error correction; and
4. *support or sustaining activity* – those activities which do not add value to the customer, but may be required for sustaining the business – eg stock taking, accounting.

The third category, he said, involves no added value to customer or business, and the aim should therefore be to eliminate these activities from any given process to the fullest extent.

Typically, the scope for improvement is considerable. For the average manufacturing company the activity cost profile shows only 40%-60% of the activities are value adding, and the figure for the average non-manufacturing company is a mere 35%-45%.

FIGURE 3 ORDER FULFILMENT PROCESS ACROSS DEPARTMENTS



Goal setting and stretching performance

What most organisations have, in terms of measurement of their performance, is a hierarchy (Figure 4) in which the board is concentrated on stakeholder needs (PBIT, ROCE, service etc), managers are focused on process or departmental measures (ie budget performance), and supervisors and employees, who should be subject to personal performance measures, are often aware of only 'woolly' and unquantified targets unconnected with departmental goals. The ideal is the second chart in Figure 4, in which driver volume and unit costs are the departmental focus, and at the supervisor/employee level, personal performance measures relate to causal analysis of driver volumes and costs.

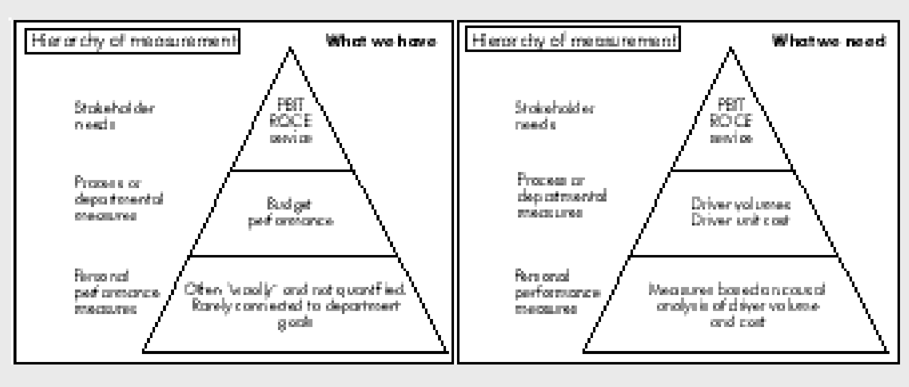
The traditional goal-setting behaviour of companies is to take the current value of a driver and alter it by plus or minus x (where x is usually a single digit figure within the comfort zone) to arrive at a target for next year.

What McKenzie recommended, however, was ABC analysis to find out what the business does, and its key drivers; use of that information to effect process improvements through the reduction of non-value adding activities; benchmarking the business against competitors to establish stretched objectives; analysing the causal factors in any inefficiency perceived, and, finally, the setting of personal objectives and performance measurements based on these factors.

Moving towards the ideal process involves drawing up a flow chart with 'error loops' or NVA activities grouped where possible, identifying the drivers that trigger them, and performing a root cause analysis of each. It should then be possible, with realistic expectations, to chart the new ideal process including changing the drivers.

Thus ABM in conjunction with benchmarking, profitability analysis, and process improvement, can 'stretch' the organisation's objectives over a realistic period to reach standards previously unattainable.

FIGURE 4 THE HIERARCHY



John McKenzie is a director of software and consultancy firm Armstrong Laing plc. Tel: 01565 687 000; fax: 01565 750 030; email: johnm@armstrong-laing.co.uk

Risk is what you make it

Chris Mansell writes about the stresses and strains of risk management, and looks at the issues of providing security for loans.

Any treasurer worth his cap and collar is into risk management. So indeed are those company directors who seek to be at the leading edge of corporate governance. Inevitably there is an emphasis on procedures, controlling committees and reporting. While some framework for risk management within an organisation is essential, it would be unwise to ignore the human factor which operates at a collective as well as individual level.

To the financial community corporate risk combines the potential size of a loss (or indeed gain) with the variability of that outcome. Whether or not to hedge a stream of US dollar receivables might offer a simple example. If 5% of a company's sales are so denominated, the level of risk is insignificant compared with 35% exposure. And even though the conversion rate to sterling may vary by 10 or more percentage points over a 12-month period, there is much more flexibility in timing the conversion of the smaller cash flow.

An individual's perception of risk is quite different. The two factors that combine, according to research, are (i) fear and (ii) control, or the extent to which we personally cannot handle the potential outcome, mitigated by the degree of control we think we have over the situation.

The current state of loss or gain is an important factor. When individuals are winning, they become more risk-averse, being anxious to hold on to the gain. The reverse applies in a loss situation, on the basis that they have little to lose by taking further risk (eg Barings). These characteristics run contrary to a rational organisation's objective of maximising profits. With individual attitudes shifting over time as well as events unfolding, the model becomes pretty complex.

Further dents in the rational corporate machine arise from what psychologists call cognitive bias. We all use shortcuts (or mental templates) in decision-making, both individually and collectively. Some people call it using experience, others (with PhD's) heuristics. The trouble is that these patterns are based, for example, on giving more weight to information that is familiar and available. This is reinforced in the financial markets by the notion of following the consensus (the momentum). Research undertaken at the University of Chicago has shown that a significant proportion of market volatility stems from overreaction to recent news.

We also enjoy having our prejudices reinforced. Once a view has been formed there is a tendency to pay more attention to information that confirms rather than gainsays it. Another interesting area, to which the more dynamic breed of manager is prone, is the illusion of control: the belief that a situation can be controlled (embodies lower risk) when logically it cannot. Worse, time and much nervous energy is expended in trying to change a situation rather than adapt to it. Comments about 'doing something' about the current strength of sterling reflect this trait. Finally there are personality factors. Some people are just more risk-averse than others.

The research work has pointed up several areas that are worth watching:

- managing upside as well as downside risk. Some management cultures foster a 'gloomier than thou' approach to judgement, leading to missed opportunities;
- the annual bonus cycle is liable to influence risk-taking decisions as they seek to lock-in rather than dissipate gains. This may lead to short-term under-achievement; and
- control illusion is apparently widespread, especially in high stress environments. Creating opportunities for discussion, reflection and mind-changing might usefully be encouraged.

Taking charge

The least enjoyable bit of obtaining a bank loan is the negotiation on security. Personal security normally takes the form of a guarantee or comfort letter agreeing to pay some or all of a borrower's debt in the event of default. The guarantee will not nominate a particular asset for realisation so all a guarantor's assets are at risk.

Real security describes where a specific asset owned by the debtor is pledged and it is up to the bank to ensure that the security is adequate. Banks tend to prefer a fixed charge which is specific. A general floating charge is weaker security. The company is free to sell the assets or grant a fixed charge over them which takes priority. Worse still, the bank will rank behind preferential creditors in liquidation.

FORTHCOMING FACULTY EVENTS

20 June
AGM &
LECTURE
LONDON

Dr Veronica Hope Hailey of the Cranfield School of Management discusses 'Human capital - human performance - human resources - what's happening to people in our organisations today?' Registration 6.00pm; AGM 6.15pm; lecture 6.30pm and buffet 7.30pm.

Dr Veronica Hope Hailey BA MSc PhD MIPD, is senior lecturer in strategic human resource management at Cranfield School of Management. As a visiting fellow at London Business School, she is part of the research team working for the Leading Edge Forum, a multi-sector consortium of companies funding a large nine-year research project examining HRM and change management in their own companies. Her previous appointments include a Fellowship at the University of Cambridge. She is consultant to a number of major corporations and has written various books and articles.

CONFERENCE PROGRAMME 2000

20 September
LONDON

29 November
SOLIHULL

The Faculty is holding a series of half-day conferences, with a range of speakers. The timetable will be the same for these events (the first was in Huddersfield in April):

9.00	Registration and coffee.
9.25	Welcome and introduction.
9.30	'The development of strategic performance measurement' *Kevin Bounds, director of world class finance – insurance, KPMG Consulting.*
10.30	'The balanced scorecard – what and why?' *John McKenzie, director, Armstrong Laing.*
11.30	Tea/coffee.
11.45	'The inner business of creativity and innovation' *Marian Moriarty and Dave Smith, Inner Business.*
1.00	Buffet lunch.

Kevin Bounds is director of world class finance – insurance at KPMG Consulting, after a line career in financial services, which included being finance director for NatWest Life and then Nationwide Life. Kevin also sits on the executive committee of the Faculty. John McKenzie is director of sales and marketing at Armstrong Laing. He is a member of the Finance Faculty of the Management Centre of Europe, based in Brussels, where he teaches on performance measurement and financial planning and control courses. Dave Smith spent 15 years working in R&D: amongst other qualifications, he has a degree in applied biology. Dave has a deep interest in metaphysics, which led to him create Inner Business with his partner Marian Moriarty. Marian Moriarty, a founder of Inner Business, works as facilitative consultant, trainer and coach in the fields of creativity, innovation and change management. She spent eight years as a marketeer with an American multinational.

From left to right: **Kevin Bounds, John McKenzie, Marian Moriarty and Dave Smith – pictured at the April Huddersfield conference**

TO ATTEND ANY FACULTY EVENT, PLEASE FILL OUT THE FORM WHICH ADJOINS THIS PAGE, REMOVE IT BY TEARING ALONG THE PERFORATION, AND MAIL IT OR FAX IT TO DEBBIE CAME AT THE FACULTY'S ADDRESS GIVEN ON THE BOTTOM OF THE FORM

Making the case for SMEs

Paul Edwick is the latest recruit to the Faculty committee, having been elected in April. He unashamedly brings with him a brief for the small to medium size enterprise. Helen Fearnley reports.

Paul Edwick has already served on a BCAB committee (now disbanded) on the issues facing SMEs, and would like to further that work within the Faculty. Those running small businesses, he says, "in general face a broad range of subjects on which (they) are the in-house source of expertise".

His chief interest is "the development of start-up companies, from marketing, design and other front-end issues through to the critical question of funding". The funding issue, he feels, is all too readily left to the factoring houses, which often cannot adequately meet the needs of rapidly growing companies.

As he sees it, factors are fine for many businesses with steady growth and little seasonality, but provide no help with initial development and working capital. The big factors who dominate the market are effectively formula lenders with all of the inflexibility that that entails. For growth trading companies, smaller, flexible factors are crucial, as is a proper bank manager.

Edwick began his own career by qualifying with a small London practice, then moving to Arthur Andersen where he spent six years in the audit division. In both firms, he specialised in retail and publishing companies.

A move into industry followed, leading to an eight-year stint in the home improvements sector, first at Wickes, where he spent the majority of his time dealing with operational, IT and management issues, then at Norcros in a more mainline finance role.

Of these two – very differing – experiences, he found his time at Wickes perhaps the more beneficial. "There, it was not so much a question of following audit trails as establishing management processes that would carry through the board's plans."

Since 1994 he has been running the privately-owned fashion brand Lucy Locket. The company – started with minimal capital by Edwick and his wife – now has a turnover of between £1 million and £2 million. It sells in the UK mainly at the mid- (or higher) market level to customers including Harrods, John Lewis, and high street multiples, and has successfully developed a distinctive house style.

In Edwick's view, the challenge for the next two years is to further increase Lucy Locket's appeal with a wider product range sold through more varied distribution channels in the UK market, plus expansion into the US.

Turning to a broader canvas – his ambitions for SMEs, through his Faculty committee participation – Edwick says he has three priorities.

"First, the most pressing need is for a reduction in red tape. Politicians' statements on this bear no relation to their actions, and they need to be told this bluntly. Second, I am longing to see SMEs make intelligent use of practical IT. Currently even big companies do not use it correctly (e-mail messages, for example, being simply ignored rather than picked up, when the addressee is travelling). But for SMEs, IT provides real opportunity.

"And third, we need greater encouragement of entrepreneurialism. It is no accident that the City has turned against the risk averse, cost cutting culture of so many large businesses. The challenge now is to enable the ideas people to have a go at creating new wealth-generating businesses."

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