ICAEW FINANCE & MANAGEMENT FACULTY

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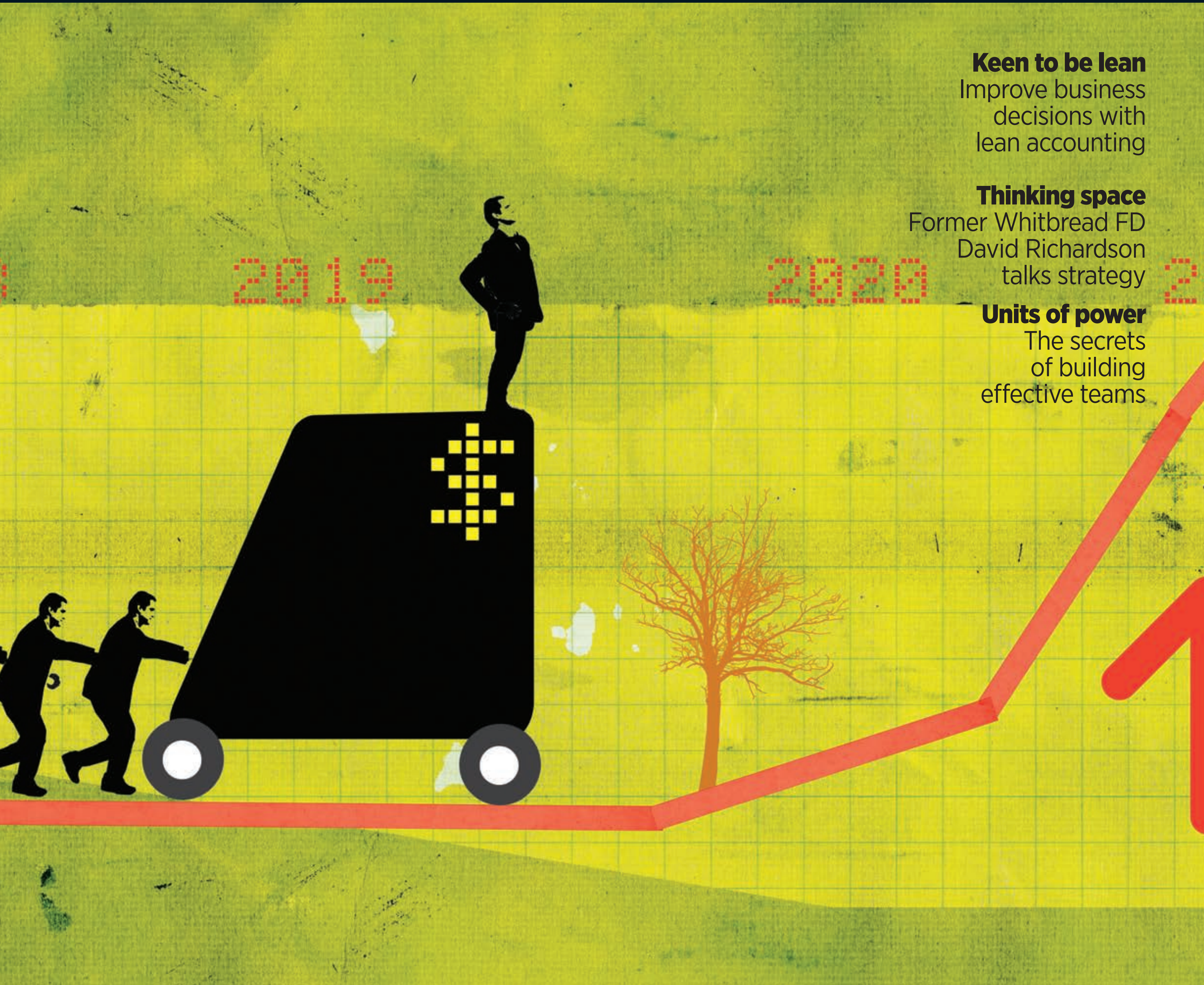
FINANCE & MANAGEMENT

"IT'S NOT ABOUT FINDING OUT FACTS… IT'S WORKING OUT THE ART OF THE POSSIBLE" PAGE 10



Keen to be lean
Improve business decisions with lean accounting

Thinking space
Former Whitbread FD David Richardson talks strategy

Units of power
The secrets of building effective teams

Long-range forecasting
Better tools to foretell the future

Official fuel consumption figures in mpg (l/100km) for the RX F SPORT: urban 43.5 (6.5), extra urban 47.1 (6.0), combined 44.8 (6.3). CO_2 emissions 145g/km. GS 450h F SPORT: urban 40.9 (6.9), extra urban 49.6 (5.7), combined 45.6 (6.2). CO_2 emissions 145g/km.

AGM 2012 Report

FINANCE & MANAGEMENT FACULTY

Chairman Carolyn Bresh welcomed members to the faculty's 2012 annual general meeting (AGM) on 9 May, noted there was a quorum, and proceeded to introduce acting faculty head Emma Riddell.

Later, she invited members to raise any questions they had about the content of the annual report. Prior to taking those members' questions, however, she reviewed the faculty's achievements over the past 12 months – another successful year, despite the continuing difficult economic climate.

First she expressed appreciation of everyone who had helped the smooth running of the faculty's services – namely, the executive team (Emma Riddell, Rick Payne, Jennifer Chong [appointed technical manager in late 2011], Caroline Wigham and Aude Bezler), the members of the committee with particular gratitude expressed to Tony Powell deputy chairman and Dr Philip Smith council representative, and ICAEW's faculties' operation manager Norma Pavitt (for invaluable support on compliance).

Looking at what had been on offer for members during 2011, Carolyn singled out the extensive events programme (back to its usual consistently high standards after a couple of disappointing events), the faculty magazine *Finance & Management*, and the special reports (*Personal Development* and *Balanced Scorecard* getting special mention). She also mentioned the faculty's continuing adaptation to members' changing needs – evident in the evolving online services such as webcasts, edited recordings of events, and electronic bulletins (all particularly appreciated by the growing international membership). She noted that the faculty's LinkedIn community now involves almost 1,300 finance and management professionals, while the Women in Finance network has over 400 members.

Additionally, she praised the FinanceDirection thought leadership programme's report *The Finance Function: A Framework for Analysis* for its painstakingly researched findings and guidance for those seeking to build an effective finance function.

Despite the depressed economic climate, membership numbers remained fairly steady at 8,032 at the end of 2011 (8,131 in 2010). And despite starting to charge a small amount for events, attendance figures appeared unaffected.

Looking ahead, she said the faculty would continue to seek to meet the needs of members, wherever they are located. The aim is to continue to evaluate and evolve the service – and to that end feedback from members is welcome.

Regarding the formal business of the meeting, the first proposal – that the annual report of the committee and the financial statement for the year ended 31 December 2011 be accepted – was put to the meeting, questions invited and answered, a vote taken, and the report and accounts approved. The chairman noted some changes in the committee membership since the last AGM – namely, the uncontested election to its membership of Ben Freeman (finance change consultant at Make Change Happen Ltd), Tristan Price (group FD at M.P. Evans Group PLC) and Nick Wildgoose (global supply chain proposition manager at Zurich Insurance Group), plus the re-election for a three-year term of Graeme Scott. Tony Powell, faculty deputy chairman, has also taken up a co-opted place.

She also mentioned the valuable contributions that had been made by Daniel Holden, Helen Jesson and Patricia Spreull, who stepped down after the 2012 AGM, and her hope that all three would stay involved in an informal manner.

Finally, after inviting and answering questions on the faculty's activities, she declared the formal business of the AGM concluded.

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is founder of Jean Cunningham Consulting


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TOP LINKEDIN THREADS

- Zero based budgeting – alive and well?
- Managing cross cultures and virtual teams
- Ten steps to stronger governance

To enter the debate join our group – ICAEW Finance & Management Faculty at linkedin.com

CONFERENCE CALL

More than 80 FDs gathered at Chartered Accountants' Hall in May for the ICAEW FD Conference, which took as its theme the Many Hats of the Finance Director – based on the articles we ran last year.

Former Young FD of the Year Andrew Lewis captivated delegates with his account of the turnaround at Avon Rubber. He joined the company a week before the collapse of Lehman Brothers in 2008 and his first duties included managing a heavy loss for the year and refinancing the company's debts just as the global banking system was imploding.

Lewis emphasised that a no-suits policy was one of many ways he's demonstrated that through hard times and good, the finance function is at one with the business. Indeed, breaking down the barriers between the FD and the rest of the organisation was one of the themes of the whole day.

And in a panel discussion, Balfour Beatty CEO and former FD Ian Tyler explained that although command of the numbers and commerciality is a given for those seeking to be a great finance director, today you must demonstrate outstanding leadership both as a board member and the head of your function to win over colleagues and team members.

ICAEW is hosting a conference specifically for financial controllers on 18 October. Look out for more details over the coming months on our website and in the pages of *Finance & Management*.

GET INVOLVED WITH YOUR FACULTY

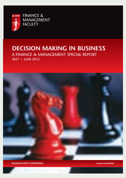
We are always looking for volunteers for the faculty's organising committee. The committee's role is to set the strategy and to ensure that the advice, events, publications and technical guidance we deliver is accessible and practical. The committee meets four times a year and works mainly via email – so it's a great opportunity to get involved.

For more information please contact Emma Riddell at emma.riddell@icaew.com

SPECIAL REPORT: DECISION-MAKING IN BUSINESS

Decision-making is a vitally important activity that lies at the centre of every business. Business decisions can be complicated but regardless of the complexities, there are steps decision makers should follow to achieve a robust decision-making process.

Our latest special report on decision-making in business is not a step-by-step guide, but aims to provide you with an overview of the key aspects, including important techniques to improve your current decision-making processes. This report, by a range of authors, also aims to provide practical guidance and an outline on the theory behind the process from a leadership and data quality perspective.



To read the full report, see icaew.com/fmsr37

MEMBERSHIP BENEFITS SUMMARY

We want you to have access to the best value CPD, plus services that will help you advance your career. But do you make full use of everything available to you as a member of the faculty?

- Monthly magazine;
- In-depth regular special reports;
- Monthly e-newsletter;
- Free online access to any article or report published by the faculty;
- Regular events with discounted rates for faculty members;
- Opportunities to network with your peers through our LinkedIn groups;
- Women in Finance network; and
- Chance to be part of our thought leadership project.

Plus – since 2011:

- Shorter, sharper webcasts available to watch on demand.

And remember, in a networked world, the more accountants in business who join the Finance & Management Faculty, the more value all of us get from it.

If you know someone who might be interested in joining, direct them to icaew.com/fmjoin. We offer an enhanced corporate membership scheme.

Call our client relationship manager on 020 7920 8659.

WEBSITE RESOURCES

If you enjoy this magazine, then check out the faculty's website – icaew.com/fmfac, where you will find:

- articles;
- special reports; and
- webcasts.

You can search the archive by topic – log on to icaew.com/fmfknowledgesearch

Faculty events

Building a successful finance function; women's business network and the risks of outsourcing

TURNING AROUND A FINANCE FUNCTION – PANEL DISCUSSION
CHARTERED ACCOUNTANTS' HALL, LONDON

19 June 2012, 17.30-19.00

This event is free to faculty members. Join us for a lively debate on how to build a successful finance function. We will discuss issues such as: What constitutes a poorly performing finance function? What does success look like? How do you overcome the common pitfalls when implementing change? Our panel will include CFOs who have been there and other experts in the field.

Who should come? Finance professionals with responsibility for a finance function.

Why? An understanding of how to develop your finance function.

More information and online booking: icaew.com/fmfjuneevent

WOMEN IN FINANCE NETWORK: MANAGING YOUR PERSONAL BRAND – A VIEW FROM FINANCE
CHARTERED ACCOUNTANTS' HALL, LONDON

26 June 2012, 17.30-20.00

A personal brand is "the public projection of certain aspects of a person's personality, skills or values that stimulate precise, meaningful perceptions in its audience about the values and qualities that person stands for." Sinead Bryan, vice president of Finance for Oracle UK, will discuss how she has taken control of her own personal brand in her career journey and she will share some practical experiences in developing and leveraging a personal brand. This session will allow you to take some time to reflect on your own personal brand and consider if it is helping you to achieve your own career goals and aspirations.

Who should come? Women in business.

Why? To develop your own individual brand and improve your personal impact.

More information and online booking: icaew.com/wifjuneevent

OVERCOMING THE PITFALLS OF FINANCE AND ACCOUNTING OUTSOURCING
CHARTERED ACCOUNTANTS' HALL, LONDON

10 July 2012, 8.30-10.00

This event is free. Great advances have been made in the practice of finance and accounting (F&A) outsourcing in recent years. During this session, Simon Speirs, from Sutherland Global Services, will share some of the lessons learnt that now allow greater flexibility and help mitigate key risks. We will identify some of the key pitfalls and provide practical advice on how to avoid them. The pitfalls we will be discussing include: The risk of loss of control over your own operations, difficulties in managing supplier relationships, overcoming internal resistance to outsourcing, reputational risk associated with an underperforming supplier, and the risk of outsourcing something that would better remain in-house. This session will be practical with lessons from industry and there will be plenty of time to answer your questions.

Who should come? Finance professionals considering, or currently implementing, F&A outsourcing.

Why? For an awareness of the pitfalls in F&A outsourcing and how to avoid them.

More information and online booking: icaew.com/fmfjulyevent

WOMEN IN FINANCE FLAGSHIP EVENT: HEAD HUNTERS – REALISING YOUR DREAM JOB
CHARTERED ACCOUNTANTS' HALL, LONDON

19 September 2012, 17.30-20.00

Trying to find the right job in today's competitive environment can be a difficult task. How can you increase your chances of landing your dream job? This event will feature a panel of leading head hunters from a variety of fields of expertise. There will be advice and helpful tips to drive your career forward, plus the opportunity to ask questions in smaller groups.

Target audience: Women in business.

Benefits: Assistance to find your ideal job position and networking opportunities.

Further information about this event will be available shortly on our website.

Further information about the above events can be found at icaew.com/fmevents

A window on strategy

A 22-year stint at Whitbread culminated in **David Richardson** becoming the leisure group's FD. But he arrived in the role after a career in pure strategy – which, he tells Andrew Sawers, remains a much misunderstood discipline

Part finance, part marketing, it's the cool and sexy part of business that everyone wants to be involved with. Put 'strategy' into Google and you get 905,000,000 results. Type in 'generally accepted accounting principles' and you can take 900,000,000 off that number: a paltry 4,920,000.

Because everyone wants to have their say on strategy, there are usually several people at the top of an organisation who weave it into part of their role. And it rarely has an entire person all to itself – maybe it's just too good not to share it around. But a "strategy director", as such, remains a rare beast indeed.

David Richardson is – or more accurately, was – that rare beast. With a finance background stretching back to his training at Touche Ross, he had a number of finance assignments at beer and pubs group Whitbread before landing the plum role of strategic planning director – a main board role he relished for eight years before adding the finance director job.

DEFINITIONS OF STRATEGY

"Strategy is a much overused word," says Richardson, who retired from Whitbread in 2005 while still in his early 50s to take up a "plural" non-executive career with companies such as Serco, De Vere Hotels, Forth Ports and Tomkins. (He's also chairman of ICAEW's Corporate Governance Committee.) "If you ask people for definitions of 'strategy' I think you'd get a lot of different answers." For him, strategy is about; "working out which products you take to which markets and how you do that and how you do it in such a way that you create value or make money for your shareholders or beat your cost of

TINA HILLIER

capital. Strategy is about working the product-market matrix," he says.

In this, Richardson is clearly a disciple of Igor Ansoff, widely regarded as the father of strategic management. In a 1957 *Harvard Business Review* article (see snipurl.com/ansoffHBR) and then a 1965 book, he developed the idea of a matrix that helps managers think about how to take existing products into new markets, or new products into existing markets, or new markets and new products, and so on. The matrix you build up then helps you think about market penetration, product development, market development, or diversification. Sure enough, when asked to name someone who has inspired him, Richardson immediately says "Ansoff".

But for someone steeped in finance, Richardson's take on the skill set required for a strategy role comes as a surprise: "The people who do it either have a marketing background or a finance background and, in my view, you need more from marketing. The finance bit you can buy in. The marketing bit requires more inspiration."

Not, presumably, something for which most finance people are well known. So how does a finance person plug that gap? "There are umpteen books you can go and read," he replies – 100,791 books, it would appear. "There are good seminars and a thing called the Strategic Planning Society. Then you start asking questions: what products do we have? What products are adjacent to the products we have that we could expand into? Which markets are we in, which markets are adjacent to those?"

But it's more than just asking a series of questions, which any comprehensive, but generic, checklist might well be able to take care of for you. "The art is not about finding the facts," he explains, "it's about working out, what's the art of the possible? Would so-and-so fit? Does that have a resonance in the marketplace? Does it fulfil a need?"

A challenge for finance people in this sort of role is that; "it's not a physical science, there aren't one-to-one relationships between these things. So you have to explore lots of different routes and find out what starts to come out on top. And then it doesn't always work." Richardson adds, moreover, as the strategy person, "There's no point having a whizzy idea because you're not the person who's going to implement it. You've got to get other people fired up by it."

STRATEGIC-THINKING MATRIX

This brings us to an important distinction: strategy vs implementation. "If you want to increase profits quickly in a business, better execution is by far the easiest way to do it," he says. "You can't change strategy overnight, but you can start to improve execution and performance overnight."

The strategist can't ignore the execution capabilities, however Richardson says: "If you're not operating efficiently it's quite difficult to build a strategy: 'If we were good at that, we could do this – but we're not really good at that so we can't do this!'"

So there's a strategic-thinking matrix with an overlay of skills and connections to execution. But 20 years ago, Whitbread's strategy required a lot more than that.

Back in the 1980s you'd walk into a Courage pub and buy Courage beers. Whitbread pubs specialised in Whitbread beers. The breweries owned the pubs and so they sold their own beer. Following a House of Lords ruling in a case alleging breach of Article 81 regarding vertical agreements, the Monopolies Commission investigated the industry. It concluded that the industry had to divest itself of 14,000 pubs to break the tie between making beer and the venues where it's sold. The aim was to increase consumer choice and lower prices. (Richardson is emphatic that, apart from cheap beer in supermarkets, neither aim was achieved – but that's by-the-by.)

> "If you want to increase profits quickly in a business, better execution is by far the easiest way to do it"

The industry, not least Whitbread, was in a state of upheaval thanks to the so-called Beer Orders that were issued by the government to give effect to the Monopolies Commission's recommendations. There were demographic trends, too, indicating a decline of beer drinking in pubs. What, then, to do? Richardson, who had worked at Whitbread since 1983, had been made up to strategic planning director in 1993: the task was to turn the beer and pubs company into a "leisure" business.

"Basic drinking was declining – but eating out was growing," Richardson recalls. Whitbread was already proving reasonably successful with the Beefeater and Brewers Fayre brands: "We were perceived as good operators in those sectors. A lot of the skills of running pubs are similar to the skills of running restaurants. So it's an extrapolatable piece."

Within two years, coffee shops were added to the portfolio. "Pubs fulfill a need for people: they provide a place for a break in the middle of a busy day. But if you're not going to drink alcohol, where can you go? The coffee shop business in America was beginning to get some legs," he says.

They bought and expanded the Costa Coffee chain which, up until then, had been positioned mostly at or near train stations, not the high street. "We knew that coffee was going to be good," he explains. "Starbucks didn't exist in the UK in 1994-95, when we did that work."

When Whitbread bought the David Lloyd chain in 1995, City analysts – who really ought to have known better – called Richardson to ask how much beer the gyms were selling? (To be fair, like branded coffee shops, chains of health clubs were another American import that weren't exactly well known over here at the time.)

CLEAR DESK AND DIARY

1995 was a busy year for Richardson because hotels were next, with a chain that later developed into Premier Inn and the acquisition of the Marriott franchise in the UK. The internet was about to change the hotel industry, opening up a whole new distribution channel. "That's a fascinating thing about strategy," he says. "You think you understand your market – and you do at a point in time. But there's the forward-looking bit: where is this market going?"

And it's hard to think of things like that if you have a day job to do as well. That's why Richardson not only luxuriated in being able to concentrate on strategy, he also had the clearest diary of anyone at Whitbread. Caveat: "Except when I was doing a deal.

Then I was 24/7 doing that deal. But when I wasn't, I could sit and think," he says.

Adding new legs onto the business is one thing. Amputating the 260-year-old core that gave the name to the company is quite another. In 2000, Whitbread sold its beer division to the company now known as InBev and the following year the pubs were demerged. Radical moves, perhaps, but to Richardson it simply came out of the strategic thinking process. Whitbread had been blocked by the Office of Fair Trading in its attempt to buy the pubs owned by Allied-Domecq: "We couldn't stay in the same shape we were in and get bigger, therefore you think, what shape should I change into?" Richardson explains. "You look at all possibilities and that was the normal strategic planning process."

With a board member by the name of Sam Whitbread and a residual Whitbread family holding of a few million shares in the company, Richardson concedes that, "there was a bit more explaining to do than might otherwise have been the case".

But there is a difference, as Richardson explains, between business strategy and group strategy. While the former looks at individual businesses, the latter asks, "What's the link between these businesses in a group?" and "does the group add value to these businesses?"

"At its peak Whitbread had enormous breadth: beer manufacturing, Costa Coffee, David Lloyd, four-star hotels – it was quite a complex beast," says Richardson. "And it was challenged all the time for being a corporate conglomerate. 'How can anybody run all these businesses successfully?' It's a reasonable question."

In Whitbread's case, answering it has often resulted in disposals, even of businesses that had been in the group a fraction as long as beer had been: David Lloyd, Marriott, Heineken, Pizza Hut – all sold. Now it's pretty much just Premier Inn, Beefeater, Brewers Fayre and Costa Coffee.

And there's been one more disposal since Richardson left, too: there's now no one person on the board who calls themselves "strategy director".

A case of matrix unloaded?

Andrew Sawers is former editor of *Financial Director* magazine

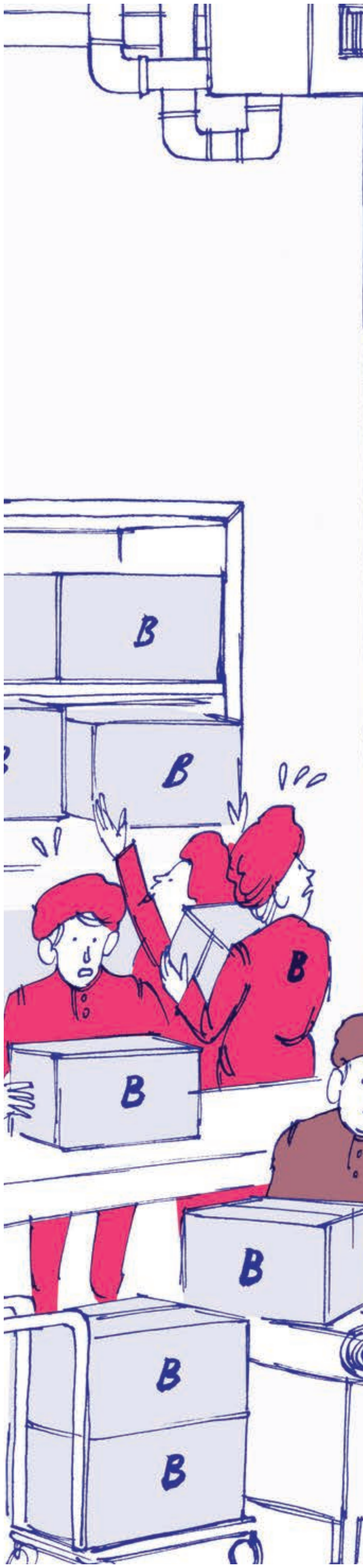
STRATEGY AND THE REST OF THE BOARD

The CEO: "Chief executives are battered to death by all sorts of things. In a lot of ways they are the chief strategist because, unless they are convinced, nothing is going to happen. However, they can't be the guy who does the thinking because they don't have the time to do that. The CEO has got to totally trust his strategy guy."

The CFO: "The strategy guy is gung-ho: 'We could move in to ABC; it will cost a few hundred million.' The finance guy is to some extent the corporate conscience. He's got to be the brake, the sceptic – and at the end of the day he's got to raise the money. He's a challenger to the strategist's process – but it's not a conflict, it's a natural combination."

The board: "The board is vital to the role because it sits at the top of the business. [But] the board can really only be informed by the executives. The non-execs can't sit in a company and say, 'Why don't you do X?' Their job is to help or to make the executives think of issues they might not otherwise have thought of."

The lean vs standard cost accounting conundrum



Ever felt your business decisions are based on irrelevant or incomplete information? **Jean Cunningham** uses three case studies to illustrate how lean accounting can improve your decisions, whatever your industry

A study reported several years ago in the *Harvard Business Review* concluded that 50% of executive decisions are made on intuition. Surely that is cause for alarm. Is business decision-making necessarily that much of an art? Are executives not well trained in the use of decision-making tools? Or is it that executives sense that their information and data is skewed for some reason, and so go on gut feel in order to arrive at a comfortable decision?

The following are three true stories to show how using lean accounting, rather than standard cost accounting, can lead to better decisions.

CASE A: A 'MARGIN' MISJUDGMENT

Manufacturing company A had purchased a large, new press. Its existing product base would use only 10% of the capacity of the new machine, so the sales force was asked to approach new customers to capture business that would utilise this press. After diligent efforts, the sales people returned to the corporate office with several new opportunities that would be manufactured using the new press. However, they were soon told the orders would not be accepted. What happened?

Company A, like most others, used standard cost accounting. So the orders were submitted to the accounting department to be 'costed' for evaluation of the profit potential of the orders.

The gross margin percentage for the orders based on standard cost accounting was only 16% – less than A's target margin of 25%. So the controller decided to reject the orders. The sales force was deflated. Something did not seem right and its intuition was buzzing. After all, the equipment was available and while the staff might have to be increased, the decision still didn't seem to make sense.

Standard cost accounting treats all manufacturing costs as variable. So in order to develop the potential cost for these products, the accounting group looked at each of the routings required to manufacture the product and estimated the amount of time required at each routing. They then applied the costing rate for each routing to those hours to get the estimated labour and overhead cost. Then, they added the actual materials required, based on the bill of materials. When adding these together, the total manufacturing cost was identified.

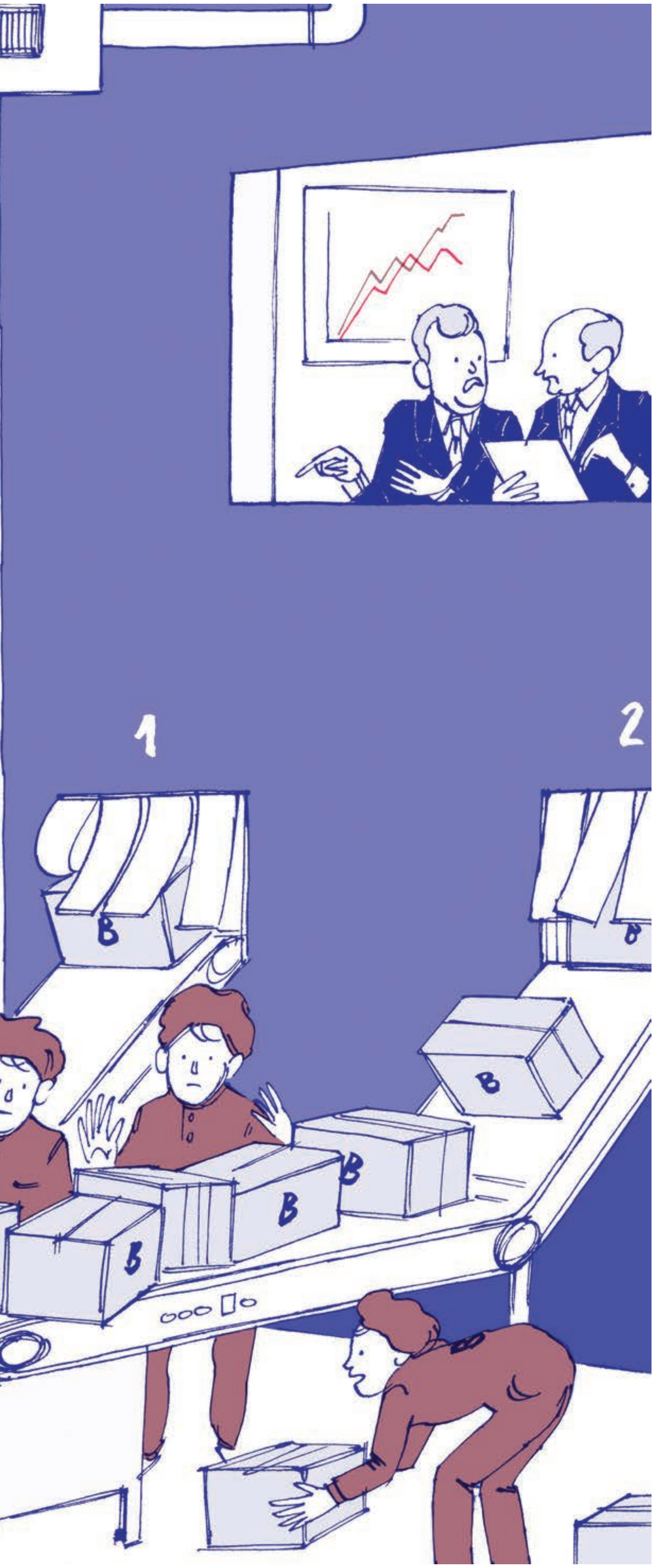
What types of costs were put in the cost per hour for each routing? They included labour, supervision, utilities, supplies, equipment depreciation, material handling, maintenance, etc. These are all the costs that GAAP indicates are manufacturing costs.

However, the reality of any new orders to utilise the new press was that the only resulting cost increases would be for materials plus one additional direct labour employee (if, indeed, one needed to be hired at all).

A lean analysis of the impact of the new orders is shown in the tables overleaf, outlining:

1. The 'traditional' decision factors for decision-making in this business.
2. The lean analysis of existing business.
3. The lean analysis of the new business – whether 10,000 units or 2,500 units.
4. The lean analysis of the combined 'old' and 'new' business.

Should the sales team's orders be pursued, the key



considerations would be:

- one additional employee needed:
- a 50% probability of 10,000 new units ordered: and
- a 95% probability of 2,500 new units ordered.

And the lean analysis for the new orders would be as shown in Table 3 overleaf.

FAULTY ASSUMPTIONS

As shown in Table 4 overleaf the overall gross margin percentage on the new business increased well beyond the 25% threshold when only the actual costs (incremental revenue, material, labour) were added to the existing book of business.

After the controller had made the 'thumbs down' decision, the sales force sought outside help to uncover what impact these orders would really have. Then they were able to get a meeting with the president and the controller to present a different picture – the analysis shown in the tables overleaf.

When the controller was faced with this 'actual increase' analysis, he nevertheless remained unconvinced. He was concerned about what would happen if ALL the business came in at this lower gross margin percentage? What if the press reached capacity and a second machine was required?

This, even though the time to reach capacity on this machine – even with these new orders (and others) – was expected to be years in the future. The controller was holding so tightly to standard cost thinking that he was willing to forego near-term incremental profit and cashflow to avoid what 'might' happen in the distant future.

This kind of thinking occurs because of the way traditional financial analytical information is presented which drives decision making on faulty assumptions about manufacturing a product. And, in this particular case, once a decision maker announces a decision, it is often hard, emotionally, to reverse the decision even when faced with evidence to the contrary.

It would have been much easier to pick out the relevant costs and revenues for decision making if only:

- the financial statement had been displayed with the expense types clearly listed; and
- the accounting adjustments for GAAP inventory valuation had been displayed separately.

A statement arranged like this is called a 'plain English' or 'lean' financial statement. (Below is how a lean financial statement might look.)

LINE ITEMS ON A TYPICAL LEAN STATEMENT

- Net sales
- Material cost
- Variable margin
- Variable margin %
- People pay
- Overtime
- Benefits and taxes
- Supplies
- Utilities
- Facility cost
- Equipment depreciation
- Manufacturing costs
- Accounting adjustment for labour and overhead in inventory
- Total cost of sales
- Gross margin

The lean statement continues to follow GAAP with manufacturing costs gathered in the cost of sale section, and inventory valuation includes labour and overheads. It is just presented differently.

The lean financial statement can take many different forms. But the one shown here demonstrates some of the key elements they have in common, namely:

- The costs that truly vary with sales volume are separated from those that either vary indirectly with sales volume or not at all.
- Each type of cost is reported rather than merged into 'standard cost and variances'.
- The accounting treatment of changes in labour and overhead in inventory is captured on a separate line. This treatment is especially critical when the inventory levels are decreasing (as happens in the early stages of a lean manufacturing transformation).

If A's controller had been used to seeing lean financial analysis, he almost certainly would have approved the new orders. The advantages in profit and margin would have been obvious, and the need to apply intuition would have been minimised – at least, relative to financial impact.

> If A's controller had been used to seeing lean financial analysis, he would have approved the new orders

RESULT – A BAD DECISION AVERTED

Luckily, the president of company A was not part of the initial negative decision, and only saw the lean analysis. In the end he decided to override the controller and the new orders were taken.

CASE B: SHOP FLOOR GAINS BURIED BY TRADITIONAL REPORTING

A private equity firm B acquired several companies in related industries that collectively comprised over 50 manufacturing plants in the US. This merging resulted in duplication and excess capacity across the plants as a whole. Simultaneously, management began to adopt lean concepts in one third of the plants. At the end of the first year, the plants that had adopted lean concepts were seeing significant decreases in work in process (WIP) and finished goods – as is to be expected from the initial stages of a successful lean transformation.

As part of the original purchase plan, the private equity firm was planning to close a few of the plants. It was now time for management to decide which plants to close.

Two of the plants selected for evaluation made the same products in the same area of the country. One had started a lean transformation and the other continued using traditional manufacturing techniques.

A decision was about to be made to close the plant undergoing the lean transformation because its gross margin for the past twelve months was the lower of the two, and its production per employee was less. But operations staff were concerned that this was the wrong choice.

> The lean plant had reduced spending and improved cashflow

During the preceding year all the plant's employees had been trained in lean concepts and had deployed them in small teams to make improvements to the equipment set up, placement, and maintenance.

They had reduced overtime. They had reduced batch size – resulting in lower finished goods levels and faster lead times. They had eliminated large amounts of WIP and finished goods.

As a result, the lean plant had achieved some reduced spending and significant improvement in cashflow. Yet the income statement showed a lower gross margin percentage and productivity per employee was down. Why?

The lower margin and productivity figures were a result of the traditional income statement being used, and the non-lean-centric information presented by standard cost accounting.

Lean manufacturing is based on customer orders (pull), and not on building up inventory (push). Even though revenue remained strong, the plant was not replacing the inventory being eliminated (a good thing).

Because of this, the current costs – that had actually decreased (another good thing) – were not being moved off the income statement to the balance sheet.

Therefore, there were unfavourable variances with labour and overhead was not being 'absorbed' to the balance sheet.

Also, because the productivity metric was based on units produced instead of units shipped, the productivity metric trended negative – because the only way to reduce inventory in times of level revenue is to reduce the number of units produced.

So, even though the workers and supervisors of the plant were hugely successful in retaining cash, reducing spending, reducing lead times, and engaging all the employees in lean learning, they were all about to lose their jobs, and they all knew intuitively that 'management' was crazy or worse.

If the plant had used lean financial analysis and statements, the operations staff would have seen the actual costs becoming favourable. Also, the very positive reasons for the unfavourable gross margin would have shown in the accounting-based inventory valuation line. Instead the reasons were buried behind variance and standards.

RESULT – THE WRONG CHOICE FOR VALUE CREATION

In the end, the lean plant was closed. The choice was made by corporate-level decision makers based on traditional GAAP numbers only.

This is a perfect example of dramatic improvement gains on the shop floor being buried in traditional reporting framework. From a value creation vantage point, it looks like a mistake.

1. TRADITIONAL DECISION FACTORS

Quote price	$30/unit	**Gross Margin %**	16.67%
Standard cost	$25/unit	**Gross margin target**	25%
Gross margin	$5/unit	**Current gross margin**	23%

2. LEAN PROFIT STATEMENT FOR EXISTING BUSINESS

	Direct ($)	Shared ($)	Total ($)
Sales	100,000		100,000
Material	20,000		20,000
Direct Costs	18,000		18,000
Shared		39,000	39,000
	62,000	(39,000)	23,000

3. ANALYSIS OF NEW ORDERS

	Incremental impact with 10,000 new units ($)	Incremental impact with 2,500 new units ($)
Revenue	300,00	75,000
Material	60,000	15,000
Variable margin	240,000	60,000
Direct cost	40,000	40,000
Profit	200,000	20,000
Gross Margin %	67%	26%

4. LEAN PROFIT STATEMENT SHOWING OLD, NEW, AND COMBINED BUSINESS

Lean profit statement existing business				New Total with 10,000 additional units	New Total with 2,500 additional units
	DIRECT ($)	SHARED ($)	TOTAL ($)	($)	($)
Sales	100,000		100,000	400,000	175,000
Material	20,000		20,000	80,000	35,000
Variable margin	80,000		80,000	320,000	140,000
Direct costs	18,000		18,000	58,000	58,000
Shared		39,000	39,000	39,000	39,000
Gross Margin	62,000	(39,000)	23,000	223,000	43,000
GM %			23%	57.5%	24.6%

ILLUSTRATION GWENDAL LE BEC

CASE C: MORE MEANINGFUL DATA FOR SERVICE COMPANIES

For service related companies including legal, medical, consulting etc, the issues related to manufacturing costs don't exist, but lean accounting can still help provide more meaningful information. Just like in the manufacturing environment, some of the cost and revenue is truly variable, others are direct to a specific product line, and yet others are general overhead to provide support to the product lines.

As an example, consulting services company C traditionally reported its financial statement based on the type of cost: travel, salaries, benefits, office rent, etc.

Faced with significant shifts in volume it was not sure if it should decrease staff in some areas, or add staff in other ones. Traditionally it would just have done a cost reduction across the board, or increased spending related to shifts in overall revenue, ie 'If sales are up 8%, every department budget is up 8%.'

This time the company decided to:

- realign some financial line items to show two types of revenue for product lines: repetitive sales versus one-time sales and any variable costs (commissions, bonus, travel, advertising) associated with each;
- next, look at the more fixed costs that were direct to a specific product line which included employees salaries and related benefits; and
- finally, separate the remaining cost between office cost, marketing, and owner costs.

Now they could see the relationships between these elements and manage them accordingly, based on the purpose of each cost.

RESULT – FASTER PROFIT GROWTH

The improved categorisation, presentation, and understanding of the nature of costs resulted in profits growing much faster than revenue, leading to improved margins.

ASK YOURSELF SOME KEY QUESTIONS

These are difficult times where companies more than ever need to make the best decision every time. As a decision maker basing decisions on financial analysis to support your company's growth and success, I think it is important to ask yourself the following set of key questions.

When faced with similar situations to those described would you:

- Have the information and numbers that are truly relevant to product or structural decisions?
- Be prepared to put in the additional time and effort it takes to overcome the misleading financial indicators?
- Make the correct decision?

Well, would you?

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GETTY IMAGES

Better forecasting power

Uncertainty in economic markets and the effects on world trade make it even more difficult for finance to deliver reliable forecasts. **David Baines** explains some techniques to improve forecasts during times of volatility – and to help you achieve them

Were the future certain, forecasting would be easy. But it rarely is. As WC Fields once remarked; "The trouble with the future is it hasn't happened yet."

If you face massive uncertainty, draw comfort from the fact that you are at least aware of it. The even bigger danger is when you think things are set fair. Lulled into a false sense of security, you are loath to acknowledge warning signs until too late. Remind yourself to re-read this paragraph when today's difficult times are a distant memory.

A graphic example of failing to spot change is given in Figure 1, overleaf. It shows successive sales forecasts from 1974 to 1979 of an old-established type of switch and compares them with actual sales. Ericsson's forecasters clung to the same trend line in all their forecasts, simply starting from the latest outturn figure. They ignored the precipitous fall in sales as customers moved to a new technology.

Jan Wallander, a non-executive board member of Ericsson at the time, called this thinking 'same weather tomorrow' because it failed to acknowledge the radical changes in the market.

How differently Ericsson would have behaved had it had an accurate forecast in mid-1974. It would have:

- aggressively pursued R&D into the new switch technologies;
- invested heavily in new technology sales; and
- swiftly decommissioned old plant, replacing it with facilities to make new-generation switches.

ARE YOU JUST GUESSING?

First a simple thought: if you struggle to achieve sufficiently accurate forecasts, maybe the best thing to do is to stop making them. Many organisations provide a detailed forecast for every budget line for each of the 12 months of the budget year. Why? If the variable that is being forecast depends on factors that cannot possibly be predicted with any accuracy at the designated future point in time, you are simply inviting people to guess. And if you are guessing, no one will take notice of your forecast. It's a waste of time.

FORECASTING TECHNIQUES

You can't stop forecasting completely just because it is difficult. For most organisations, forecasting the big variables in the business is essential for timely planning. So what techniques – other than guessing – are available? They can be split into two categories, objective and subjective.

Objective techniques

These take past performance and use mathematical methods to project a forecast. They range from the simple to the bewilderingly complex and, unless you have a penchant for advanced mathematics, it is perhaps good advice to steer clear. However, it is worth mentioning one method, regression analysis, which is available on Excel and, while being mathematically powerful, is easy to use.

Suppose you want to forecast a variable, for example sales volume, but have little idea what the future holds. Ask yourself if there is another variable that you can forecast with reasonable accuracy and that you suspect has a relationship to sales. Depending on the product or service you are concerned with, you might choose gross domestic product (GDP) or customer sector size or number of people in a particular socio-economic group. Assemble past data of sales, and of your chosen variable, for a set of comparable periods, such as each quarter in the last five years.

Regression analysis determines from this data whether your hunch is true that a relationship between sales and your chosen variable actually exists. If it does, regression analysis gives you the algebraic relationship, and tells you how strong it is. Once you have this relationship, you can

> If you struggle to achieve sufficiently accurate forecasts, maybe the best thing is to stop making them

> For most organisations, forecasting the big variables in the business is essential for timely planning

forecast sales from the forecasts of your chosen variable. The four steps involved, using GDP as the variable, are summarised in Figure 2, overleaf.

For those who want to pursue regression analysis using Excel, TREND and LINEST are the two functions you need to explore.

Subjective techniques

These involve people's judgments rather than mathematical manipulations. Four techniques offer insights that can make the difference between stabs in the dark and informed predictions. They provide not just a forecast but prompt you to develop plans for delivering it. Note that mathematical methods wouldn't have helped Ericsson much, but all four subjective techniques would.

1. Historical analogy

There is nothing new in the world. Have similar circumstances to those you now face been experienced before? Are there any pointers that might guide you to a better forecast based on those earlier events? The technique is apt for new product or service introductions and for economic downturns.

2. Expert opinion

For most sectors and markets, huge amounts of information and opinions are available. You can build a profound knowledge and understanding by giving yourself time to keep abreast of developments in your field. Places to seek out information include:

- newspapers and journals (the *Financial Times* was predicting a credit crisis emanating from sub-prime mortgage lending at least 18 months before chaos struck);
- the internet;
- industry reports;

- the British Library (free to join, and gives you access to just about everything);
- your network of contacts.

One company has six board members. Each is allocated one letter from PESTLE (Political; Economic; Social; Technological; Legal; Environmental) and has to report monthly on external developments associated with their PESTLE letter that they think might affect the business. It is an excellent way of reducing the chance that something will catch them unawares.

3. User opinion

Many organisations don't try hard enough to understand their customers' views and intentions. Have you ever thought; "if someone from that supplier asked my opinion, I could give them useful insights?" Never miss an opportunity to explore what your customers think. Develop your listening skills, and use them!

4. Internal opinion

The sales forecast can be difficult to get right compared to cost forecasts, which are often stable and/or predictable. Sales forecasts are usually the responsibility of the sales department and forecasting is often viewed by them as just another administrative chore.

For sales people, forecasts also entail a difficult balance between going high to satisfy senior management and going low for bonus considerations. Under these circumstances, achieving an objective sales forecast that reflects strategy, market and technology changes and likely competitor moves is a tall order.

It is therefore worth considering the process of creating your sales forecast. Test yourself with these questions:

- Is it only those in sales who can contribute to a robust sales forecast? Do people from marketing, customer service, strategic development, R&D and, for that matter, finance have a valid viewpoint, and are they involved?
- Is all the data on which forecasts are based available to the team making the forecast? This includes historical sales and margins; customer/market intelligence; relevant indicators of future demand (eg consumer spending; industrial confidence indices); strategic and business plans, and competitor plans. If the data is available, is it in a convenient format? If not, the team is unlikely to use it.
- Do you review forecasts to assess how good they are and to seek improvement lessons?

Never miss an opportunity to explore what your customers think. Develop your listening skills

None of these subjective techniques is rocket science and you will be at least vaguely acquainted with them all. The question is, are you using them? If not, you risk guesswork.

5. Timing

It is worth checking how the timing of sales is assessed. Often poor sales forecasts are due not to wrong values but to over-optimistic judgments as to when sales will occur. Look back at historical data, derive mean times at which sales of various types can expect to be invoiced, and use these timings.

DEALING WITH UNCERTAINTIES

Well, you say, we have checked all the things mentioned so far and are satisfied that we do pretty well. But we still face huge uncertainties that no forecasting system in the world can overcome. Is there anything more we can do? Definitely! The three scenario approach, described below, helps manage the uncertainty.

The three scenario approach

Good forecasting can only ensure that you rationally assess all the information and judgments that are available or that can be found. It can't work miracles or provide time travel. The three scenario approach doesn't improve the accuracy of the forecast, but it does add insight to the forecast and to the decisions you must take. It can substantially reduce risk, and so add value.

Normally when you forecast, you create a single predicted outcome, which should be the most likely. But, being optimists, people often predict the best outcome, assuming that everything will go swimmingly. If the whole budget is based on best-case assumptions, the chances of achieving budget plummet.

The three-scenario approach creates, unsurprisingly, three outcomes: as well as the most likely, you develop a best and a worst case, and give each case a probability of occurring. The probabilities

FIGURE 1: ERICSSON

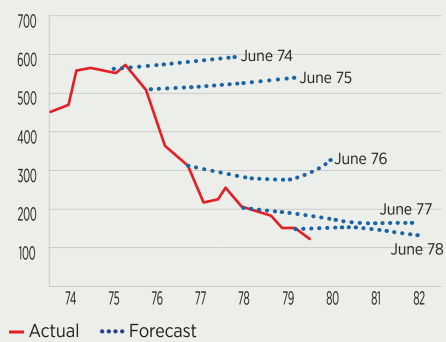
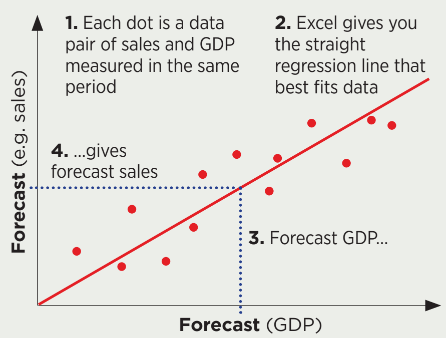
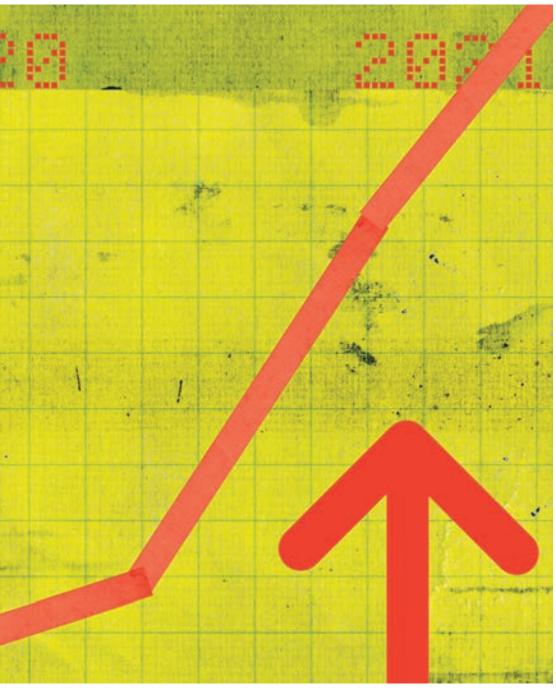


FIGURE 2





of the three cases must add up to one because, by definition, one or another will result. Let us say, to give a simple example, that you plan to develop a new service at a cost ‘c’ from which you derive a revenue ‘r’, giving you a profit π (= r–c). Together with other managers in the company, you use your skill and judgment to derive the scenarios shown in Figure 3.

Imagine you run an experiment in which you develop the new service many times, not learning from experience. You would get a different result every time because of the probabilities associated with the random variables that affect the outcome. The figure you get – the mean – by averaging all the outcomes is given by the statistical formulae:

mean revenue $= \sum_{n=1}^{3} (r_n \times p_n) = 2$

mean cost $= \sum_{n=1}^{3} (c_n \times p_n) = 1.7$

mean profit $= \sum_{n=1}^{3} (\pi_n \times p_n) = 0.3$

It takes effort to create the three scenarios. Is it worth it? Well, it helps avoid creating a best case that you mistake for the most likely. Perhaps more importantly, it gives a range of possible results. If the outcomes of all three scenarios are close together, the implied risks are low. But if the best case is mouth-watering or the worst case catastrophic, the stakes are higher. It raises questions:

- What actions can we take now to achieve the best case?
- What actions can we take now to avoid the worst case?
- What contingency plans can we make in case the worst happens?

These actions and plans will alter either the probability or outcome of a case, and hence the mean outcome. This is useful because it allows you to decide if the action plan is worth implementing.

For example, say you are thinking of running a pilot of the new service before the full launch. Doing so will change the case probabilities because you will learn lessons from the pilot. You judge that the new probabilities are as shown in Figure 4 below.

Applying the new case probabilities to the mean formulae shows that running the pilot increases mean profit from £0.3m to £0.7m. So provided the pilot costs less than £0.4m, it is worth doing. Providing quantification of the options in this way is right up finance’s street, and delivers a great service to the business.

You are unlikely to want to apply the three-scenario approach to every forecast in the budget, only to the most important. Nevertheless, it enables you, when looking at the budget figures, to get a sense of the range of likely outcomes rather than a single figure. After all, a single figure seems simplistic given the uncertainty.

People often predict the best outcome, assuming that everything will go swimmingly

SUMMARY

Short of building a miraculous prediction machine, forecasting will always be error-prone because of the uncertainties the future holds. But we can do better than uninformed guessing based on a desire to achieve a rosy outcome, or a naive faith that the past will repeat itself. Short of miracles, the way forward means hard work and honest assessment: assemble the relevant facts, opinions and viewpoints; determine the best and worst cases and decide what to do about them; be guided by the strategy; don’t just look at the numbers – debate the underlying reasons and plan the way forward.

I cannot forecast how you will get on, so good luck.

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FIGURE 3

Scenario	n	Probability p	Revenue r (£m)	Cost c (£m)	Profit π =r-c (£m)
worst case	1	0.2	1.5	3	(1.5)
most likely	2	0.6	2	1.5	0.5
best case	3	0.2	2.5	1	1.5
mean			2	1.7	0.3

FIGURE 4

Scenario	n	Probability p	Revenue r (£m)	Cost c (£m)	Profit ϖ =r-c (£m)
worst case	1	0.1	1.5	3	(1.5)
most likely	2	0.5	2	1.5	0.5
best case	3	0.4	2.5	1	1.5
mean			2.15	1.45	0.7

Asking the other questions

Failing to take into account the unquantifiable can ultimately lead to poor business decisions. Learn **Sir Donald Cruikshank**'s lesson and always keep an open mind

ANDREW BAKER/IKON IMAGES

What you know, and particularly what is quantifiable, is rarely enough information or the right information with which to make a decision. This is actually quite disturbing stuff. It is a question of; "What can we know?"

One of the reasons I keep a diary is not to do with issues facing me, but with issues facing other businessmen or politicians. I write down what the outcome on an issue is going to be and why. In other words I use information available at the time to write my diary.

When the original idea was proposed that Granada, Carlton and BSkyB would get together to deliver digital terrestrial television in the UK. I saw that as being anti-competitive, too much of a concentration of power, particularly since Sky dominated the digital satellite television market.

The competition authorities decided Sky had to leave that consortium, and I have a contemporaneous diary entry saying that Granada and Carlton would be crazy to proceed with their current plans because of the way in which Sky would probably respond; partly through spite, but partly for good management reasons. So what information was missing?

If I put myself in Granada and Carlton's shoes, all the market analysis was still the same – the propensity of people to have a box in their home, which would pick up a digital terrestrial signal. None of that had changed and neither had the financial analysis.

What had changed was the competitive context in which they were now launching that service. What they failed to understand was how Rupert Murdoch and Sam Chisholm, chief executive at that time, would react… in part, it has to be said, irrationally because they were angry about being thrown out of the original idea.

As far as I know, the executors of Granada and Carlton made no real effort to understand the new context in which they were working. In particular, they made no effort to try and judge or find out what Sky might do in the circumstance.

It is interesting that the main reason for outcomes being different from what you predicted is not that you misinterpreted information, which you had available at the time, but that you were missing information.

Missing information – particularly about other incentives and other people – can often be hard to pick up. It tends to be the way in which customers and markets evolve, and just human nature.

Missing information – particularly about other incentives and other people – can often be hard to pick up

The other area that is difficult is the tendency – in your own head, and certainly among your staff – to present analysis that tends to rely firmly on the things that can be quantified.

The inclination is to fight shy of presenting arguments based on things that can't easily be quantified. It's the pressure, particularly in the private sector, to translate things into balance sheet and

An over-reliance on quantifiable information can stop creative or lateral decision-making dead in its tracks

P&L terms all the time.

So the things you don't know – plus this pressure on yourself and on your staff to just use that which is quantifiable – often leads to poor decision-making.

Now we come to the issue of; "Well, what do you do about it?" And this is where experience comes in. It's important to be open-minded and to understand what the scientists are doing 'in the garage'. It's the accumulation of all this peripheral information – partly from your own experience and partly from interaction with others way outside the immediate network of decision-makers.

Keep an open-mind, and that will increase your chances of making the right decisions where the information is actually not available in any form that can be quantified and translated into an argument.

LESSON SUMMARY

- You are rarely armed with enough knowledge to make a decent decision: it is often missing information that leads to poor decision-making.
- Making an effort to understand market forces, such as competition, can stand you in good stead; as can attempting to empathise with other organisations and second-guessing their next steps.
- Remaining open-minded and accepting influences from beyond your everyday sources of information can help guide you in terms of decision-making.
- An over-reliance on quantifiable information can often stop creative or lateral decision-making dead in its tracks.

IDEAS FOR ACTION

- Become familiar with problem solving by keeping a diary and considering what you would do if you were faced with the problems confronted by politicians and business leaders.
- Keep on top of how consumer trends are changing by identifying appropriate market research partners. They can organise focus groups from which they can glean quality insights that can help inform decision-making.
- Maintain a current awareness of market conditions by creating a competition task force, which meets monthly.
- Interact with peers in different organisations and industry sectors by accepting invitations to attend lunches, dinners and other networking opportunities.

Find out more

This article is transcribed from 50 Lessons' library of over 500 video lessons given by 100 business leaders. To view and hear the full interview online, visit 50lessons.com

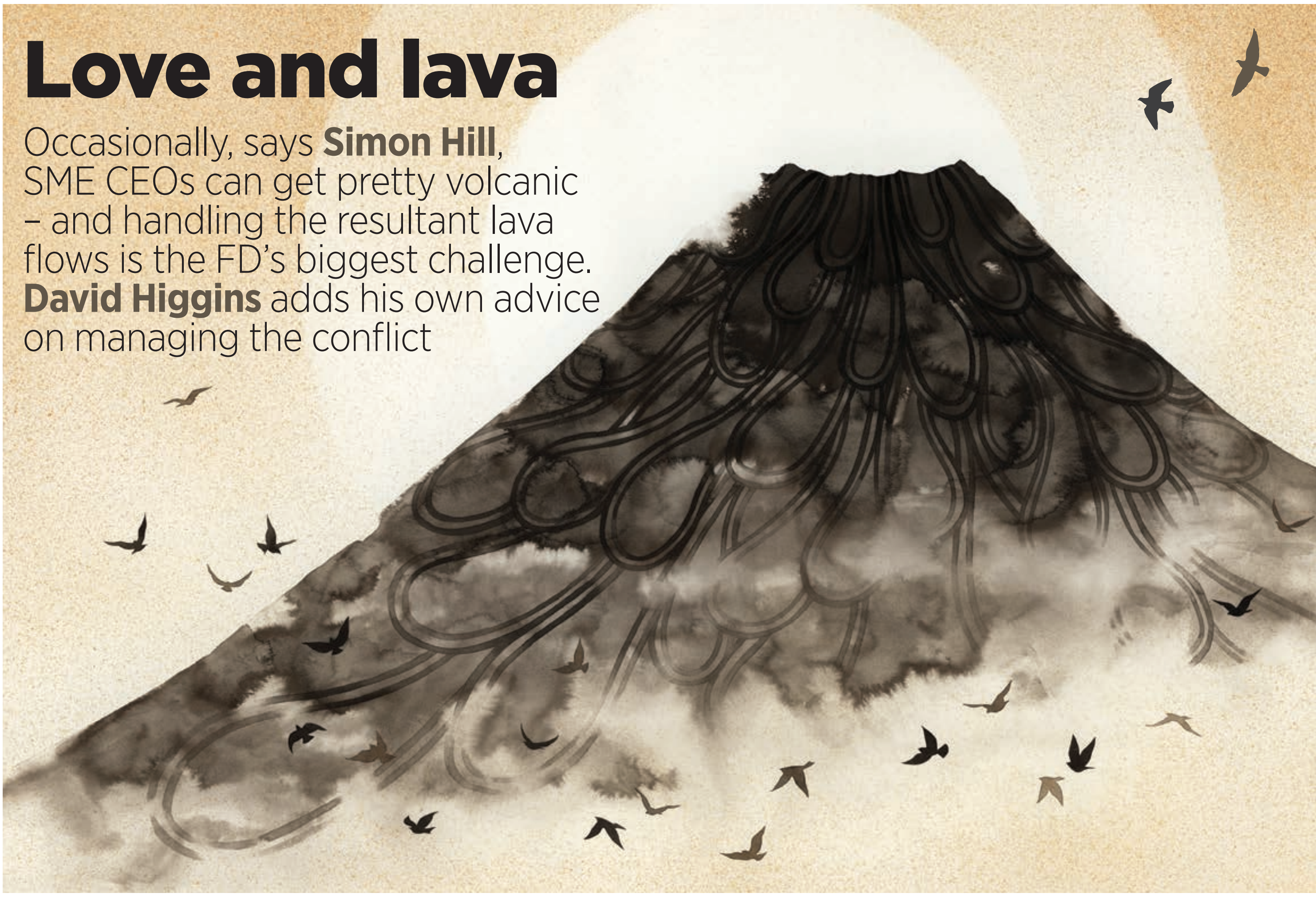
SIR DONALD CRUIKSHANK'S CAREER MILESTONES

Knighted in 2006, Sir Donald Cruickshank is the former chairman of the London Stock Exchange and a current director of Qualcomm (since June 2005).

- A consultant at McKinsey before joining Times Newspapers as commercial director, he then moved to the role of managing director (MD) of the information and entertainment division of Pearson.
- In 1984 he became managing director of the Virgin Group, where he spent the next five years.
- He was chief executive of the National Health Service in Scotland from 1989 to 1993.
- From 1993-1998 he was director general of OFTEL.
- He then spent three years as chairman of Action 2000, the UK Government's Millennium Bug campaign.
- Sir Donald was appointed by chancellor at the time Gordon Brown to be chairman of the government's review of the UK banking sector in 1998. His report was published in March 2000.
- He became chairman of the London Stock Exchange in May 2000, a position he left in July 2003.
- Sir Donald also served as chairman of SMG from 1999 to 2004, Formscape Group Ltd from 2003 to 2006, and Clinovia Group Ltd. from 2004 to 2006.
- He became chairman of the mobile and web platform Audioboo in April 2010.

Love and lava

Occasionally, says **Simon Hill**, SME CEOs can get pretty volcanic – and handling the resultant lava flows is the FD's biggest challenge. **David Higgins** adds his own advice on managing the conflict



CORBIS

Eyjafjallajökull (no, I haven't just leant on the keyboard) is an Icelandic volcano. It brought European air travel to a standstill in 2010. Reports in late 2011 suggested it's likely to be upstaged by a grown-up version called Katla in the not too distant future. Yet in Iceland, life goes on. People choose to live there. Benefits outweigh risks. Even its economy has bounced back from spectacular financial meltdown.

FDs operating in entrepreneurial SMEs make a similar trade-off – excitement, opportunity and variety in exchange for volatility, conflict and the occasional violent eruption. So what are the typical problems with CEOs? And what's the best way to handle this kind of seismic activity?

"IT'S AGAINST THE RULES?"

How FDs must curse Douglas Bader's observation that "rules are for the obedience of fools and the guidance of wise men". It's the entrepreneurs' charter: they know they're right most of the time, and no amount of evidence to the contrary will dissuade them. Such mavericks grow their businesses by overcoming obstacles, never taking "no" for an answer and hacking through red tape.

But it's an approach that sets such CEOs on a collision course with FDs. For example: a trade magazine publishes an annual industry league table based on revenue. The CEO wants to rank as high as possible. But what "revenue" does the FD supply? For the last financial year? The last 12 months? Last month multiplied by 12? The best month's turnover multiplied by 12? Including recharged expenses or VAT?

For the CEO, it's about positioning the business, and his success story, well. For the FD, there's a risk of misrepresentation. Perhaps no real decisions will be based on the tables. But there could be problems if the magazine's rules change or growth flattens, and if they do win business based on a seemingly high turnover and the client checks things out at Companies House.

WHAT TO DO: *Always make your case. But enforcing the rules is seldom simple for a small business FD. CEOs want options, a clear picture of the consequences of breach and evidence that the best commercial position has been sought. They may still try to brow-beat you into doing the wrong thing – but an FD's resistance is rarely futile.*

> Such mavericks grow their businesses by overcoming obstacles, never taking "no" for an answer and hacking through red tape

"NATURALLY THERE WOULD BE A FEW INCIDENTAL EXPENSES..."

Why do personal expenses bring out the "do as I say, not as I do" in owner-managers? The FD is asked to sound the frugal horn. It's zero tolerance on employee T&E claims, yet when it comes to the CEO, anything goes. "Field research" holidays, golf club subs (it's networking), flowers for Mrs CEO... and the FD has to justify it. A test of diplomacy ensues. The FD explains that the behaviour has no merit: no tax is saved; business performance is clouded; suspicions are raised

unnecessarily. The CEO harrumphs.

WHAT TO DO: *Revisit remuneration to account for this kind of spending. Topping up compensation with benefits has nothing to commend it. If the CEO persists, just put it down to stupidity, stubbornness, shadiness or a toxic cocktail of all three.*

"THE MAGIC OF HYPOTHETICAL FUTURE VALUE ACCOUNTING"

Say something often enough and it becomes accepted as the truth. And every CEO wants to be known as a "high net-worth individual". In smaller businesses, that "net worth" is usually tied up in their company. In other words, it's very "net" and not necessarily as "high" as they'd like so it's understandable they talk up its value a lot.

In some cases, the delusion descends to such an extent that the future is mistaken for the present. The business *could* be sold for six times revenue – so it's worth £squillions, right? And if it's worth that much, why wouldn't we spend – even if that means borrowing – accordingly?

This is the stuff of nightmares for an FD. Dissent from the valuation could be construed as treason. Tacit approval risks spawning largesse.

WHAT TO DO: *Facts are your friend. Ground conversations in reality, but do so in a way that saves face. Making the CEO look stupid is not wise. Unless your garden really does need attention.*

"BECAUSE I'M WORTH IT..."

Smaller businesses tend not to have remuneration committees. Some don't even have independent directors. So who sets the CEO's pay? What constitutes a reasonable incentive plan? As FD, you have to provide the checks and balances to argue against excessive behaviour.

But it can be tricky. One example is the CEO who loves to proclaim how he/she doesn't take a salary. In fact, he/she takes cash out of the business as dividends (probably for tax reasons). Or they will excuse their elevated pay as recompense for the hardship in the lean years when the business was getting off the ground.

WHAT TO DO: *Bite your tongue. If the CEO is the biggest shareholder, there's no option. The issue tends to disappear as the company's board expands. Caveat: if the cash going into the CEO's bank account jeopardises the business, consider your options.*

"HANG ON, LADS; I'VE GOT A GREAT IDEA..."

"It's time we started buying some businesses." The CEO might just as well have invited you for a foxtrot in a minefield. An M&A strategy might go very well, allow you to work closely with your CEO and be a pleasant experience for you both. Then again, it might not.

Deal fever is a dangerous thing, even for huge corporations. The most valuable call is often the one that says "stop" and quite often it's the FD with the evidence to make it. Sadly, nothing drives overpayment like a CEO – their "must-win" personality frequently overrides better judgment.

M&A is an example of the "pet project" genre – situations where the sharp, commercial acumen that characterises most CEOs goes out of the window. Others include the corporate makeover, office refurbishment and the "white elephant" IT system that will solve everything.

WHAT TO DO: *You must speak up when it comes to "pets". Help the CEO share your perspective. Present other options. Allow the options to become the CEO's ideas. But make your point, it's your job.*

Simon Hill is a principal at Everymind.
everymind.co.uk

DAVID HIGGINS' DOs AND DON'Ts OF THE CEO/FD RELATIONSHIP

The degree of friction between CEO and FD depends entirely on the personality of the two individuals. But conflict is not always a bad thing. Tension helps align the top two, as each will have had to argue fiercely for a certain course of action, testing the other's hypothesis.

A recent study found that at the heart of the conflict between FDs and CEOs is the dual nature of the finance role today – being both financial controller and business partner. Combining the two is no easy feat. But if the FD fails to demonstrate both attributes, the pairing will never work. So how should conflict be managed?

DO:

- Get to know your CEO and the other individuals in the business. A well-connected FD is more influential and can help shape the CEO's plans.
- Be collaborative yet independent – this yields honest and supportive communication.
- Recognise the strengths of the CEO, but support the areas of weakness.
- Spend time outside finance. Knowing how the business operates gives you a better understanding of the challenges facing it.
- Ensure that the business understands the broader nature of your role. You're a business partner, not just an accountant.

DON'T:

- Be a technocrat. A good FD can talk confidently about business models instead of financial statements. Your world isn't only spreadsheets.
- View finance as a function separate from the business. There has to be a joined-up approach to ensure fluidity and open communication.
- Live in an ivory tower. FDs with an open mind will be in a better position to shape the business plans of the CEO. Relationships with key investors, analysts and opinion-leaders really help.
- Be afraid to say "no". Independence is crucial to safeguarding the business from uncalculated decisions.
- Lose objectivity. Get close to the business, but not so close it clouds your objective analysis. That is essential in helping the CEO build a sound business.

David Higgins is chairman and founder of leadership advisory firm Inception Partners

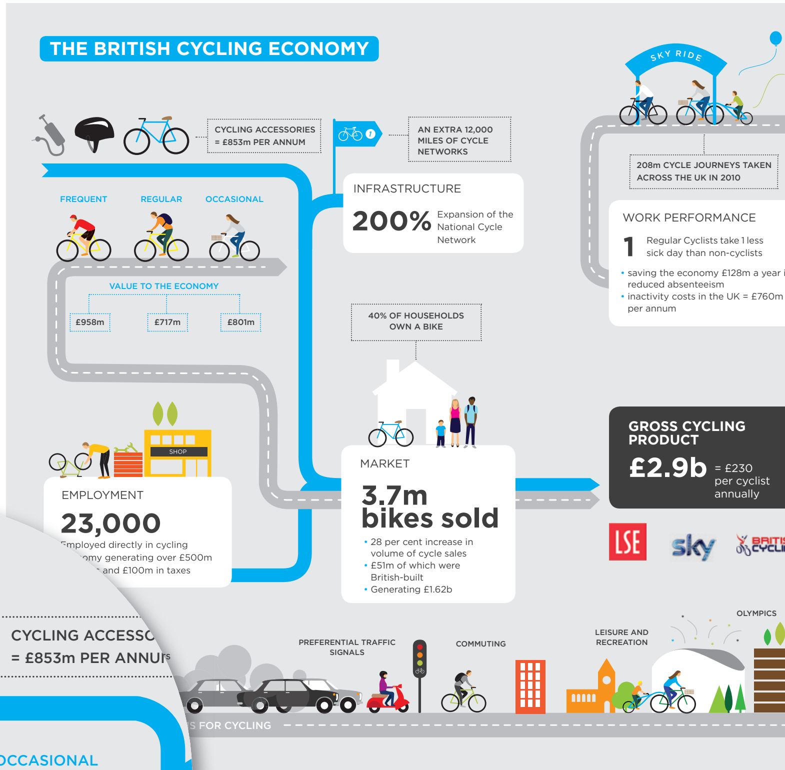
Worth 1,000

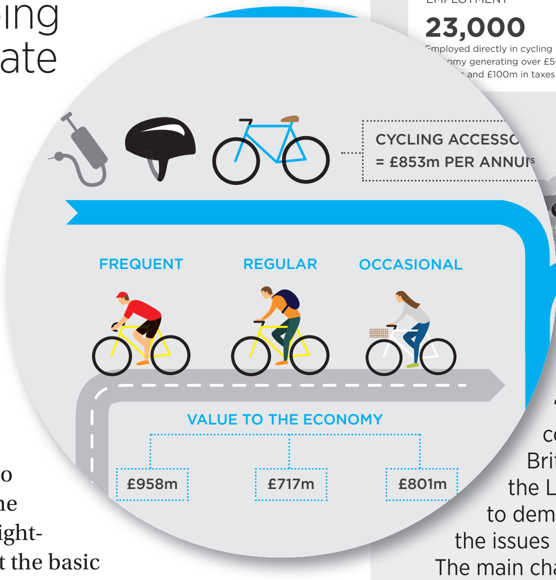
Well-presented infographics capture the reader's attention and impart important information quickly. So we asked three design agencies to show us how they've been helping clients communicate corporate data more effectively

Excel has been both a blessing and a curse for finance functions. Obviously it's a brilliant tool – most FDs and FCs would be lost without it – and its charting functions have helped them visualise data much more easily.

Too easily, perhaps? It's great to place a few pointed charts into the board pack instead of reams of eight-point spreadsheet print-outs. But the basic options for graphs and charts that Excel offers perhaps blind us to some more creative infographic treatments that might allow external audiences and non-financial managers (even some FDs) to understand what's happening more quickly and completely.

If it's true a picture is worth a thousand words, maybe it can stand for a fair few spreadsheets, too. So we looked at some interesting treatments being used to communicate key data to stakeholders and asked the three corporate report design agencies to explain the thinking behind them.





LSE/SKY CYCLING ECONOMY

Salterbaxter's brief was to bring to life the "Gross Cycling Product" (GCP) in report conceived and commissioned by Sky and British Cycling, and independently produced by the London School of Economics. We were asked to demonstrate the scale of the findings and illustrate the issues in the report using an appropriate infographic.

The main challenge was to ensure the overall tone was neutral. This couldn't feel like another sales tool. We created a fun, friendly and informative infographic that captured a very dry research piece in one spread, It shows how the different areas of research are connected, what the key elements and issues are and extracted little nuggets of easily digestible data for the reader.

In a world where information is coming at us from ever more angles, businesses are going to have to think smarter about what they say, where they say it and how they say it. Good information design is simple, interesting and engaging.

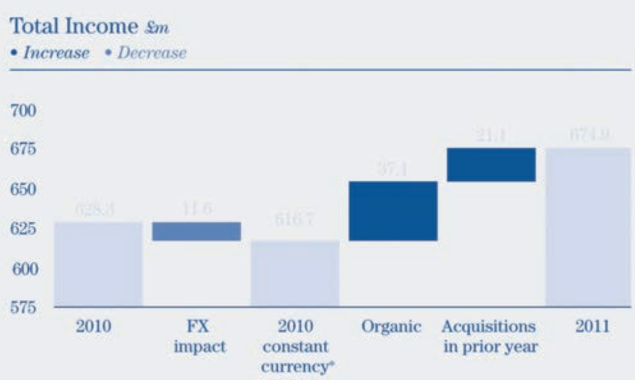
Adam Downes, Salterbaxter

LONDON STOCK EXCHANGE GROUP ANNUAL REPORT 2011

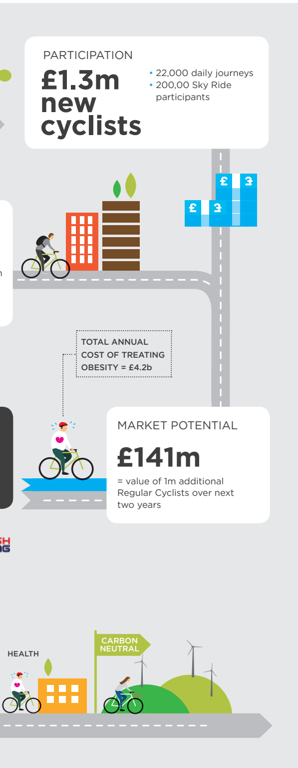
We were asked to present the Financial Review information in a clearer and more engaging way. The information in the previous annual report was in dense narrative paragraphs. So we used charts and diagrams to bring the narrative to life.

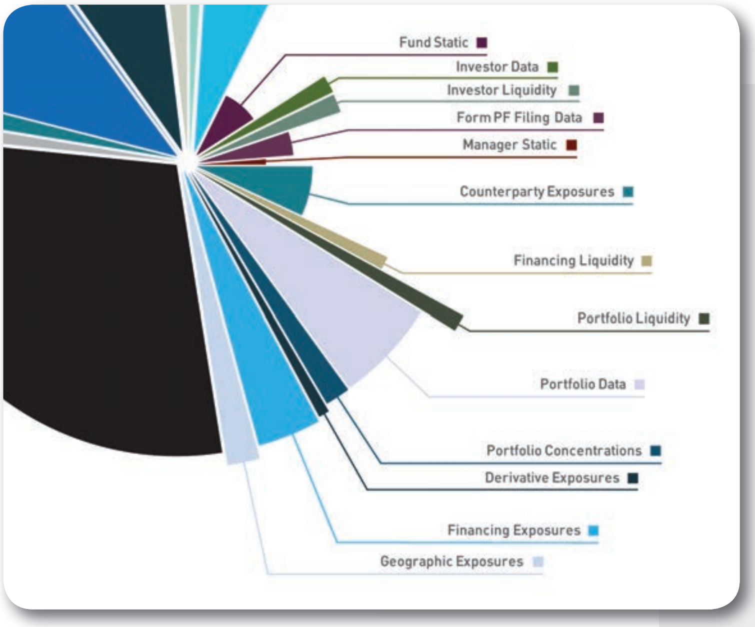
Bridge charts are commonly used in presentations to analysts and investors, but rarely within annual reports. They set out how a metric has developed from year to year, as demonstrated here in the use of a bridge chart of total income from 2010 to 2011. Foreign exchange effects are stripped out to provide total income for 2010 at constant currency rates. Movements for the year are split between organic growth and growth due to acquisitions.

Janice Lingwood, Addison Corporate Marketing



* Comprises 2010 Total Income restated to 2011 foreign exchange rates





GLOBEOP FINANCIAL SERVICES ANNUAL REPORT 2011

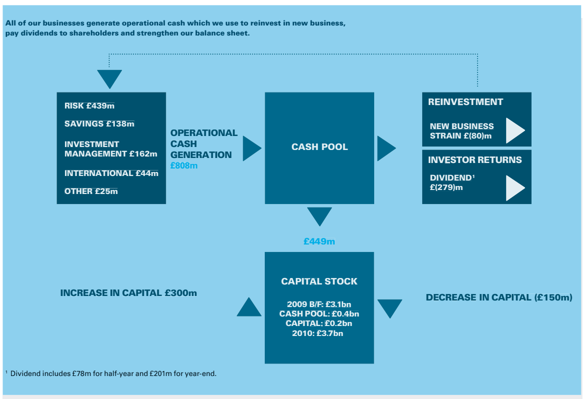
GlobeOp Financial Services is a leading, independent global hedge fund administrator specialising in middle and back-office services. Data management – how it's collected, aggregated and reported – underpins their client and investor services.

In 2011, it launched the monthly GlobeOp Hedge Fund Index, then became the first administrator to launch a reporting support service for new hedge fund regulatory obligations. Black Sun worked on the GlobeOp 2011 Annual Report to highlight these new initiatives. Both GlobeOp and Black Sun went through an extensive brain-storming process, before narrowing it down to the key premise that "information is beautiful".

The Form PF (private fund) service involves complex quarterly or annual forms and calculations. The challenge of presenting such data in a visually engaging way is compounded by complicated portfolio, risk and performance data. The pie distribution shows the different types of data required and the radius of each part show the 'time pressure factor' – how soon in the reporting process this data might normally be available.

With this treatment, Form PF data comes alive through the use of dramatic, unusual and insightful visuals. These bold graphics enable GlobeOp to demonstrate how data reporting can be innovative and beautiful while remaining useful.

Paul Edison, Black Sun, and Heather Clay, GlobeOp



LEGAL & GENERAL ANNUAL REPORT 2010

Over a number of years, we have worked closely with Legal & General to restructure the narrative section of their annual report. In particular, Legal & General wanted to clearly explain their financial model and we collectively agreed that it could be better communicated through an illustration.

We introduced this graphic, which demonstrates how cash generation is at the heart of delivering sustainable growth. The graphic simply sets out how the business segments' operational cash is used to reinvest in new business, strengthen the Group capital position and reward shareholders.

Embedded within the graphic are the current year cash figures that tie into the detailed reconciliation of operational cash generation to IFRS profit that is provided underneath it. This has been an invaluable tool when communicating to shareholders, as well as other stakeholders.

Janice Lingwood, Addison Corporate Marketing

CHART TOPPERS

Information aesthetics is now a popular discipline. Here are some sources of further reading:

- chartporn.org and infosthetics.com
  Eclectic mixtures of artistic and data-driven infographics.
- coolinfographics.com
  Social and cultural themes.
- visual.ly/category/business
  Thousands of examples of snappy infographics.
- bowencraggs.com
  Representing data (and a host of other tips) for companies online.
- corporateregister.com
  Archive of reports, plus awards and trends in corporate reporting.
- snipurl.com/ARcharts
  Amazing variety thrown up by Google...
- davidmccandless.com
  Great ideas from a data artist and author.

Janice Lingwood is consulting director at Addison Corporate Marketing, **addison.co.uk**

Adam Downes is senior designer at Salterbaxter, **salterbaxter.com**

Paul Edison is creative director at Black Sun, **blacksunplc.com**

CHEMICAL WORLD

In the first interview of three in a sponsored series about innovative practice in finance, **Adrian Holliday** talks to Graham Baker, VP Global Finance Services, at AstraZeneca

What do AstraZeneca's customers want from finance?
Our customers look for insight, support, challenge and robustness. People rely on us to take a lead on industry ethics and compliance. And at a time of economic uncertainty we need to be properly invested and ensure shareholder returns are supported. That's what our customers want the finance team to do.

How is AstraZeneca an intelligent organisation?
Our environment is very fast-changing. I believe that the heart of intelligence is the ability to learn. That means creating an environment where people feel able to challenge, and feel supported in that. It's not particularly about projects. It's about the underlying culture you work in. And that thrives in openness, integrity and diversity. R&D is critical. But it's also about everyone who drives the business forward.

How do you manage the balance between productivity improvement and cost management?
We have to provide very high levels of transparency for any changes – particularly for revenue expectations. The business is wrapped up in products with a product lifecycle of perhaps 10 years, and the patent life 10-12 years. Our business has 57,000 people in it. It's a complex organisation. It's important to look at success beyond period-upon-period growth. If you re-orient targets towards exceeding expectations against a target you create a completely new dynamic within that team.

How does a global organisation keep on top of new technologies, helping your team deliver strong results?
In many ways it's easier with a global business, rather than with a business that only sees its performance in one or two markets or channels. In Asia-Pacific, back in 2008, we decided to put into place a captive service centre [in Kuala Lumpur]. In contrast with the European experience where a lot of hearts-and-minds persuasion was needed for finance to let go of control of transactional processing activities, many of the challenges we had in Asia-Pacific were about, "why can't we do this quicker? Why do we want to build a captive centre? Why don't we put it straight into the hands of the BPO?" As it turns out that captive in KL has been extremely successful. But when you're dealing with markets such as China and the Philippines, you have perspectives on business change and processes that are more dynamic than the conservative perspectives you have in established markets. Spending some time with an Indian ITT team who tell you they can implement an ERP system for £2.50 is refreshing!

> This is an industry that deals with vast amounts of data. One of the key tasks of finance is to orient and capture the most relevant points from a sea of data points coming in

You say how performance in emerging markets will be key to your success. How do you ensure the facilities and operations in fast-growing economies are as future-ready as those in developed markets?
To capture the dynamism, raw talent and enthusiasm that we see in emerging markets, we do want local leadership. We have international assignment programmes, but we want mobility going both ways, in and around our business. We also want the challenge: why does it have to be done in a certain way?

Does finance use social media to help monitor investor sentiment?
We do, clearly, monitor industry comment and perceptions of our business from key external stakeholders, partners, doctors, regulators, payers and investors. We use all channels to do that. We monitor and track investor sentiment when we announce our quarterly results. But the reality is, our primary channel is face-to-face interaction with our key stakeholders and investors.

How reliant are your team on financial analytical tools? Do they supersede a more traditional human interpretation of data – or merely enhance it?
This is an industry that deals with vast amounts of data. One of the key tasks of finance is to orient and capture the most relevant points from a sea of data points coming in. And analytical tools have a profound effect to manage that data.

Graham Baker
VP Global Finance Services, AstraZeneca

Technical updates

Our regular round-up of legal and regulatory changes

TAX

News and updates from the Tax Faculty weekly newswire. Subscribe free: visit ion.icaew.com/TaxFaculty and click the sign-up link on the right.

PENSION AUTO-ENROLMENT

The government is introducing a requirement for employers to enroll their workers into a qualifying workplace pension scheme from October 2012 – so-called auto-enrolment.

The ICAEW response to the Department for Work and Pensions's (DWP) consultation is at icaew.com/AutoEnrolRep

We welcome DWP's proposal to exempt dual-status workers – where they're both a "jobholder" who works in Great Britain under contract; and a "qualifying person" who works under contract in an EEA state where the employer is subject to laws relevant to occupational pension schemes of that state. But we're concerned about the number of other unresolved cross-border issues.

Why is the proposal confined to the EEA? What are the other impacts on cross-border employers and employees? How will it be possible to enforce the auto-enrolment obligations of foreign-based employers?

And while guidance published by the Pensions Regulator (snipurl.com/TPRguidance) is informative, we have concerns about its wording.

ADR FOR SMEs

It is now possible to apply online to take part in HMRC's pilot of the Alternative Dispute Resolution (ADR) process for SMEs. ADR uses a facilitator to see if a VAT or direct tax matters can be resolved without the need for a tribunal hearing.

Results of the pilot so far show ADR can be effective in unblocking long-running disputes – and helps clarify key issues under dispute. Using ADR will not affect existing review and appeal rights.

You can use a new online application form to take part, or apply to HMRC via phone. There is more information at hmrc.gov.uk/adr, including FAQs, details of which cases are suitable and a map showing all the areas included in the pilot.

HMRC TOOLKITS

HMRC toolkits list the errors that HMRC commonly sees in completed tax returns, with advice on avoiding them. Although they are designed primarily to help tax agents, some toolkits are useful for company finance functions. For example, among toolkits released for 2011/12 returns is one on chargeable gains for companies. See hmrc.gov.uk/agents/prereturn-support-agents.htm

FINANCIAL REPORTING

You can find out more on the latest from the Financial Reporting Faculty, including UK GAAP and IFRS standards and consultations, at icaew.com/frf

IMPROVEMENTS TO IFRS

The IASB is seeking comments on an exposure draft of proposed amendments to ten IFRS under its annual improvements project. Comments are due by 5 September 2012 on the topics in the box below. Final amendments are expected to be published early in 2013.

UK AUTUMN ROADSHOW 2012

The ASB is expected to publish brand new standards for all UK GAAP reporters and subsidiaries this autumn. The Financial Reporting Faculty's UK Autumn roadshow will provide an opportunity to understand the practical implications for your business,

IFRS	Subject of amendment
IFRS 2 Share-based Payment	Definition of 'vesting condition'
IFRS 3 Business Combinations	Accounting for contingent consideration in a business combination
IFRS 8 Operating Segments	Aggregation of operating segments. Reconciliation of the total of reportable segments' assets to the entity's assets
IFRS 13 Fair Value Measurement	Short-term receivable and payables
IAS 1 Presentation of Financial Statements	Current/non-current classification of liabilities
IAS 7 Statement of Cash Flows	Interest paid that is capitalised
IAS 12 Income Taxes	Recognition of deferred tax assets for unrealised losses
IAS 16 Property, Plant and Equipment **IAS 38 Intangible Assets**	Revaluation method – proportionate restatement of accumulated depreciation
IAS 24 Related Party Disclosures	Key management personnel
IAS 36 Impairment of Assets	Harmonisation of disclosures for value in use and fair value less costs of disposal

including: the options you have; the choices you need to make; and the impact on your systems, training and reported numbers.

There will also be practical help in the complex areas of UK financial reporting that are of current concern, and we'll be offering an overview of recent and forthcoming changes to both UK and international accounting requirements. The Roadshow will be coming to a town near you from 25 October 2012. Scan the QR code below for more information.

MOVING TO IFRS?

With radical changes in the pipeline for UK GAAP, you might be considering a move to IFRS in the near future. The IFRS Transition factsheet considers the implications of moving over and provides practical tips on how to manage the process. Factsheets are free to download for Financial Reporting Faculty members.

EMPLOYMENT LAW

This section is an extract from the monthly bulletin of law firm Herbert Smith – but does not constitute legal advice and should not be relied upon as such. See herbertsmith.com

RECRUITMENT RIGHTS

Employers can refuse to provide recruitment information to an unsuccessful job applicant who meets the advertised job criteria – but risk this being used as sufficient evidence of discrimination to shift the burden of proof to the employer.

The European Court of Justice (ECJ) ruled that in deciding whether the burden of proof shifted in Meister v Speech Design Carrier Systems, the court can take into account the fact that the employer refused all access to recruitment documentation (rather than providing redacted documents), the employer's acceptance that the claimant satisfied the job criteria, and its failure to invite her to a job interview.

SLEEPING ON THE JOB

The dismissal of employees for sleeping at work was not an automatically unfair dismissal if they were "refusing" to accept an employer's breach of working time law (the requirement to provide rest breaks). "Refusal" must be explicit and cannot be implied from an employee's failure to comply with the employer's instruction to work without a break. (Ajayi v Aitch Care Homes [London], EAT)

TERMINATION TIMING

Where an employee sends a letter resigning with immediate effect, the effective date of termination (for calculating qualifying service, for example) is the date on which the information is communicated to the employer, which a recent case confirmed as the date on which a letter is opened and date-stamped, whether or not any named addressee has read the letter. (Horwood v Lincolnshire County Council, EAT)

AGE DISCRIMINATION

In *Seldon v Clarkson Wright and Jakes* the Supreme Court (SC) has confirmed that "inter-generational fairness" (creating openings for younger employees) and "dignity" (avoiding the need to expel partners by performance management) are potential legitimate aims for mandatory retirement of partners at a law firm. They are held to be aims of a public interest nature and consistent with the social policy aims of the State.

But employers must also show that they actually apply to their business. For example, preserving someone's dignity may not be a legitimate reason in a business that has sophisticated performance management measures in place for other sections of the workforce. The particular retirement age chosen must also be appropriate and necessary to achieve the aims, and this case was sent back to the tribunal to determine this. Here the age chosen was 65 to mirror the then-statutory default retirement age. The SC ruled that it was proper to take this into account.

However, even if the tribunal finds that the age of 65 was justified in this case, it will not necessarily be a green light for others given the abolition of the default retirement age. Employers who've chosen to retain compulsory retirement ages should keep a close eye on this case at tribunal. More at: snipurl.com/retirement1

* The SC found in *Homer v CC West Yorkshire Police* that employers should only impose requirements for job holders to have a degree if these can be justified. Where an employee was close to compulsory retirement age – with insufficient time to acquire the degree needed to be on the highest grade – this was a disadvantage on grounds of age that required justification.

From the Faculties

Keep in touch with our selection from ICAEW's other faculty magazines


CORPORATE FINANCIER

PROFILE LEADERSHIP

As head of MITIE, Ruby McGregor-Smith CBE tells Marc Mullen how investing in innovation and strategic acquisitions will keep the services group on its growth trajectory

MIGHTY HIGH

"The excitement of working with young management teams who are excited about setting up businesses is the best buzz ever"

CHARTECH
EULA BE SORRY

When was the last time you read every word of the terms and conditions on a new piece of software or a website before you ticked the box to say you accepted its clauses? It's a reasonable bet most people will say, "never". But, says James Pearce, that could be a big mistake, particularly in business situations.

One of the big issues is that the Ts&Cs these days tend to sign your business up to software audits – meaning the vendor can inspect your machines and the records you keep on licences and system usage at any time. And it's not just a formality: companies such as Microsoft have been exercising these rights, often with SME customers.

The result? A visit from software inspectors and where insufficient licences are discovered (or even poor record-keeping) the need to buy new software at full RRP. There's another danger: the fear this induces in many business people has resulted in the growth of consultancies offering to manage software audits and any possible consequences. But their businesses are often built around scare tactics.

Pearce offers some useful tips on ensuring your business doesn't fall foul of the law – or the software vendors' terms – particularly in an era of rapidly changing IT practice. In short, don't ignore the problem. It's must-read stuff.

For more from the IT Faculty, visit icaew.com/itfac

CORPORATE FINANCIER
MIGHTY HIGH

Ruby McGregor-Smith is CEO of outsourcing group MITIE. She's a former Stoy Hayward auditor who joined Serco in 1991 and undertook a variety of finance and operational roles for the then recently privatised outsourcer. She moved into M&A for the group as it expanded into North America (more on that later) – then decided to spend more time with her young family.

McGregor-Smith is clear about the challenges of being a woman in a male-dominated business world – and admits the decision to break from her global role was one of the toughest in her life. Then in 2002, after her son had started school, MITIE founder and chairman David Telling called with the offer of the FD role.

She became CEO in 2007, and has continued Telling's founding principles. The group's name stands for Management Incentive Through Investment Equity, which explains its model of buying into young businesses in a way that offers excellent rewards, ensuring staff and management are motivated and passionate.

The group now also undertakes traditional M&A deals – starting in 2003 with the £75m Initial Security acquisition – and this piece explores their strategic approach to target identification and execution. But this down-to-earth, direct and open CEO – she communicates with staff through Facebook and Twitter – stresses employee and supply chain relationships are still at its core. "It has to be fun to work," she says.

For more from the Corporate Finance Faculty, visit icaew.com/cff

BY ALL ACCOUNTS
UNFOLDING THE STORY

Narrative reporting seems to attract a lot of attention – and 14 formal consultations in just two years, according to the Investor Relations Society. Pearson CFO Robin Freestone worries that too much is being heaped on its narrow shoulders, however. And while narratives have improved "immeasurably" over the past 20 years – allowing annual report users to get a real picture of a company in the round – boiler-plate statements and other clutter are still getting in the way of a good story.

Worse, he frets, fewer people even bother reading annual reports these days. Freestone is equally unhappy with the idea of going all-out for compliance reporting (like the US) or for boiling everything down to data made available online. So he believes there must be a middle way – a chance for annual reports to evolve and maintain their role to paint a picture.

A big step forward would be joining up the front and back ends a bit more. Just how much do management spin audited figures for use in the narrative section, for example? And how does that affect trust in the report? We need better ways of answering shareholder's big questions – especially in areas like net debt and M&A – while minimising the pages of disclosures on irrelevant accounting tweaks.

For more from the Financial Reporting Faculty, visit icaew.com/frf

PULLING TOGETHER

Effective teamwork can be key to business success. **Steve Coomber** examines the factors that create such high-performing teams

Research teams at Thomas Edison's West Orange, New Jersey laboratory in the late 1800s worked a six-day week for low wages against a backdrop of creativity-stifling time clocks and burdensome administration. Moreover, Edison was notoriously hard on his teams. He sowed the seeds of envy and competition among his workers, locked them into his lab on occasion and, with his unreasonably tough demands, drove at least one employee to a nervous breakdown.

Ask an average team member in an organisation today what makes great teams tick and their response is likely to include terms such as collaboration, harmony, consensus and unity. Maybe even empathy, emotional intelligence and relationship-oriented leadership. Not ideas Edison appears to have had much time for. Yet Edison, the first to commercialise the lightbulb, led some of the most successful R&D teams of all time, filing 2,332 patents worldwide, producing many inventions still in use today.

So what are the factors required to create a high-performing team? As it turns out, recent research reveals team performance to be a much more complex, and less predictable topic, than it seems.

"We don't think about whether there are people in the team who can get the information and resources that the team really needs"

PETER SPURRIER/NTERSPORT IMAGES

TOLERATING TENSION

Take the research of Mark de Rond, an academic at Judge Business School, University of Cambridge, for example. In his study of high-performing teams de Rond has lived alongside Cambridge University rowers during selection and preparation for the Boat Race, and surgical teams at the battlefield hospital at Camp Bastion, Afghanistan.

His findings reveal several characteristics of high-performing teams. Interestingly, although many might think otherwise, peace and harmony are not essential prerequisites. "Even very effective teams feel quite dysfunctional, at least occasionally," says de Rond. According to de Rond a number of difficult tension points are usually present. Tensions that coexist and characterise high-performing teams include: competition and cooperation; trust and vigilance; and change and stability. These must be tolerated, otherwise performance will suffer.

"If you weed out competition in the interests of harmony, for example, you tend to disallow something that is an innate part of many of the high-performers in the team," says de Rond. "So, if you have a team that feels relatively dysfunctional, rather than having a heart-to-heart, you may be better off giving the team something to do that challenges them."

Do not just select the most technically competent individuals, either, as it doesn't necessarily make for the best team. "Sometimes teams must sacrifice technical competence for more socially gifted (but still competent) individuals," notes de Rond. "Here the role of the more socially gifted might be, for example, to diffuse conflict, or provide some of the glue that binds teams together."

Dissention, or at least a degree of pushback, is often considered essential for effective team performance. One argument being that it counters the risk of groupthink, the thought process that occurs when a team's fixation on a harmonious decision means that it overlooks alternative courses of action. Groupthink is usually associated with negative outcomes – such as the Enron debacle.

However, Alex Haslam, professor of social and organisational psychology at Exeter University, and author of the *New Psychology of Leadership*, casts a slightly different light on groupthink. "When you have groupthink, high cohesiveness and a strong shared identity, you get more commitment to the team task, and the team is more effective," he says. "A strong sense of shared identity facilitates leadership, commitment and buy-in, and reduces the likelihood that people bale out, or are underwhelming in their contribution."

In other words, groupthink through extreme cohesiveness is something of a double edged sword. It can lead to spectacular failure, but, when the right direction is set, can drive remarkable success. Not that building togetherness is easy with modern ways of working. Physical propinquity and regular opportunities to meet and experience day-to-day team interaction will build shared identity and purpose. But flexible and home working, virtual teams, plus fluid office space arrangements, mean that these types of interactions are becoming less frequent.

SOCIAL CAPITAL

Another area on which people focus with teams is functional competences. "We tend to rely on functional diversity – considering whether there is a person in the team for each aspect of the team's work," says Suzanne Edinger, a lecturer in organisational behaviour at Nottingham University Business School. "We don't think about whether there are people in the team who can get the information and

Vital teamwork; a battlefield hospital

STEVE LEWIS/REUTERS

resources that the team really needs."

Edinger investigated the role of social capital – the resources embedded in the connections and relationships that people have with one another – in team performance. Studying 55 teams, Edinger analysed the strengths of people's external and internal contacts, and the strength of networks amongst the team. The data revealed that the level of social capital a team could leverage correlated with its performance as rated by clients.

The results show social capital is an important, yet often overlooked, component of team performance. "When a team is put together, team members are often very focused on the output – especially if there are objectives to be met in a short timeframe. So they will start dividing up the tasks – and be very task focused," she says. "Team members should take a step back, think more about how they can achieve their goals, and leverage the expertise and the resources available to them through their connections".

This means uncovering people's connections, discussing previous projects worked on, for example, and considering how those connections can best be used.

It is a common assumption that great teams have great leaders. Yet the question of team leadership isn't so straightforward. In 1993, for instance, Ric Charlesworth was appointed coach of the Australian women's hockey team – the Hockeyroos. With the team performing poorly, Charlesworth abandoned the accepted practice of having a playing captain and vice-captain, hoping the whole team would assume leadership responsibilities. From 1994 to 2000, the Hockeyroos won two World Cups, two Olympic gold medals, and a host of other trophies.

Research by Katherine Klein, professor of management at the Wharton Business School, University of Pennsylvania, also shows that non-conventional leadership models can create high-performing teams. Klein studied medical teams in action at the Shock Trauma Center in Baltimore. When asked to identify their leader, the medical team members named different people. In practice, leadership was assumed by different people at different times, depending on what action was required, and the skills, knowledge, and status of the team members. "Ultimately we discovered this combination of a hierarchical formalised system that allowed the teams to be very fluid and responsive," says Klein.

Klein calls this leadership phenomenon "dynamic delegation". It illustrates the power of norms and routines, something that other organisations can benefit from. "Teams that discuss team norms and plan a team charter outperform teams that don't," she says. So before getting fixated on a task, it is worth spending time talking about team goals and processes, and what happens when the team runs into conflict.

"Teams should have a clarity about their purpose. Team members and leader should think very openly about the way they work together"

PAUSE FOR THOUGHT

The importance of whole-team talks is highlighted by the new teambuilder process developed by Adrienne Rosen, head of talent identification at consultants Fairplace Cedar, together with Paul Dobson, senior lecturer in organisational behaviour at Cass Business School, City of London.

The original academic research was motivated by Dobson's desire to address underperformance in some student teams on the MBA programme. The result was a 9+1 factor model of team performance, subsequently developed into a consulting intervention to help assess and improve team and team leader performance. "It is more comprehensive than most team-building measures," says Dobson. "Most don't consider, for example, team context, or technology and resources."

Perhaps the most significant aspect of the process, is that it makes teams pause to consider the way they function. Something that doesn't happen often enough, Rosen believes. "Teams should have clarity about their purpose. Team members and leaders should think very openly about the way that they work with one another," she says. "Creating a catalyst for a conversation forces the team and team leader to look at things in a more objective way, and confront issues they find difficult to discuss. A series of meetings allows the team to create solutions together and look at practical steps it can take to improve performance."

But, even when a team appears to have got everything right, overlooking one important factor can scupper success, as Paralympian swimmer Marc Woods discovered. Now a motivational speaker and consultant, Woods relates how, at the 1996 Atlanta Paralympics, he was part of a swimming team deprived of first place by 12 one-hundredths of a second. Despite reviewing the event thoroughly, he couldn't understand why the team finished second in a race they should have won. Until he watched a video recording.

"I always stopped the video before the medal ceremony. But this time I watched it. There we were: four members of the relay team, with our silver medals. Two with beaming smiles; and two of us looking devastated. It was then I realised, in our team, two wanted nothing less than gold, and two were happy with any medal. We hadn't agreed on the best possible outcome."

As far as team performance is concerned, it was a lightbulb moment for Woods. An effective team is always the one with the same goal in mind.