

Management Quarterly

PART 1

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Management Quarterly

A new way to keep ahead

Management Quarterly aims to deliver the basic building blocks in core management disciplines. It is produced in association with Cranfield School of Management. Each issue will contain articles on Strategy, Human Resources, Marketing and Finance, with other occasional subjects such as Project Management and Knowledge Management. Over a three year period this will build up to a comprehensive overview of practical business knowledge, and modern management ideas.

Management Quarterly will:

- Provide a comprehensive grounding in the knowledge needed to operate a successful business.
- Enable the reader to understand current issues and debates in these areas, and distinguish core ideas from current fads.
- Provide a wide ranging programme of CPE suitable for members both in business and advising businesses.

Key points

- Each part will be self standing and include recommended further reading.
- Writers are selected from Cranfield School of Management and other leading business schools.
- Experts in each field explain and discuss the relevance, practicality and usefulness of key new concepts and ideas, thus enabling the senior executive to keep really up-to-date.
- A message board is available on the Faculty internet site.
- Chartered accountants often have limited reading time. *Management Quarterly* is succinct and the writers will direct the reader to other, and often fuller, expositions on the subject. The program is no substitute for an MBA but it will follow some of the major threads on an MBA.

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Chartered Accountants may join the Faculty by telephoning 0171 920 8486.

STRATEGY

PART 1 WHAT IS STRATEGY?

Philip Davies, Cranfield School of Management

Aims of the Strategy course and learning goals

This first article will lay down the framework for the series by defining what strategy is, as well as what it is not. We will then discuss some problems of making strategy work in practice using a mini case study – Honda's entry into the US motorbike market in the 1960s – to illustrate the points made.

Given the confusion about the subject as well as its importance, this series of articles has been designed to provide more understanding but without reducing the content to a simple series of frameworks. We will seek to focus on how strategy works in practice. In addition, because in our view it is only by trying it out for yourself that you can learn anything, we will provide a series of questions that you can consider between each article. In this way you will be able to build up a knowledge base of theory linked to your own actual situation. Further readings are also included.

Basic concepts

The word strategy derives from the Greek *Strategos* and originally meant the general who commanded both land and sea forces in time of war. Until the late 1970s strategy remained a largely military concept defined as *the art and science of disposing of military forces prior to combat*. Strategy did not become a common term in business until the 1980s when there was an explosion of popular management books using the term, such as Porter's *Competitive Strategy*. The concept of strategic management, with its focus on competition, became the new gospel in business and government. Today the notion of strategy is widely used in all aspects of business, public sector organisations and even sport. Yet while the term is commonplace there is no academic consensus yet about what it actually means. Each business school, guru and consultancy appears to have their own definitions and tools.

Definitions

Strategy is the pattern in the stream of events that integrates the organisation's activities so that co-ordinated action to achieve an agreed purpose is possible. A good strategy describes:

- The purpose, vision and values of the organisation.
- The sources of sustainable competitive advantage.
- What products and services the organisation seeks to provide to what markets.

A strategy is *not* the budget, a once a year away day, the Annual Report, a plan, a mission statement, consultants' recommendations or a corporate vision – although all these elements can help develop a strategy.

The strategy may be expressed in a policy document or it may be implicit, simply *the way we do things around here*. The form is irrelevant: what matters is that it is clearly understood by the stakeholders. How the strategy is communicated also varies: if written, which is the case in most sizeable organisations, a strategy document usually contains long-term and medium-term objectives as well as operational plans for turning these strategies into reality.

Strategy takes place at different levels. Corporate strategy considers what businesses the firm should buy or sell, how the centre can add (or avoid destroying) shareholder value, as well as the vision for the future; eg, to be a document company (Xerox) or the 'world's favourite airline' (BA). Competitive strategy considers how individual businesses can compete in a particular market. Finally, operational strategy is the process through which particular functions, or (increasingly) project teams, turn the strategy into specific actions. All levels of strategy need to fit together.

Strategies cannot be secret, because to be implemented they need to be understood. How a strategy might be carried out in practice, eg which company you intend to buy next, is obviously sensitive, but your strategic intent to grow the business into Europe must not be, otherwise you will confuse yourselves, customers and the stockmarket.

Strategy in practice

Strategy is simple in principle but in practice difficult because of the friction caused by inadequate information, time, chance, the actions of others – the fog of business. What is important therefore is to keep the purpose of strategy in mind. 'Strategy', as a colleague of this author once remarked, 'is teaching a fish how to swim downstream'. Strategy must help you to achieve something in an area in which you have a sustainable competitive advantage. It is therefore about achieving a goal or *winning*. Too much analysis leads to paralysis. Strategy needs to lead to action.

How a successful strategy is developed varies according to the organisational situation or context, and needs to take into account factors such as:

- The competitive environment.
- Sources of sustainable competitive advantage.
- The resources of the organisation itself.
- Organisational culture and history.
- The desires and values of stakeholders, especially the executive team.

While the process through which strategy takes place can be usefully divided up for teaching purposes into analysis, choice and implementation, the process is continuous. Frequently, managers are required to make important decisions on the basis of inadequate information. Above all, the relentless pressure of events drives strategy. A hostile takeover bid, a major product failure, top team dynamics, the unexpected opportunity to buy a competitor, whether the CEO does a good presentation to the institutional shareholders – all these events have to be dealt with against the clock and under extreme pressure.

What ultimately determines organisational success is not the plan but the process of planning. In reality strategies are rarely implemented as originally intended. They either emerge out of the planning process, are imposed by head office or new circumstances (such as changes in legislation), or fail. Some are unexpected opportunities: an example of this is how Honda came to dominate the motorcycle market in America in the 1960s.

Case study

In 1958 two Japanese businessmen landed in San Francisco. They were employees of the Honda Corporation and had come on a fact finding tour to see whether there was a market for their large motorbikes in America. They reported back that 10% of the export market, then dominated by the British who had 49% of the total US market, was a realistic target and, after some problems in getting adequate finance from the Japanese Government, they returned with a small stock in 1959. They made many mistakes. The large bikes were not robust enough for American conditions and had to be redesigned. Finally, after eight months of failure they had a breakthrough. A sports shop asked to stock their small bikes – the Supercubs – which Honda's staff had been using to ride around San Francisco. Using an innovative campaign 'You meet the nicest people on a Honda' they then went on to achieve massive sales growth. In the 1970s they achieved similar results in the UK, eventually destroying the British motorcycle industry. Their success has been attributed to a capacity to learn as well as strong resources to fix problems. When asked how the strategy was developed, however, the Japanese managers themselves stated that there was no clear strategy just a determination to succeed combined with luck and corporate strength.

Honda's corporate strategy was to enter the US market because their domestic market was saturated. Their competitive strategy was initially to sell big bikes through dealers but, opportunistically, they switched to small bikes through sports stores. Their operational strategy of excellent engineering support and production capability meant that they could redesign the big bikes when they started breaking down and then export in sufficient volume to meet new demand for the small bikes. There were also excellent relationships between the key executives.

Strategy takes place at various levels throughout the organisation. It is a pattern in the stream of events. But strategy, as the case study shows, is ultimately about action under pressure. The next article will look at Corporate Strategy and the role of the Centre in directing this pattern.

Issues to consider

- What is my current involvement in strategy development: corporate, competitive or operational?
- How is strategy developed in my organisation in practice?

Further reading

- ***Competitive and Corporate Strategy***

Bowman, C and Faulkner, D Irwin (1997), London.

This book supports the Cranfield MBA core strategy course. It is good on the links between competitive environment and corporate strategy.

- ***Exploring Corporate Strategy***

Johnson, G and Scholes, K, Prentice Hall (4th edn, 1997), London.

This is the best 'tools and techniques' book. It explains the grammar of strategy and is especially good on change, culture and power.

- ***The Strategy Process***

Mintzberg, H, Quinn, J B and Ghoshal, S (European edn, 1995) Prentice-Hall, London.

This is an excellent series of key articles with case studies illustrating the points being made. A good masters level text book.

Aims of the HRM course and learning goals

Human Resources Management (HRM) has a prominent place in modern management. The course will explain the strategic significance of HRM and the effect that the major HRM issues have on corporate efficiency. In Part 1 we introduce the modern role of the subject, the important effects that globalisation, technology and the knowledge economy have had on HRM and corporate response to those effects. Finally, we consider the components of a strategic HRM system.

Strategic HRM: increasing prominence of HRM as a strategic activity

HRM has traditionally been seen as a separate functional department, not as a mainstream management function. Many general management training schemes may require participants to spend set periods of time in marketing or finance, or sales and operations, yet few schemes include secondments into the HR or personnel departments.

However, if you examine current MBA programmes and executive development programmes you will find HRM or strategic human resource management (SHRM) appearing as core subjects on the syllabi. Increasingly, senior business managers within corporations are expected to have a view on the management of people. It is no longer permissible for senior managers to express ignorance of HR, or, as is sometimes the case, total derision for the worth of the whole area. Furthermore, in sophisticated corporations, who are struggling with the complexities of growth, size and internationalisation, HRM is recognised for the key contribution it can make at a strategic level to the overall competitive advantage of an organisation.

The reasons for the elevation of HRM into the strategic debate are almost entirely business driven. HR and personnel practitioners have been proposing for decades that HR should have a seat at the senior management table but this call has often been made by those practitioners who have strong views of what constitutes a 'best practice' model of HRM. However, the recognition of HR's potential strategic contribution has come about because of economic changes.

The significance of HRM

The economic changes that corporations are currently experiencing are numerous and varied, and have been discussed extensively in the press and media. Here we focus on three key developments that elevate the strategic significance of the management of people: globalisation, technology and the knowledge economy.

- **Globalisation** The *globalisation* that we are experiencing at the end of this millennium is the ability of corporations to organise and divert capital to wherever in the world is most advantageous to them in terms of competitive positioning. In some cases this has meant the shift of the labour intensive units of Western corporations into lower cost economies.

There are numerous implications for people management which arise from these developments. First, at an individual level, for many staff in organisations this has increased their need to be able to deal with cross cultural issues in their everyday working lives. Secondly, some staff in the West have experienced globalisation either through their jobs being changed or their jobs disappearing to other parts of the globe. Staff therefore feel that they have less control over their own personal destiny. This is manifesting itself in higher stress levels, feelings of anxiety and uncertainty about their ability to respond to the complexity of the situation.

- **Technology** Concurrently with globalisation as a driving force *technological* developments have had an impact on the way in which corporations configure the management of people. Many human skills have been replaced by information technology. For example, in the past, in the retail banking sector branch staff developed the skill of making lending decisions. However, the information systems now in place can make those lending decisions instead of bank staff. Technology also affects the speed at which information can be sent around the world such that barriers of time and space are broken down. In addition, the emergence of IS systems have triggered the establishment of the virtual organisation and for virtual teams to be possible. 'Virtual' organisations are not limited by time and space; they do not need physical buildings in order to exist, instead existing through interaction between the members of the group. They can be formed instantly and disbanded as soon as they become redundant.
- **Knowledge economy** A further development has been the emergence of the ideas of the *knowledge economy*, knowledge management and the promotion of innovation. The knowledge economy is a response to the changes in Western economies. As labour production is increasingly shifted from the Western nation state into lower cost economies and technology becomes replicable across the world then the resource that appears to offer a competitive advantage is knowledge. Can the 'knowledge' and learning that is within the organisation be harnessed and accumulated such that it can be more innovative in its priorities or faster in its responses?

HRM and corporate responses to economic change

Mature Western corporations have responded to these three developments (globalisation, changes in technology and the need to compete through knowledge and innovation) by downsizing and delayering. These cost-cutting measures also represent attempts to get closer to the customer by breaking down monolithic organisational structures that slow down both decision making and the communication of ideas throughout the organisation. In short, these organisations are seeking corporate renewal. However, the consequences for employees have been the removal of recognised vertical career paths, the erosion of job security, and the creation of a climate of distrust of senior managers and anxiety about the speed of change.

All of these macro economic developments and micro organisational responses necessitate experimenting with organisational structures, and forms of employment relationships; new types of careers and jobs; and a very different approach to the management of people at both an organisational and individual level. Accordingly, interest in the strategic management of the human resource has increased.

A strategic human resource management system

A strategic HRM system is made up of three components as illustrated in *Figure 1* below.

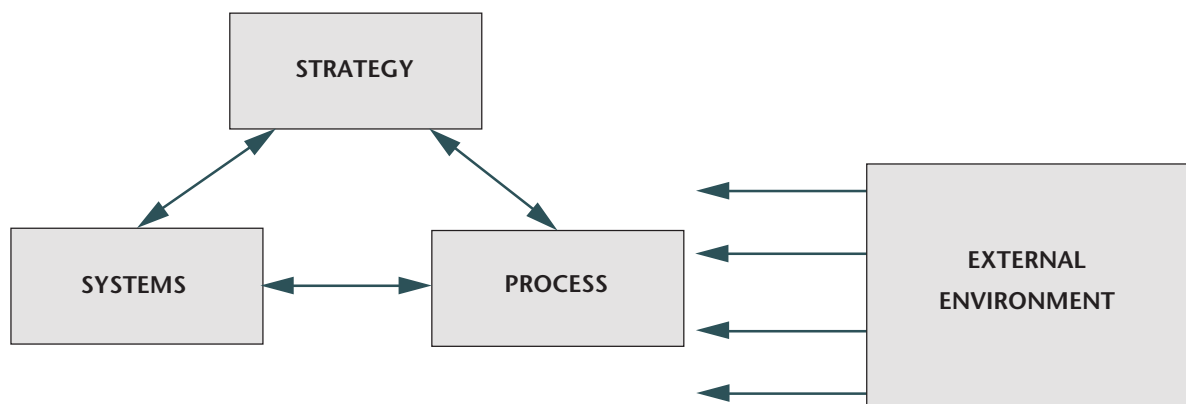


Figure 1: Strategy, systems and process

The *systems* component is what most people associate with traditional personnel management. These are the activities associated with sourcing, appraising, rewarding and developing staff, usually accompanied by *formal* policies and procedures for each area. See *Figure 2* below.



Figure 2 Systems

However, if someone is asked how their employing organisation treats its staff they will usually describe how their *line manager* treats them rather than formal personnel policies that exist. This is what is called the *process* component of the HRM system. Questions to ask about this element of HRM are ‘what sort of managerial style is prevalent in a corporation?’; or ‘How skilled are the line managers in the interpersonal skills associated with coaching and mentoring?’ These activities of people management are part of the informal culture of an organisation. They are also critical indicators of an organisation’s ability to deliver good people management through its line managers (see *Figure 3*).



Figure 3 Process

Strategy is the key, critical component of a strategic HRM system. Examples of the activities that are both connected to business strategy and involve decisions about the management of people are set out in *Figure 4*. All *senior managers* (not just HR Directors) are concerned with this category of decisions. For instance, a decision to introduce a total quality management (TQM) system may involve both the production director and the HR director working synergistically.

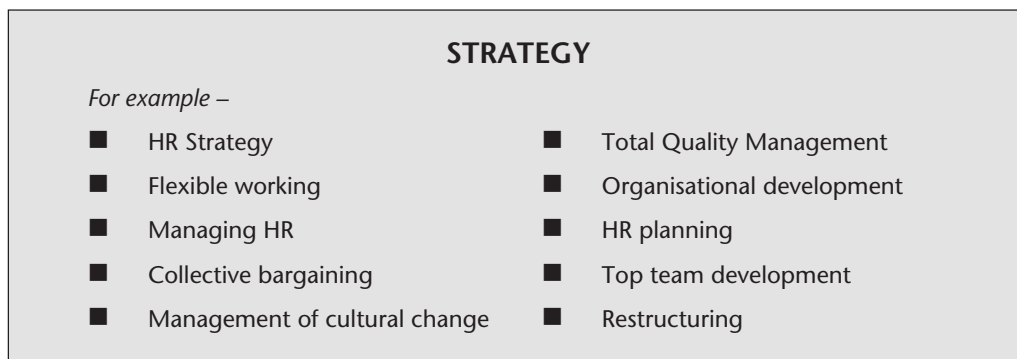


Figure 4 Strategy

Linkage

It is clear from the description of these components that the responsibility for the delivery of an HR management system extends beyond the HR/personnel department to encompass both line and senior managers. In addition, it is also clear that unless these three components are working in harmony with each other, the good work done in one area can be cancelled out by contradictory activity in another. This then requires three important forms of linkage between the different components of an HRM system.

- **Vertical linkage** The activities within both the systems *and* process boxes must be convergent with the strategic intents of the business.
- **Horizontal linkage** The activities within the systems box must be convergent with the activities within the process box. There is little point in investing resources in personnel designing a new performance management system if the behaviours of line managers undermine both the performance metrics used and the system itself.
- **Temporal linkage** This means that the HRM system must be capable of changing over time as the organisation changes over time

Conclusions

In this first article, we have explained how changes both in the external business environment and within organisations have resulted in HRM taking on strategic significance. We have also outlined the three main components of a strategic HRM approach: strategy, systems and process. We have also emphasised the need to achieve vertical, horizontal and temporal linkage between all three components.

Further Reading

■ **Strategic Prospects for HRM**

Tyson, S (IPD), (1995)

A collection of edited articles which examine the organisational and environmental impacts of HRM in the twenty-first century. A mixed bag of papers which provide a good overview of current themes.

■ **Human Resource Champions**

Ulrich, D Harvard Business School Press, (1997)

A book which re-examines the role of the HR function at the end of the twentieth century. A challenging and refreshing read which advocates four separate roles for the function: Strategic partner, change agent, administrative expert and employee advocate. An essential read for senior managers or anyone who aspires to that position. The author is rated amongst the top ten management educators in the world.

MARKETING

PART 1 MARKETING IN TODAY'S WORLD

Helen Mitchell, Cranfield School of Management

Aims of the Marketing course and learning goals

The aim of the marketing course is to provide a sound basis from which the reader can understand and apply the key concepts and techniques used by marketers. In this introduction, the difficulties in defining marketing, its ethical parameters and its place in society are addressed.

What is marketing?

Whilst it is possible to give a reasonably accurate definition of certain business practices, such as distribution or manufacturing, the concept of marketing means many different things to many people. Some see it as selling, while others see it as market research; a commonly held view is that it is something to do with advertising. Even within the marketing community definitions vary, with academics and practitioners providing a wide range of opinions – marketing is variously defined as:

- The process of matching the resources of the business with identified customer needs.
- A social process by which individuals and groups obtain what they need.
- The delivery of a standard of living to a society.
- A management process which identifies, anticipates and supplies customer requirements efficiently and profitably.
- An important functional area of management and an overall business philosophy which recognises that the identification, satisfaction and retention of customers is the key to prosperity.

In essence, marketing is concerned with all of these but, most importantly, it is the idea that companies should ultimately be concerned with satisfying the needs of the customer. Charles Revlon put it perfectly when he said:

'In our factories we make cosmetics, but in the store we sell hope.'

This idea of focusing on what customers need has been the basis of trade since exchange or barter began and it is useful to look back at the historical perspective in order better to understand how the modern marketing concept developed.

The development of modern marketing

Although marketing as we understand it today is considered to have begun in the post-war years of this century, one can argue that marketing as a *function* has existed for thousands of years. Many early civilisations were centred around trading relationships, founded on the premise of supplying goods which met customers' needs and wants. One can even look back to evidence of customer focus in Hellenic Greece. Here, traders would sell different lines of merchandise which were adapted to allow for changes in demand and taste; these goods were also some of the earliest examples of branding, as they were stamped with symbols that allowed customers to identify their place of origin. An early form of international marketing, an important issue for many marketers today, was evident in the Middle Ages. The textile guilds rented blocks of stalls in fairs and markets across Europe, often years in advance, they also controlled the quality of the goods, shared tax burdens and vigorously protected the guild's (brand) name.

However, it is only in the twentieth century that marketing has come to be referred to as a management *philosophy* together with a recognised code of techniques. From the late nineteenth century to 1930 businesses' role was seen primarily as production. Manufacturers were in a suppliers' market, fulfilling an unending and insatiable demand for new goods and services. The economic recession of the 1930s then saw a switch to a sales orientation as demand slumped. This was seen to create effective demand and sophisticated sales forces and techniques such as advertising and sales promotions were developed to sell, sometimes unwanted, goods to the customer; their satisfaction was secondary to the sale and after-sales service was not considered.

In 1954 Peter Drucker acted as the catalyst to what is seen as the 'marketing revolution', he positioned marketing as the most important component of business success and urged companies to become marketing-orientated. He stated that:

'... Because it is its purpose to create a customer, any business enterprise has two – and only these two functions – marketing and innovation ... Marketing is the distinguishing, the unique function of business ... marketing is so basic that it is not just enough to have a strong sales department and to entrust marketing to it. Marketing is not only much broader than selling ... It is the whole business seen from the point of view of its final result, that is, from the customer's point of view ... Concern and responsibility for marketing must therefore permeate all areas of the enterprise.'

Marketing orientation

Although Drucker was not saying anything dramatically new, it was the emphasis he put on marketing becoming central to business success that elevated it as an important management concept. His powerful, customer-focused agenda for companies has lost little of its relevance today. In a recent study of Japanese, UK and US companies, to investigate the success of marketing orientated companies, Wong and Saunders demonstrated that organisations classified as 'innovators', 'mature marketers' and 'quality marketers' performed significantly better in terms of sales, market share and profits than those with a more financial or production orientation. (See Figure 1)

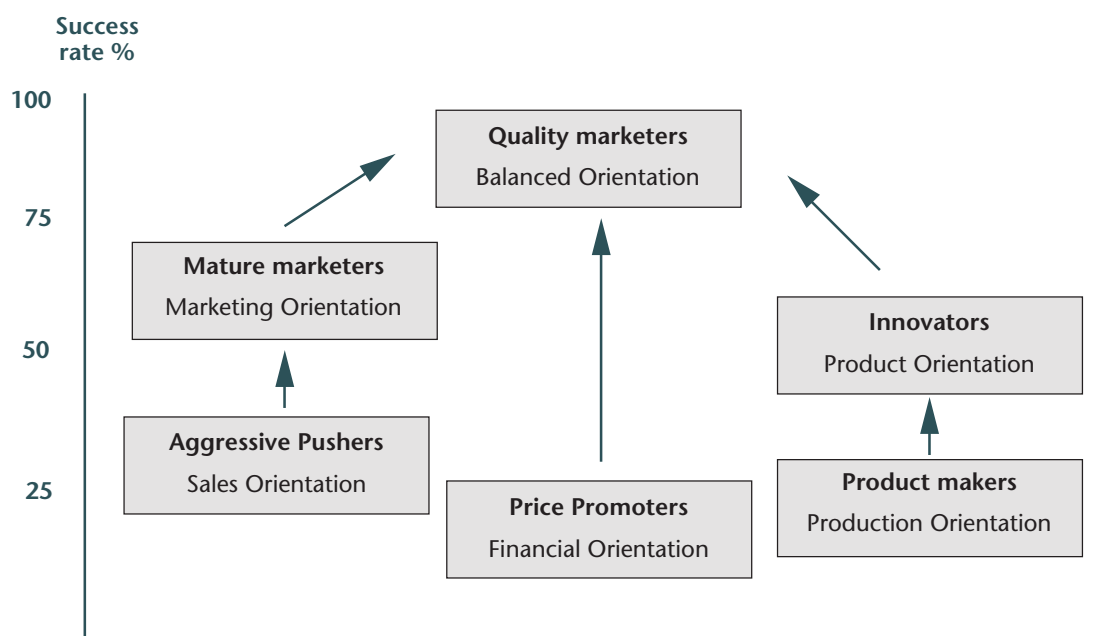


Figure 1 Business orientation and success rates (Source: Wong, V and Saunders, J (1993) 'Business Orientations and Corporate Success' Journal of Strategic Marketing 1,1, pp 20-40)

The reason for their success is that a marketing-orientated firm produces goods or services that customers want to buy rather than what the company wants to make. It is essential that every activity the firm undertakes is driven by the principles of marketing and that in every part of the organisation there is a sense that the customer is the central focus.

In contrast, the production-orientated company's efforts are on the manufacture of products that they are good at producing, with little attention paid to the customer. The demise of the British motorcycle industry is a classic example of too much focus on production. Companies such as Triumph were producing fine quality machines and were happy with the 2-5% rise in sales that they were achieving annually. However, this rise was due to the general rise in the marketplace for bikes generated by the customer-focused Japanese, who were experiencing 50-70% rise in sales by producing stylish and well designed machines that customers preferred.

A sales-orientated company is driven by sales volume delivered by highly motivated, incentivised salesmen. By the very nature of their emphasis the outlook is short-term and, as a result, many companies that follow this approach will find it very difficult to sustain their existence due to a lack of repeatable business. Britannia Encyclopaedias are an example of a sales-orientated company: what they are ultimately selling is knowledge but the growth of technology may soon make them superfluous as customers (and more importantly their children) will prefer to access this data by computer which is more accessible and interactive. This is being provided by software companies not book publishers. Britannia are presently addressing this by providing information via on-line services and CD Roms, and will undoubtedly have to become more marketing-orientated in the future.

As firms begin to achieve a more balanced orientation, it is clear that the customer will be the central focus of a firm's activities. This will be considered in future articles, looking at how customer relationships will be built on quality and trust, over longer periods of time, bringing value to all parties. Branding will also become increasingly important as the significant signpost to lead customers to want to create such relationships.

Marketing, ethics and society – the future?

We have seen that the basis of the marketing concept of the last 40 years has been to focus on the customer and supply goods to satisfy their needs. However, recently academics, practitioners and consumers themselves have begun to question the relevance of this approach to the world of today.

The main issue is marketing's role in sustaining materialism, and commercial activities of all kinds are being appraised in the light of society's concerns for future resources and the environment. Consumers themselves are no longer passive, as Shell found out to their cost in the Brent Spar fiasco. Their market share collapsed overnight in Germany as environmentally conscious consumers objected to their plans to dispose of the oil platform in the North Sea.

Marketing has been singled out as one of the drivers behind increasing consumerism and material waste. However, as Martin Christopher (see inset box below) points out, consumerism is pro-marketing and the very fact that consumers want more responsible business practices provides an opportunity for companies to build better relationships with consumers. Marketing is no longer done on the initiative of the marketer, the customer now works through representative groups and institutions. Consumers are demanding truth in advertising and labelling, high safety standards, recyclable packaging and ethically responsible corporate practice (seen most recently in the outcry over the investigation into reports of small children in India being paid a few pence a day to produce £25 footballs for the Western European market).

Marketers now have an opportunity to reassess and develop products and services that meet short-term customer needs but also their long-term expectations for a better quality of life.

Reinventing marketing**Martin Christopher, Professor of Marketing and Logistics**

In the last few years more than one voice has been raised questioning the future of marketing. There has been a view, quite widely held, that marketing has failed to deliver the goods in the sense of a constant flow of innovative products and services which offer ever-higher levels of value for customers and consumers. Instead, the critics have implied, there has been a greater reliance on 'me toos', brand extensions and wasted expenditure on producing ever-glossier advertisements that fail to strengthen brand loyalty.

However, an alternative point of view contends that, far from failing the customer and consumer, marketing has been the principal driver of product development, service enhancement and an unprecedented level of choice.

The reality is probably somewhere between these two extremes. The need for marketing is as strong as ever, what needs to be challenged is how the principles of marketing can best be applied in today's quite different competitive environment.

One of the issues that needs to be confronted by both academics and practitioners is that the fundamentals of marketing theory were developed and first promulgated in a world that is quite different to one that we know today. Much of what still provides the foundation for today's marketing strategies was actually formulated in the 1950s in a competitive environment (primarily the North American consumer goods market) that starkly contrasts with the global marketplace of the late 1990s.

Whilst the fundamentals of marketing orientation hold good, no matter what the changes in the market and competitive framework, there is now a widespread realisation that marketing must do more than merely generate sales but also must seek to *retain* those customers and develop enduring relationships with them.

The focus, perhaps, now needs to switch from the blind pursuit of market share and emphasise instead the quality of that share. In other words, are we doing business with customers who make money for us and who stay with us? What are the quality of our relationships with those customers? Underpinning this is the belief that marketing should not be the sole responsibility of the 'marketing department' but rather should be cross-functional and process orientated.

Many organisations have already sought to make the transition from the traditional concept of marketing as a function to the idea of marketing as a means by which the core processes of the business are co-ordinated and focused upon the customer. These core processes include innovation, brand management, customer and supply chain management. (These will be discussed in future articles.) Clearly, there are a number of daunting barriers to achieving this radical change in orientation – not the least being the different skills required to manage effectively in a cross-functional team-based organisation. The challenge to business managers today is to become increasingly more flexible in order to be able to respond to these changes and those to come.

Further reading■ ***Marketing – an Introduction***

Christopher, M and McDonald, M, MacMillan, Hants.

An excellent introduction to marketing, written in a simple-to-read, clear format. Used as one of the core texts for the Cranfield MBA.

■ ***The Principles of Marketing***

Kotler, Armstrong, Wong and Saunders, Prentice Hall, London, 1997.

Contains many interesting and helpful cases and examples in a European context.

■ ***Even More Offensive Marketing***

Davidson, H , Penguin Business Books, London.

A sequel to the highly successful Offensive Marketing, this classic text is especially written for business people. Practical, original and stimulating.

■ ***The Principles and Practice of Marketing***

Jobber, D, McGraw Hill, London.

Used as a core text by the Chartered Institute of Marketing, this book provides an excellent grounding in the basic principles of marketing with many European examples.

■ ***Post Modern Marketing***

Brown, S, Routledge, London.

A challenging and controversial book, which casts a postmodernist's eye over contemporary marketing.

FINANCE

PART 1 FINANCIAL PLANNING AND REPORTING

Ruth Bender, Cranfield School of Management

Aims of the Finance course and learning goals

All our members, by definition, have a background in finance. This course is designed to reintroduce readers to concepts and practices that they might not have used recently, and to set out some new ideas in the area of finance.

Introduction

Much of finance involves making decisions based on forecasts about what might happen in the future. We identify a problem, for example whether or not to apply for a bank loan or to undertake a capital investment, and then make projections of the likely financial impact of such an action. Financial planning is something that is so basic to the work of accountants that often we fail to consider our aims and methods. However, it is because financial plans are fundamental to much decision making, that it is appropriate to start the 'Finance' track of *Management Quarterly* by looking in some detail at the reasons and methodology behind the practices.

Financial planning is undertaken for many reasons, for example regular budgeting activity, analysis of proposed capital expenditure, preparation of tender proposals, acquisition or disposal analysis, fund raising, or the determination of cash requirements for a company in trouble. In this article we examine the broad principles underlying these different types of plans, and how they translate into financial models.

Forecasts

No matter what the reason for preparing the financial plan, certain questions need to be addressed in order to create the most appropriate forecasts.

- **Why is the forecast being prepared?** Without an understanding of what the users require, the end result is unlikely to meet their need.
- **How accurate does it have to be?** Forecasting the daily cash requirements of a business in an exercise to determine whether it can survive without wrongfully trading needs to be as accurate as possible. However, in forecasting the twenty year revenue projections for a major item of plant it must be accepted that, whilst every effort should be made to use appropriate assumptions, spurious accuracy is totally misleading to the reader.
- **How long is the forecast period, and over what intervals of time?** It is important to understand the decision horizon, and to know whether weekly, monthly, quarterly or annual information will be of most use to the decision maker.
- **Who is going to use the forecast?** The format needs to be tailored to the user. If it is to be used internally by people with an intimate knowledge of the business and finance, there will be a very different 'feel' to the plan than one which needs to be understood by outsiders or non-financial people.

Furthermore, once the forecast has been prepared, three other matters have to be addressed. First, the assumptions must be clearly stated. These are the most important part of any forecast – most readers

will not immerse themselves in the detailed numbers, but just look at the assumptions and the 'conclusion'. It is vital that they be able to appreciate the commercial sense (or otherwise) of the projections. The boxed text below illustrates this.

Stating assumptions

An illustration of the importance of clearly stated assumptions arose when the author was preparing forecasts for the valuation of a distribution company. The company was about to move premises to a building – not yet identified – which could be any one of three different sizes, leading to three possible levels of activity, and hence three possibilities for the valuation. It was only when the logistics director read the forecast assumptions (which had been discussed with all of the directors individually) that he realised that his co-directors were under a misapprehension – one of their projected scenarios for the company's future was physically impossible to manage. The company's plans were changed as a result.

The second important point regarding forecasts, no matter what their purpose, is that they should be subject to a 'reality check' – do the forecasts make sense?. If they do not reflect commercial reality, they are probably wrong. The boxed illustration below gives an example of this.

Commercial Reality

Last year the author was asked to comment on a funding proposal prepared by the production director of a small packaging company. He wanted to buy a particular machine, and had prepared an evaluation showing payback in about eight months, and a massive return on investment. The numbers were all internally consistent, but one had to ask 'How can the acquisition of a standard machine, widely available to all of our competitors, lead to such a competitive advantage that it would increase sales and returns by that factor?' (The outcome of the case was that they bought the machine anyway, and the returns were not achieved!)

The third matter to consider is a post-project evaluation. Too often, plans that go adrift are consigned to a drawer and ignored. Project outcomes should be compared to the original plans, and reasons for divergence determined, preferably in a blame-free environment. The feedback from this can then be used to improve the future planning process. (*Good Practice Guideline 14, Post Completion Review* explains this further.)

Financial modelling using computer spreadsheets

Computer spreadsheets, which have revolutionised the preparation of forecasts, are often misused and are potentially dangerous. Whereas 'proper' computer programs are designed and documented, spreadsheets are often prepared on an ad hoc basis by the user, without documentation, and then adapted and revised by the original user and others, without ever determining whether the internal logic remains consistent.

Some basic rules for the preparation of financial spreadsheets are as follows:

- Even if only a cash flow forecast is required, best practice is to prepare an integrated package of cash flow, profit and loss and balance sheet. Triangulation of these documents can provide an extra 'reasonableness check'.

- Although rarely requested by the user, it is often useful when preparing a month-by-month cash flow forecast also to prepare an annual cash flow statement, similar to those shown in financial statements. This too provides a useful reality check.
- Logic checks should be built into the spreadsheet (for example, ensure that closing debtors agree to the debtor days assumption).
- Resist the temptation to cram complicated formulae into individual cells. The spreadsheet will be easier to understand, and to alter, if workings are shown. Similarly, keep input figures separate from formulae, to facilitate changes.
- Document the spreadsheet, specifying the overall layout of the model, with range names and explanations of macros. State when and why the original model was prepared, and how (and by whom) it has been updated.

Dealing with risk¹

Financial planning is about the future, hence there will always be an element of risk involved – the one thing that can be almost guaranteed is that the forecasts will turn out to have been inaccurate in some respect. Different businesses will be subject to different types of risk, and it is important to understand the causes. Generally, risk will be one of four types:

- **Inherent industry or market risk** For example, water utilities will be more sure of future sales than will high fashion companies.
- **Geographical risk** For example doing business in a developing country as opposed to, say, the USA.
- **Lifecycle risk** For example, start up companies, with no track record, are unlikely to be able to forecast as accurately as well-established businesses.
- **Operational gearing** Projects with relatively high levels of fixed costs will always produce more volatile results.

Risk in forecasts can be treated in different ways. Where applicable, a higher hurdle rate (or higher target profitability) may be used, to allow for a wide margin of error; or projected cash flows may be adjusted, to take account of their likelihood of occurrence; or a full simulation of possible outcomes could be run; or some sort of sensitivity analysis will be undertaken. Sensitivity analysis, a commonly used method, is discussed below.

Sensitivity analysis

Sensitivity analysis involves varying the expected cash flows, generally one item at a time, to see the effect that this will have on the overall outcome. The widespread use of spreadsheets has made this a very simple process.

Traditionally, many financial planners carry out sensitivity analysis by adjusting sales (or another variable) by plus or minus 10% and documenting that result. Although such analysis is better than nothing, the technique should be taken a lot further. The art of sensitivity analysis is to look to see what might happen, and then adjust the model accordingly. Each major assumption should be tested to determine the parameters on which it was set up, and how much variability is likely to occur. Then each in turn should be adjusted in the model, to see the effect on the key decision parameter (normally cash or profit). Having done this, the next step is to consider whether that particular sensitivity is critical to the decision – how much would that variable need to change before the project became non-viable? If it is not critical, a sensitivity can be noted and ignored. However, areas in which the change to the

¹ For further details, see generally *Technical Focus 10, Business Risk Management*.

parameter have led to a potential change in the decision must be dealt with further.

As an illustration, sensitivity analysis on forecasts to justify a capital project might include:

- Altering the build up of sales, so that the maximum capacity is reached a year later (or earlier) than expected.
- Altering sales prices.
- Altering the cost of key inputs, for example, assuming that wages inflation is greater than expected, or that commodity prices change.
- Adjusting working capital needs.
- Changing the discount rate.
- Extending/reducing the time period of the forecasts by one year.
- Altering the terminal value received by realising assets at the end of the project.

Some of these changes will lead to significant differences in the projected viability of the project, others will have little effect. The next stage of the process is to try to reduce the project's riskiness by trying to get better information or control over those variables which have the maximum impact. For example, if sales build up is a key parameter, perhaps more might be spent on market research to refine the possible likely drivers; if input prices are critical, then attention needs to be paid to ways of reducing these.

Working capital management

In modelling cash flows it is vital to identify and understand all the cash movements through the business. Without such understanding, there is a danger that the model will be wrong – garbage in garbage out – and decisions will be made in error.

A key aspect of business modelling is the understanding of working capital movements – how stock build ups or changes in debtor or creditor terms will impact upon the decision outcome. *Good Practice Guideline 7, Working Capital, Good Practice Guideline 21, Strategic Working Capital Management* and *Case Study 5, Inventory Reduction* explore this area in detail.

Further reading

The policy of *Management Quarterly* is to recommend texts which the authors believe will add to members' understanding of a subject and their ability to apply the lessons in practice. Where no suitable text has been identified, none will be included here. This applies in particular to earlier sections of the Finance track, in which it is accepted that members already have knowledge.

Previous Faculty publications will, where applicable, be included for your reference.

- **Post Completion Review**

International Federation of Accountants (1996) ICAEW Faculty of Finance and Management *Good Practice Guideline 14*, June 1996.

- **Strategic Working Capital Management**

Bender, R (1998) ICAEW Faculty of Finance and Management *Good Practice Guideline 21*, February 1998

- **Working Capital**

ICAEW Faculty of Finance and Management *Good Practice Guideline 7*, May 1994.

- **Inventory Reduction**

Edwards, J (1998) ICAEW Faculty of Finance and Management *Case Study 5*, July 1998.

IN THE NEXT ISSUE . . .

Strategy *What does a corporate headquarters do?*

The corporate HQ can take a hands-on or hands-off role. Which is more appropriate? How does the corporate HQ add – or destroy – value to the business?

Human Resources *Changing roles and responsibilities within people management*

The role of HR has changed significantly over the years. We look at how HR managers, and senior and line managers interact on HR issues. Strategic and tactical models of the HR function are considered.

Marketing *Marketing planning*

Marketing planning is defined, and the steps in the planning process are clearly set out, including a section covering the obstacles to implementing a marketing plan. Marketing audit, and organisation and control are also covered.

Finance *Operating and business systems*

Good systems are vital for a successful organisation. We discuss reporting structures, the content of management accounts, performance measures, business risk, and how financial control can best be maintained.

OUTLINE SYLLABUS

Management Quarterly is designed to be an three-year endeavour, setting out key management techniques in core disciplines. Over that time, it is expected that the content may develop and change. However, here we set out the current anticipated syllabus for the journal.

Strategy

What is strategy?
 What does corporate HQ do?
 Corporate strategy and M&A
 Competitive strategy
 Strategic analysis tools – the external environment
 Strategic analysis – assessing internal resources
 Linking external and internal analysis
 Strategic choice: stakeholders
 Strategic decision making
 Strategic change
 International strategy
 The future of strategy

Human resources

Introduction to people management
 Changing roles and responsibilities
 Strategic HRM and the management of change
 Resourcing the organisation
 Motivating and monitoring
 Developing the organisation
 Personal development and people management competencies
 Managing conflict and difference
 The role of trade unions and collective representation

OUTLINE SYLLABUS – Continued**Human resources – Continued**

Impact of the European Union
International HRM
Ethics and corporate governance

Marketing

Marketing in today's world
Marketing planning
Understanding customers – the consumer
Understanding customers – the organisation
Market research and information technology
Market segmentation and positioning
Analytical tools for marketing
Managing the marketing mix
Developments in marketing
Relationship marketing
Branding
International marketing

Finance

Planning and reporting
Operating and business systems
Interest and discounted cash flow
The cost of equity
The cost of capital
Shareholder value
Valuation of companies
Financial instruments
International finance
Mergers and acquisitions
Project finance
Venture capital

Articles are also being commissioned to cover: knowledge management, project finance, information systems, just-in-time operations, total quality management. Further material on people management, concentrating on the individual rather than the organisation, will also be included.

Management Quarterly will act as an aide-memoire for members, provide new ideas, and encourage good practice, but the Faculty cannot accept responsibility for the accuracy or completeness of issues of *Management Quarterly*. **Being general in nature, the points made in *Management Quarterly* may or may not be relevant to specific circumstances.** Responses from the membership will be a very important part of the successful development of the series. Comments please, to Chris Jackson on 0171-920 8486 (or by e-mail to CDJackson@icaew.co.uk).

Management Quarterly is compiled and edited by Ruth Bender, who joined Cranfield School of Management as a lecturer in 1994, having completed her MBA there. Prior to this, she was a corporate finance partner in Grant Thornton. Ruth is a member of the Faculty committee.

Each member of the Faculty in the year of publication will receive one copy of every *Management Quarterly* published by the Faculty free of charge. Copies are not available to non-Faculty members.

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Any members who have not received the above should contact Chris Jackson at the Faculty using the contact details set out below.

Faculty website – <http://www.icaew.co.uk/finman.htm>

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