CHAPTER 1ONE

Strategy

- Tool box 1: What should a mission statement contain?
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Strategy

FORMULATING BUSINESS STRATEGY involves making decisions on business direction, assessing sources of competitive advantage, examining external factors, taking into consideration aspirations and interests of all stakeholders, conducting organisational audit and then deciding on people, processes and products in order to gain and sustain competitive advantage. This chapter deals with appropriate **tool boxes** to structure your thinking and action to formulate an appropriate business strategy.

Every business requires a direction. This direction is influenced by an organisation's mission. An organisation needs to have mission in order to articulate its corporate vision. Mission is about an organisation's philosophy of how it intends to conduct itself.

TOOL BOX 1ONE

What should a mission statement contain?

In preparing a mission statement ask yourself these questions:

1. What does your organisation stand for?
2. What does it believe in?
3. What does it expect from its employees in terms of their behaviour?

Mission statements should be focused and should be easy to understand in terms of behaviours and standards.

After preparing a mission the next step is to prepare strategy for the organisation. *Strategy provides the direction and goals*. According to Michael Porter, strategy is a combination of the goals for which the organisation is striving and the means by which it is seeking to get there. To focus on a meaningful direction and prepare appropriate strategy, top management have to consider asking and answering the following questions:

TOOL BOX 2TWO

Deciding on business direction

A. What business are we In?

B. What do we want to achieve?

C. How are we going to achieve them?

D. What is the timescale involved?

Answering the above questions will give direction to your business and clarify your business objectives and the time within which you want to achieve your objectives.

The four questions in **Tool box 2** appear very simple but they are fundamental questions all businesses should address to provide a clear strategy. For example, if you are in the business of making ice cream, in addressing a question 'What business are we in?' you ask yourself are we making a product which is called and recognised as ice cream or are we making a product which is not just going to meet the demand but create delight and excitement for consumers? If this is the case then you are in the business of making ice cream that would thrill and excite consumers. This will affect your decision to make a product with different colours, different flavours and different attributes (softness, texture etc).

Having answered the questions in **Tool box 2** you then proceed to formulate your business or strategic objectives. Objectives could be financial such as gross profit margin or net margin or profit per employee or cost of sales etc or non-financial such as satisfying customers, providing a very high quality product or increasing the volume of repeat business etc. In practice, strategic objectives are financial and non-financial. It is very important when formulating objectives to consider the criteria in **Toolbox 3**. If these criteria are ignored, there will be considerable frustrations in assessing business results.

TOOL BOX 3THREE

Criteria for setting strategic objectives

S Objectives should be simple and sensible and stretched to deploy fully the resources available. They should make sense to all those involved in achieving them.

M Objectives should be measurable. It is said that what gets measured gets done.

A They should be attainable and not be far-fetched.

R They should be realistic.

T They should have a timescale. Achievement should be measured within the context of different timescales. They could be every three months or six months or three years, whatever makes sense to the business.

Once the strategic objectives have passed the S.M.A.R.T. criteria highlighted in Toolbox 3, it is important to then consider the interests and aspirations of stakeholders. Stakeholders are groups of people who have direct interests in the performance of your business. The stakeholder groups are investors, managers, employees, customers, suppliers and, in some cases, regulators and the government departments.

ANALYSIS TOOL • STAKEHOLDERS' ANALYSIS

Levels of strategy

The questions in **Tool box 1** and **2** relate to corporate level strategy. The tactics of achieving corporate strategy lead to formulation of strategy at business unit level. How is an organisation going to achieve its strategic objectives? Second level or business level strategy focuses on how business units within the organisation are going to achieve these objectives. Business level strategies and objectives must be consistent with corporate level strategies.

Why is strategy important?

PAUSE FOR THOUGHT.

'All men can see the tactics whereby I conquer but what none see is the strategy out of which great victory is evolved.'

SUN TZU
Chinese military strategist (3000 years ago).

The business environment is changing dramatically and in a such a world, strategy also has to be dynamic. There is a need to adapt strategy according to the changes in the business environment within which business is operating. This is known as strategic adaptation. To bring about such a 'fit' between corporate strategy and an external environment it is important to undertake environmental analysis.

Changes in environmental factors can be categorised into sociological factors (S), technological factors (T), economic factors (E), and political factors (P). These S.T.E.P. factors have impact on business performance.

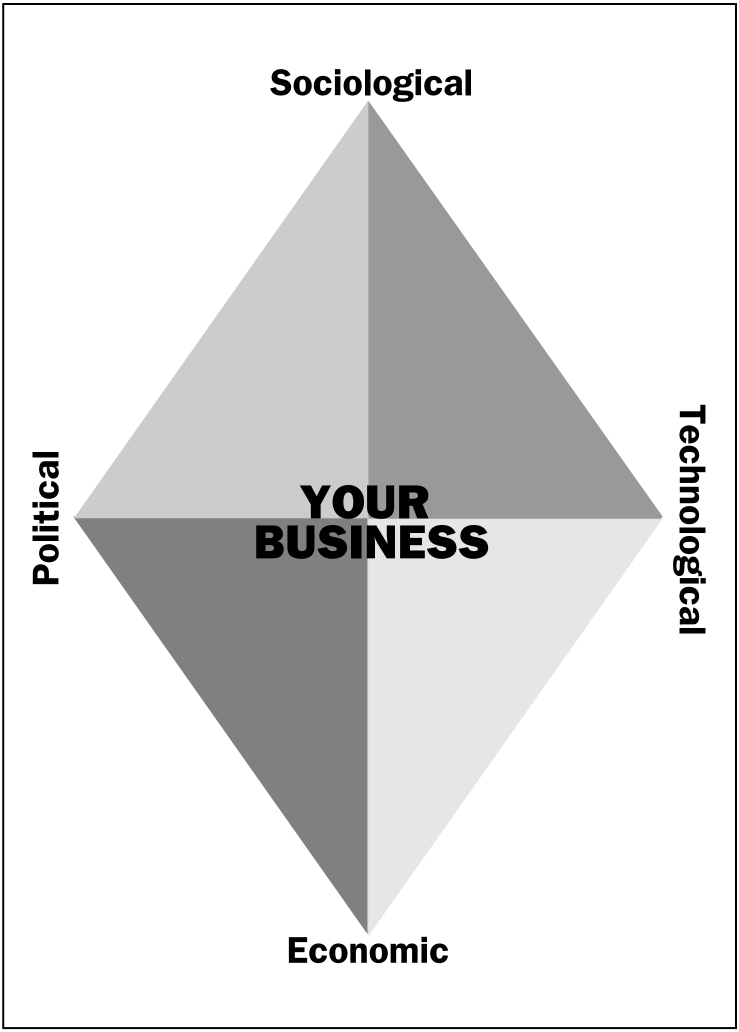
Sociological factors incorporate changes in social attitude (attitude towards smoking or drug taking for example), changes in social habits and behaviour, ageing population, more women working etc.

Technological factors include technological developments in relation to computing, teleworking, faxes, telecommunications, etc.

Economic factors relate to inflation, employment, economic growth, exchange and interest rates for example.

Political factors relate to policies of deregulation, privatisation, free trade etc.

It is very important for any organisation to undertake analysis of how such factors affect their business. Based on this analysis the organisation can then adjust its strategy.


Sociological
Political
YOUR BUSINESS
Technological
Economic

TOOL BOX 4FOUR

Conducting environmental analysis

Step one

Consider all key factors under S.T.E.P. categories (see p.11) and identify those factors which affect your business directly. For example, interest rates under economic factors affect building trade directly or the ageing population impacts on financial services industries.

Step two

Having gathered all the factors that have relevance to your business, consider the probability of change in relation to these factors. For example, how probable it is for exchange rates to change in the near future. The scale of probability should be ’high’ and ‘low’. (**See Toolbox 5**).

Step three

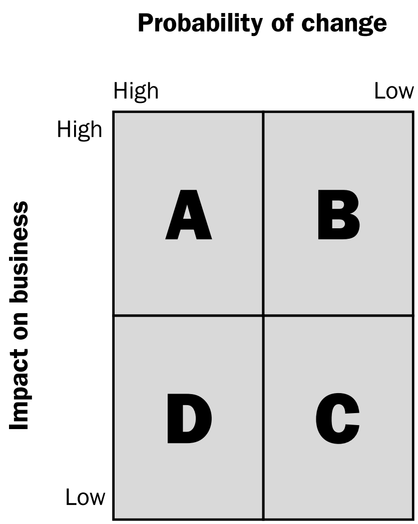
Consider the impact of these factors. Should the probability of change and impact on business put all these factors in box ‘A’ in **Toolbox 5**.

Step four

In the light of this information, should your strategy and associated strategic objectives be revised, fine-tuned or reformulated?

TOOL BOX 5FIVE

Conducting impact analysis of S.T.E.P. factors



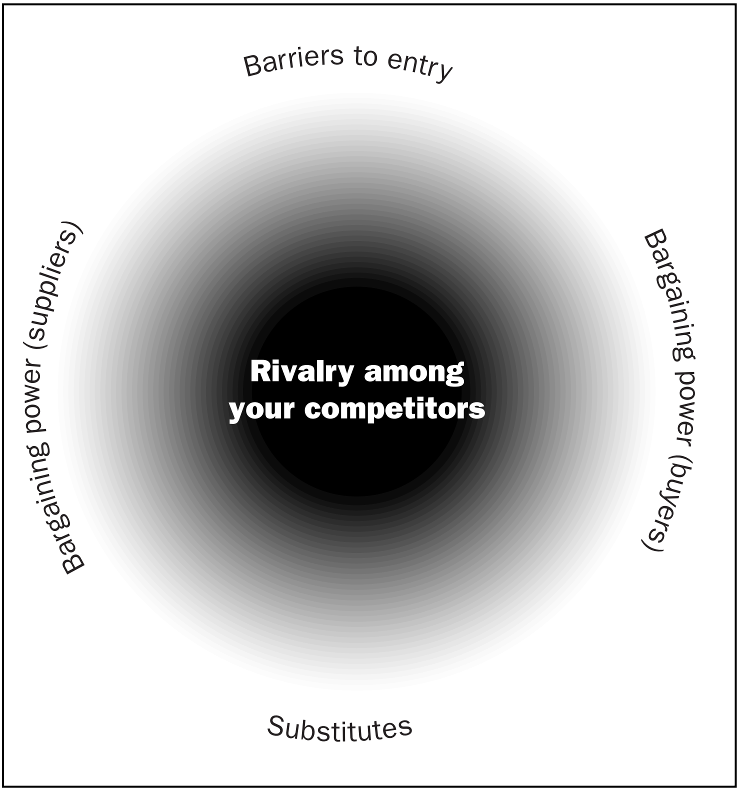
Under each heading of sociological, technological, economic and political factors identify key elements (for example, interest rates, Britain joining the single currency, new technology etc) and assess its probability of change and its subsequent impact on your business. If probability of change is **high** and its impact on your business is **high** it would fall in box A.

Consider all the items that fall in 'A' before formulating your strategy.

Having completed an analysis of external factors, the next step is to analyse the industry within which your business operates. This is known as undertaking industry analysis. Michael Porter presented a five forces framework to undertake industry analysis. These are:

rivalry among competitors, bargaining power of suppliers, bargaining power of buyers, substitutes and barriers to entry.

ANALYSIS TOOL • INDUSTRY ANALYSIS



- What kind of competition exists?
- What is the intensity of competition?
- How strong is the bargaining power of suppliers and buyers?
- What are the barriers to entering your market?
- What substitutes exist in relation to your product and service?

TOOL BOX 6SIX

Conducting industry analysis

The following factors should be taken into account when conducting industry analysis.

- How many firms/organisations are there in the industry you are operating?
- What is the relative size of their business?
- What is their market share?
- How fast are they growing?
- What is their cost structure?
- What is their profitability?
- What kind of distribution channels do they deal with?
- How much do they spend on research and product development?
- What is their advertising/promotion policy?
- What type of resources do they have?

Industry analysis will provide an organisation with useful information about the competitive environment and its business rivals.

Having accumulated information on external and industry factors, an organisation then has to conduct an audit of its current capabilities and the challenges that lie ahead. The method for doing that is known as undertaking a **S.W.O.T. analysis**. This analysis involves examining the Strengths, Weaknesses, Opportunities and Threats facing an organisation.

TOOL BOX 7SEVEN

Conducting S.W.O.T. analysis

Strengths

Looking inside your organisation, what strengths do you have in relation to your strategy, structure, people, leadership, processes, products, systems, values, culture?

Weaknesses

What weaknesses do you have in relation to the above factors?

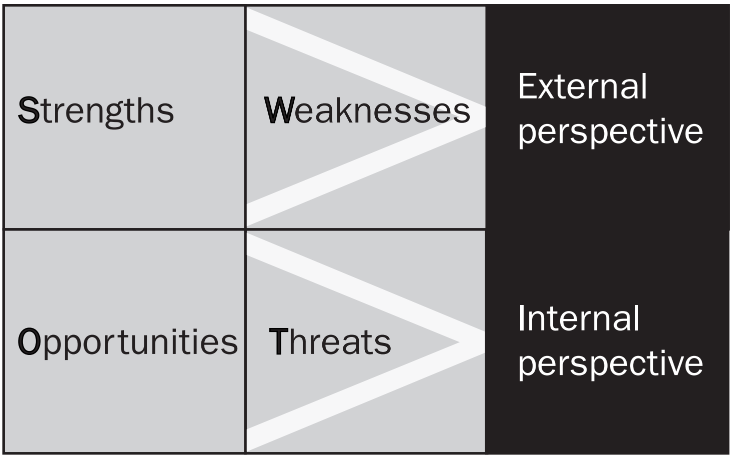
Opportunities

In scanning the external environment and having undertaken industry analysis, what opportunities do you see for your business? Make a list of these opportunities.

Threats

In looking externally, what challenges do you face? Make a list.

ANALYSIS TOOL • S.W.O.T



Please note that **strengths and weaknesses** relate to factors **inside** your organisation, whereas **threats and opportunities** relate to factors **outside** your organisation.

Gaining competitive advantage involves analysing internal and external sources.

Michael Porter has highlighted two basic types of competitive advantage. They are competitive advantage focusing on **cost leadership** and the other type focusing on **differentiation**. Whether you go for competitive cost advantage or differentiation depends on the resources you have available, what competencies your organisation possesses in terms of processes and people, your competitive environment, the nature of your business and your business strategy.

Having undertaking various analyses you then have to proceed to formulate your business strategy and strategic objectives. Objectives are expressed in quantitative terms for example, achieving 15 per cent net margin by the end of the budget period or reducing overhead costs by 25 per cent over the next three years or qualitative terms, for example, meeting customer needs or producing quality products.

- **Managing your working capital**
- Tool box 23: How to manage your working capital
- Analysis tool: Managing working capital
- Tool box 24: Conducting break-even analysis
- **Key financial ratios**
- **Managing shareholder value**
- **Budgetary control**

CHAPTER 6SIX

Managing and dealing with finance

Managing and dealing with finance

ALL BUSINESSES HAVE to deal with finance. After organisations have prepared their strategies they then have to prepare strategic objectives. Each department or section or region then have to prepare their objectives which have to be consistent with the organisation's objectives. Associated with objectives are performance indicators to monitor these objectives. Generally speaking these indicators are financial in their characteristics. Costs, profits, return on capital employed, price earning ratio etc are all indicators which have financial characteristics.

In commercial business, there are three sources of financial information. These are Balance Sheets, Profit and Loss Statements and Sources and Application of Funds.

Balance Sheet

A Balance Sheet is a financial situation of an organisation showing what an organisation owes (its liabilities) and what it owns (its assets). It is a statement of total assets and liabilities of a business at a particular moment in time. In other words, it is a financial snapshot of the business.

Profit and Loss Statement

Profit and Loss Account shows how the company has traded in the year it is reporting. The account includes revenue and expenditure items which relate to the year under consideration and these items are matched to calculate profit and loss. Profit is the excess of sales revenue over the costs incurred in achieving that sales revenue.

Sources and application of funds

This statement shows where the money in the business has come from (issue of shares, borrowing etc) and how it has been spent or applied (investment in fixed assets and working capital).

Managing your working capital

The management of working capital is the lifeblood of any business. **Profits do not equal cash**. Working capital is current assets minus current liabilities. Working capital is needed to keep business afloat.

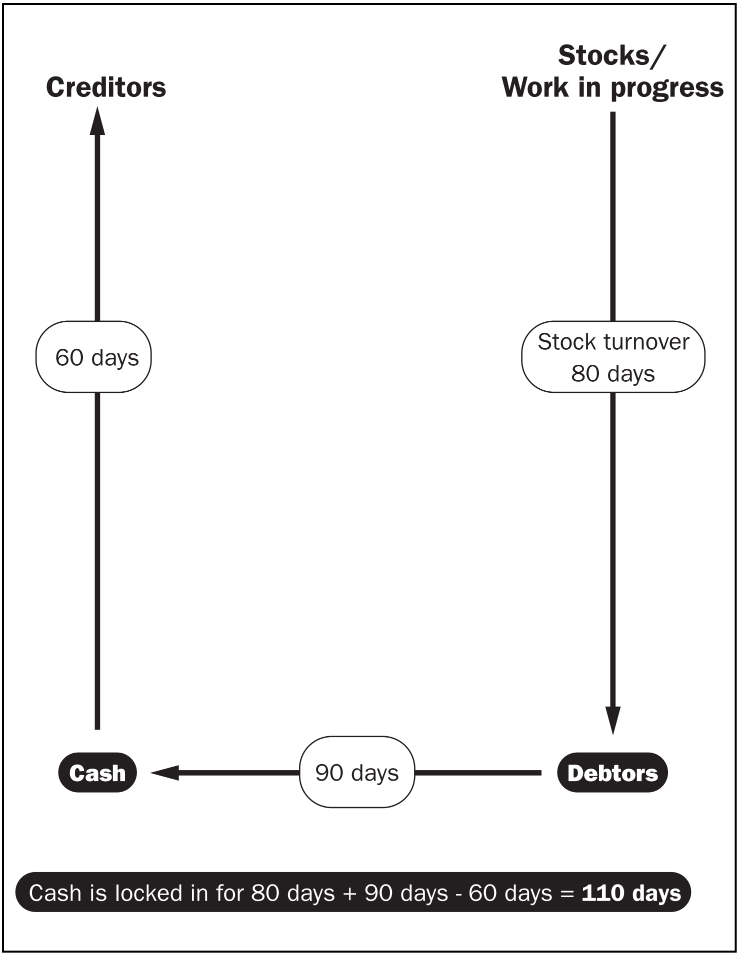
Businesses incur expenses in terms of buying raw materials, holding stocks etc and at the same time it receives money from buyers. The gap between incurring expenditure and receiving cash is very important to manage. The longer you pay your supplier and the shorter the period you allow for your customers to pay you would lead to less working capital. If the time you pay your supplier is longer than the time you receive money from customers then you need more working capital. Your working capital will also be very small if you do not hold stocks or you hold stocks for a very short period.

A business makes profit by selling its products and service but if not enough cash is generated to meet its obligations, it becomes insolvent.

TOOL BOX 23 TWENTY-THREE

How to manage your working capital

- Negotiate long credit terms with your suppliers.
- Negotiate short credit terms with your customers.
- Make sure the credit terms you negotiate with your suppliers are longer than the terms negotiated with your customers.
- Hold less stocks but not at the expense of affecting delivery promise.
- Control your cash effectively.
- Managing working capital involves controlling your debtors, creditors and your stock, including work-in-progress
- Do not delay sending out invoices. If sending abroad, make sure what the custom of the country you are dealing with is in terms of payment period.
- Make it easy for customers to place orders.
- Make sure your stock profile is consistent with your sales order profile.
- Monitor disputed invoices and make sure they are settled as soon as possible.
- Budget for stock and constantly monitor stock levels.
- Make sure that stocks recorded actually exist.
- Monitor the system of processing an item from order to delivery.
- Reduce work-in-progress time.


Creditors
Stocks/
Work in progress
60 days
Stock turnover
80 days
Cash
90 days
Debtors
Cash is locked in for 80 days + 90 days - 60 days = **110 days**

TOOL BOX 24TWENTY-FOUR

Conducting break-even analysis

The main object of doing break-even analysis is to make sure that your total sales revenue equals total costs. When your sales revenue is in excess of your total costs you make profit. Profit could be calculated at gross level or at net level. Gross profit excludes overhead costs whereas net profit includes overhead costs.

In working out break-even analysis you want to make sure that your gross profit or the gross margin you generate from your sales is sufficient to cover your overheads or fixed costs.

For example, let us assume that variable costs for your business are £50,000 per year and your fixed costs (overheads) are £25,000. You have the capacity to produce 10,000 units of product 'X'. To cover variable and fixed costs (total costs) you need to sell 10,000 units of 'X' at £7.50 each.

This is your break-even point (£75,000/10,000 = £7.50)

To sell 10,000 units at £7.50 will generate £75,000.
Your gross profit margin is gross profit x 100/75,000 = gross margin %.

In this case it will be 25,000 x 100/75,000 = 33.3%

The other aspect of finance is understanding various ratios and what they mean. Such understanding will enable you to interpret your business accounts.

Key financial ratios

Return on capital employed

Profit/capital employed. Capital employed is total assets minus current assets.

Asset turnover

Sales/capital employed. This figure will indicate the frequency with which assets have been converted into sales during the accounting period.

Both the above ratios are measure of return on investment.

Profit margin

Profit before interest payable and tax/sales.

Profit margin provides information on how a business is managing its operating costs.

Gross margin

Gross profit/sales.

The figure shows the contribution towards overheads.

Asset turnover

Sales/capital employed.

The figure will show the frequency with which assets have been converted into sales during the accounting period.

In managing working capital the three key ratios are stock turnover, debtor turnover and creditor turnover.

Stock turnover

Cost of goods sold/closing stock.

This figure shows how quickly goods move through the business.

Debtor days

Debtors/cost of sales x 365.

The figure shows the number of days' sales for which payment is outstanding.

Creditor days

Trade creditors/cost of sales x 365.

This will show the number of days' purchases for which payment is still due.

How solvent is your business? The appropriate ratios are the acid ratio, current ratio and the debt ratio.

Acid test

Liquid assets/current liabilities.

This shows the liquidity position of your business.

Current ratio

Current assets/current liabilities.

This shows to what extent your short-term assets are adequate to cover your short-term liabilities.

Debt ratio

Debt/capital employed.

The low debt ratio is an indication of high level of safety.

If your business is trading in the Stock Market then you also have to consider earning per share ratio, price earning ratio and dividend cover.

Earning per share

Profit after tax/number of ordinary shares in issue.

Many analysts use this measure to reflect business performance.

Price/earning ratio

Market price per share/earning per share.

Dividend cover

Earning per share/dividends per share.

This figure shows the number of times dividends could have been paid out of the current year's earnings.

The key ratios highlighted can reveal a lot of information on business performance.

Managing shareholder value

Stern Stewart & Co., the New York management consultants developed and popularised the concepts of Economic Value Added (EVA) and Market Value Added (MVA) in order to assess shareholder value. In an article *Creating stockholder wealth* by Anne B Fisher

(*Fortune*, 11 December, 1995), she explains MVA as 'a measure of the wealth a company has created for investors. MVA in effect shows the difference between what investors put in and what they can take out. MVA is supposed to be a good performance indicator of whether the company has made a profit for its investors.

Economic Value Added (EVA) is after-tax net operating profit minus cost of capital. A positive EVA often signifies a strong stock.

Budgetary control

Once the strategy has been determined and strategic objectives formulated, an organisation then prepares an overall corporate budget. Without preparing a budget it is difficult to measure the performance of an organisation. The corporate budget is sometimes known as the master budget.

From master budget, divisional or sectional or regional budgets are then prepared. Guidelines regarding inflation, employee numbers, key targets relating to growth and margins are often set by top management or negotiated with top management.

Budgets include information on revenues, cost of sales, gross margin, overhead costs and net margins. Once budgets have been accepted the flow of costs, revenues, and expenditure is scheduled. Budget holders receive regular information on theses flows and they have to explain any variances that occur in report format. Analysis of variances (the difference between budgeted targets and actual targets) enable budget holders to take appropriate corrective action.

Some organisations have **zero-based budgeting systems** which assumes starting from scratch each year having done all the appropriate analyses while other organisations **have historical budgeting system** which takes into consideration prior years results.