

Business and financial skills

21

Key concepts and terms

- *Absorption costing*
- *The acid test*
- *Activity-based costing*
- *Assets*
- *Balance sheet*
- *Budgetary control*
- *Budgets*
- *Business model*
- *Cash flow*
- *Cash flow statement*
- *Core competency*
- *Costing*
- *Current liabilities*
- *Direct costs*
- *Earnings per share*
- *Economic value added (EVA)*
- *Gearing*
- *Gross margin*
- *Gross profit*
- *Indirect costs*
- *Key performance indicator*
- *Liquidity analysis*
- *Marginal costing*
- *Net profit*
- *Operating or trading profit*
- *Overheads*
- *Over-trading*
- *Price/earnings ratio (P/E)*
- *Profit*
- *Profit before taxation*
- *Profit and loss account*
- *Profitability*
- *The resource-based view*
- *Return on capital employed*
- *Return on equity*
- *Shareholder value*
- *Standard costing*
- *Trading statement or account*
- *Working capital*
- *The working capital ratio*

LEARNING OUTCOMES

On completing this chapter you should be able to define these key concepts. You should also understand:

- What it means to be businesslike
- How to interpret a balance sheet
- How profits are classified
- The purpose of trading and profit and loss statements
- The meaning of profitability and the key profitability ratios
- How budgeting and budgetary control work
- The purpose of cash management
- Methods of costing

Introduction

To make an effective contribution, HR professionals must possess business and financial skills. They need to understand what their business model is – how their organization delivers value to its customers and how the business achieves competitive advantage and makes money. They need to understand and be able to use the language of the business and, because this will generally be expressed in monetary terms, they need to appreciate how the financial systems of the business work. Equipped with this knowledge, HR professionals can develop the skills needed to interpret the organization's business or corporate strategies, to contribute to the formulation of those strategies and to develop integrated HR strategies.

This requirement was spelt out by Ulrich (1997: 7) when he wrote that: 'HR professionals must know the business, which includes a mastery of finance, strategy, marketing, and operations.' Research by the CIPD (2010: 5) led to the following conclusion:

It is also evident that for some HR functions, they see HR as an applied business discipline first and a people discipline second. The ability to understand the business agenda in a deep way means that they are then able to help the business see how critical objectives can only truly be delivered if the people and cultural issues are fully factored in – insight into what it would take to truly deliver. In these places HR has a real share of voice and credibility... Where HR is grounded in the business and delivering the fundamentals well, then it is able to engage in higher value-adding 'OD' and talent-related activities that speak to the critical challenges faced in that organization.

Business skills

Business skills are required to adopt a businesslike approach to management – one which focuses on allocating resources to business opportunities and making the best use of them to achieve the required results. Managers who are businesslike understand and act upon:

- the business imperatives of the organization: its mission and its strategic goals;
- the organization's business model – the basis upon which its business is done (how its mission and strategic goals will be achieved);
- the organization's business drivers – the characteristics of the business which move it forward;
- the organization's core competencies – what the business is good at doing;
- the factors which will ensure the effectiveness of its activities, including specific issues concerning profitability, productivity, financial budgeting and control, costs and benefits, customer service and operational performance;
- the key performance indicators (KPIs) of the business (the results or outcomes which are identified as being crucial to the achievement of high performance), which can be used to measure progress towards attaining goals;
- the factors which will ensure that the firm's resources, especially its human resources, create sustained competitive advantage because they are valuable, imperfectly imitable and non-substitutable (the resource-based view).

Financial skills

A businesslike approach means using financial skills to know how to analyse and interpret balance sheets, cash flow and trading statements and profit and loss accounts, and to understand and make use of the financial techniques of budgeting and budgetary control, cash budgeting and costing.

Interpreting balance sheets

A balance sheet is a statement on the last day of the accounting period of the company's assets and liabilities and the share capital or shareholder's investment in the company. Balance sheet analysis assesses the financial strengths and weaknesses of the company, primarily from the point of view of the shareholders and potential investors, but also as part of management's task to exercise proper stewardship over the funds invested in the company and the assets in its care. The analysis focuses on the balance sheet equation,

considers the make-up of the balance sheet in terms of assets and liabilities, and examines the liquidity position (how much cash or easily realizable assets are available) and capital structure with the help of balance sheet ratios.

The balance sheet equation

The balance sheet equation is: capital + liabilities = assets. Capital plus liabilities show where the money comes from, and assets indicate where the money is now.

Make-up of the balance sheet

The balance sheet contains four major sections:

- Assets or capital in use, divided into long-term or fixed assets (eg land, buildings and plant) and short-term or current assets, which include stocks of goods and materials, work in progress, debtors, bank balances and cash.
- Current liabilities, which are the amounts which will have to be paid within 12 months of the balance sheet date.
- Net current assets or working capital, which are current assets less current liabilities. Careful control of working capital lies at the heart of efficient business performance.
- Sources of capital, which comprise share capital, reserves including retained profits and long-term loans.

Liquidity analysis

Liquidity analysis is concerned with the extent to which the organization has an acceptable quantity of cash and easily realizable assets to meet its needs. The analysis may be based on the ratio of current assets (cash, working capital, etc) to current liabilities (the working capital ratio). Too low a ratio may mean that the liquid resources are insufficient to cover short-term payments. Too high a ratio might indicate that there is too much cash or working capital and that this is therefore being badly managed. The working capital ratio is susceptible to 'window dressing', which is the manipulation of the working capital position by accelerating or delaying transactions near the year end.

Liquidity analysis also uses the 'quick ratio' of current assets minus stocks to current liabilities. This concentrates on the more realizable of the current assets and therefore provides a stricter test of liquidity than the working capital ratio. It is therefore called 'the acid test'.

Capital structure analysis

Capital structure analysis examines the overall means by which a company finances its operations, which are partly by the funds of their ordinary shareholders (equity) and partly by loans from banks and other lenders (debt). The ratio of long-term debt to ordinary shareholder's funds indicates 'gearing'.

A company is said to be highly geared when it has a high level of loan capital as distinct from equity capital.

Classification of profits

Profit is basically the amount by which revenues exceed costs. It is classified in trading statements and profit and loss accounts in the following four ways:

- Gross profit – the difference between sales revenue and the cost of goods sold. This is also referred to as gross margin, especially in the retail industry.
- Operating or trading profit – gross profit less sales, marketing and distribution costs, administrative costs and research and development expenditure.
- Profit before taxation – operating profit plus invested income minus interest payable.
- Net profit – profit before taxation minus corporation tax.

Trading statements

Trading statements or accounts show the cost of goods manufactured, the cost of sales, sales revenue and the gross profit which is transferred to the profit and loss account.

Profit and loss accounts

Profit and loss accounts provide the information required to assess a company's profitability – the measure of the return in the shape of profits that shareholders obtain for their investment in the company. This is the primary aim and best measure of efficiency in competitive business. Profit and loss accounts show:

- 1 the gross profit from the trading account;
- 2 selling and administration expenses;
- 3 the operating profit (1 minus 2);
- 4 investment income;
- 5 profit before interest and taxation (3 plus 4);
- 6 profit before taxation (5 minus loan interest);
- 7 taxation;
- 8 net profit (6 minus 7).

Profitability analysis ratios

Profitability is expressed by the following ratios:

- Return on equity – profit after interest and preference dividends before tax in relation to ordinary share capital, reserves and retained profit.

This focuses attention on the efficiency of the company in earning profits on behalf of its shareholders; some analysts regard it as the best profitability ratio.

- Return on capital employed – trading or operating profit to capital employed. This measures the efficiency with which capital is employed.
- Earnings per share – profit after interest, taxation and preference dividends in relation to the number of issued ordinary shares. This is an alternative to return on equity as a measure of the generation of ‘shareholder value’ (the value of the investment made by shareholders in the company in terms of the return they get on that investment). Its drawback is that it depends on the number of shares issued, although it is often referred to within companies as the means by which their obligations to shareholders should be assessed.
- Price/earnings (P/E) ratio – market price of ordinary shares in relation to earnings per share. This ratio is often used by investment analysts.
- Economic value added (EVA) – post-tax operating profit minus the cost of capital invested in the business. This measures how effectively the company uses its funds.

Financial budgeting

Budgets translate policy into financial terms. They are statements of the planned allocation and use of the company’s resources. They are needed to (1) show the financial implications of plans, (2) define the resources required to achieve the plans, and (3) provide the means of measuring, monitoring and controlling results against the plans.

The procedure for preparing financial budgets consists of the following steps:

- Budget guidelines are prepared which have been derived from the corporate plan and forecasts. They will include the activity levels for which budgets have to be created and the ratios to be achieved. The assumptions to be used in budgeting are also given. These could include rates of inflation and increases in costs and prices.
- Initial budgets for a budget or cost centre are prepared by departmental managers with the help of budget accountants.
- Departmental budgets are collated and analysed to produce the master budget, which is reviewed by top management, who may require changes at departmental level to bring it into line with corporate financial objectives and plans.
- The master budget is finally approved by top management and issued to each departmental (budget centre) manager for planning and control purposes.

Budgetary control

Budgetary control ensures that financial budgets are met and that any variances are identified and dealt with. Control starts with the budget for the cost centre, which sets out the budgeted expenditure under cost headings against activity levels. A system of measurement or recording is used to allocate expenditures to cost headings and record activity levels achieved. The actual expenditures and activity levels are compared and positive and negative variances noted. Cost centre managers then act to deal with the variances and report their results to higher management.

Cash management

Cash management involves forecasting and controlling cash flows (inflows and outflows of cash to and from the company). It is an important and systematic process of ensuring that problems of liquidity are minimized and that funds are managed effectively. The aim is to ensure that the company is not over-trading, ie that the cost of its operations does not significantly exceed the amount of cash available to finance them. The old adage is that, whatever else is done, ensure that 'Cash in exceeds cash out.'

Cash flow statements report the amounts of cash generated and cash used for a period. They are used to provide information on liquidity (the availability of cash), solvency and financial adaptability.

Cash budgeting

An operating cash budget deals with budgeted receipts (forecast cash flows) and budgeted payments (forecast cash outflows). It includes all the revenue expenditure incurred in financing current operations, ie the costs of running the business in order to generate sales.

Costing

Costing techniques provide information for decision making and control. They are used to establish the total cost of a product for stock valuation, pricing and estimating purposes and to enable the company to establish that the proposed selling price will enable a profit to be made.

Costing involves measuring the direct costs of material and labour plus the indirect costs (overheads) originating in the factory (factory overheads) and elsewhere in the company (sales, distribution, marketing, research and development and administration).

Overheads are charged to cost units to provide information on total costs – this process is called overhead recovery. There are four main methods of doing this:

- Absorption costing – this involves allocating all fixed and variable costs to cost units and is the most widely used method, although it can be arbitrary.

- Activity-based costing – costs are assigned to activities on the basis of an individual product's demand for each activity.
- Marginal costing – this segregates fixed costs and apportions the variable or marginal costs to products.
- Standard costing – this is the preparation of predetermined or standard costs which are compared with actual costs to identify variances. It is used to measure performance.

KEY LEARNING POINTS

To make an effective contribution, HR professionals must have business and financial skills. They need to understand what the business model is – how the organization delivers value to its customers and, in commercial organizations, how the business achieves competitive advantage and makes money.

Business skills

Business skills are required to adopt a businesslike approach to management – one which focuses on allocating resources to business opportunities and making the best use of them to achieve the required results.

Financial skills

A businesslike approach means using financial skills to know how to analyse and interpret balance sheets, cash flow and trading statements and profit and loss accounts, and to understand and make use of the financial techniques of budgeting and budgetary control, cash budgeting and costing.

Interpreting balance sheets

A balance sheet is a statement on the last day of the accounting period of the company's assets and liabilities and the share capital or reserves or shareholder's investment in the company.

Balance sheet analysis assesses the financial strengths and weaknesses of the company primarily from the point of view of the shareholders and potential investors, but also as part of management's task to exercise proper stewardship over the funds invested in the company and the assets in its care.

Classification of profits

It is necessary to understand the different ways in which profits can be classified as recorded in trading statements and profit and loss accounts. There are four headings: gross profit, operating or trading profit, profit before tax, net profit.

Trading statements

Trading statements or accounts show the cost of goods manufactured, the cost of sales, sales revenue and the gross profit which is transferred to the profit and loss account.

Profit and loss accounts

Profit and loss accounts provide the information required to assess a company's profitability – the primary aim and best measure of efficiency in competitive business. Profitability is a measure of the return in the shape of profits that shareholders obtain for their investment in the company. It is expressed in the following ratios: return on equity, return on capital employed, earnings per share, price/earnings (P/E) ratio, economic value added (EVA).

Financial budgeting

Budgets translate policy into financial terms. They are statements of the planned allocation and use of the company's resources.

Budgetary control

Budgetary control ensures that financial budgets are met and that any variances are identified and dealt with.

Cash management

Cash management involves forecasting and controlling cash flows (inflows and outflows of cash).

Cash budgeting

An operating cash budget deals with budgeted receipts (forecast cash flows) and budgeted payment (forecast cash outflows).

Costing

Costing techniques provide information for decision making and control. They are used to establish the total cost of a product for stock valuation, pricing and estimating purposes and to enable the company to establish that the proposed selling price will enable a profit to be made.

Overheads are charged to cost units to provide information on total costs – this process is called overhead recovery. There are four methods of doing this: absorption costing activity-based costing, marginal costing and standard costing.

References

- Chartered Institute of Personnel and Development (2010) *Next Generation HR, Time for Change – Towards a next generation for HR*, London, CIPD
- Ulrich, D (1997) Judge me more by my future than my past, *Human Resource Management*, 36 (1), pp 5–8

Questions

- 1 What is involved in being 'businesslike'?
- 2 What are the essential financial skills HR professionals need?
- 3 What is a balance sheet?
- 4 What is involved in balance sheet analysis?
- 5 What is liquidity analysis?
- 6 What is capital structure analysis?
- 7 What are the different ways of classifying profits?
- 8 What is a trading statement?
- 9 What is a profit and loss account?
- 10 What are the main components of a profit and loss account?
- 11 What is profitability?
- 12 What is return on equity?
- 13 What is return on capital employed?
- 14 What are earnings per share?
- 15 What is the price/earnings ratio?
- 16 What is financial budgeting?
- 17 What is budgetary control?
- 18 What does cash management involve?
- 19 What is an operating cash budget?
- 20 What does costing involve?