LCCI International Qualifications from EDI

Level 3 Award in Measuring and Improving Business Performance

Revision guide

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Introduction

This Revision guide has been written specifically to help you prepare for the LCCI Level 3 Award in Measuring and Improving Business Performance.

As a revision guide, it covers the core subject content required by the syllabus. It looks at the importance of measuring business performance and the measures/indicators that may be used in a performance management system. It looks at the usefulness of the Balance Scorecard and Total Quality Management (TQM) in performance management as well as the use of a range of operational business practices.

It concludes by considering the importance of management information in monitoring business performance and the contribution of managers, teams and individuals to business performance.

To help you make the best of your revision, key terms are highlighted in **bold** and *Improve your grade* tips are presented throughout. The language is simple and easy to read and tables and diagrams are used to aid understanding.

This revision guide is a very useful learning resource, whether in personal study or classroom situation.

1 Importance and nature of performance measurement

1.1 Importance of measuring business performance

It is important for a business to continuously monitor performance against its business objectives and targets. Continuous monitoring of performance will allow the business to assess how well it is progressing towards achieving its objectives and identify any corrective action needed to deal with any current under performance or predicted future under performance.

Measuring business performance is, therefore, important for the following reasons:

- To learn and improve performance
- To report on progress to shareholders
- To report on progress to external stakeholders, for e.g. banks and other financial institutions
- To decide on any performance bonuses payable to employees
- To implement recovery plans if performance is below target
- To comply with external reporting regulations and information request

A performance management system should, therefore, include:

- Financial and non-financial performance measures
- 'Leading' and 'Lagging' performance measures
- Key Performance Indicators (KPIs)
- SMART targets based on KPIs

1.2 Performance Measures

Performance measures are quantitative or qualitative ways to define and describe performance. They are standards of measurements that are used to show progress towards the achievement of business objectives and targets.

Performance measures are used to manage and monitor progress towards achieving goals and define the key indicators of organisational performance.

Performance measures, which are also known as **performance indicators** or **performance metrics**, can be either 'financial' or 'non-financial'.

1.3 Financial and non-financial performance measures

Financial performance measures are those standards that can be measured in monetary terms. They are used to assess the financial performance of a business and seek to answer questions such as:

- How profitable is the business? Are the profits adequate? (Profitability)
- Is the business able to meet all its financial obligations in the short term without disrupting its normal operations? (Liquidity)
- Can the business withstand financial hardship? Will it be able to pay all its debts if all the assets are sold? (Solvency)
- How effectively is management controlling the assets (i.e. debtors and stock) of the business?

Table 1 describes some of the main financial performance measures.

Table 1: Main financial performance measures

FINANCIAL PERFORMANCE MEASURES	DESCRIPTION
Profitability	Profitability is measured by calculating gross profit and net profit as percentages of sales revenue (profit margins). These are calculated as: **Gross Profit Margin = (gross profit / sales revenue) x100** **Net Profit Margin = (net profit / sales revenue) x100** A net profit margin of 56% means that 56% of the sales revenue is profit while the other 44% is operating expenses. In other words, the business earns 56p net profit for every £1 of sales income. The higher the net profit and gross profit percentages/margin, the more profitable the business. Profitability can also be measured by the **Return on Capital Employed (ROCE)**. This measures the return, or profit, of the business in relation to the capital invested. It shows how well the business is using capital to create revenue and profit. For example, a return on capital employed of 7% is the return that an investor (owner or shareholder) is receiving on their investment. This can be compared with returns that they are able to earn elsewhere, e.g. from a bank account, to assess the business's profitability.
Liquidity and Solvency	As discussed in Topic 3, a business needs to have working capital to pay its day-to-day debts. The availability of working capital depends on the business's **liquidity**; i.e. how easily it can turn assets into cash in the short-term. Liquidity is measured by the Current ratio or Acid Test Ratio. It is important in assessing the financial health of a business because if the business does not have sufficient cash to pay its short-term debts then this indicates that it may be facing financial difficulties. A business that has continuous liquidity problems may become **insolvent**, i.e. not able to pay long-term debts when they due as the value of its liabilities is greater than the value of assets.
Debt Collection Period	The business must ensure that it receives payment from its customers for goods sold on credit. It is therefore important that it monitors the average length of time taken to collect payments from credit customers. The **debt collection period** performance measure is used to do this. If the debt collection period increases, this could indicate that customers are having difficulties paying for the goods. However, it could also mean that the business credit control procedures have become less effective. A longer debt collection period will negatively impact on liquidity and likely profitability.
Level of Bad Debts	There will be occasions when credit customers are unable to pay for goods. This amount owed is known as a **bad debt**, which means the debt is written-off, i.e. payment is not expected. As bad debts are an expense to the business, a high level of bad debts will negatively affect liquidity and profitability.
Inventory Turnover Rate	**Inventory turnover** relates to the number of times the stock is sold and replaced. This is an important financial measure since it provides the business with an indication of the volume and value of its business activities. A high inventory turnover can be a positive sign that the business is selling all its stock on a regular basis. However, a high inventory turnover could also mean that the business is carrying insufficient stock to meet customer requirements. Similarly, a low inventory turnover, compared to competitors, could indicate that the business is holding too much stock or is not meeting its total sales targets; this would negatively impact on profitability.

Other examples of financial performance measure include **Total Costs** and **Sales Revenue**.

Non-financial performance measures are those standards that do not have a direct monetary value, but are concerned with aspects such as volume, actual numbers and percentages. Although non-financial measures do not have a direct monetary value, they will indirectly impact on the financial health of the business.

Table 2 describes some of the main non-financial performance measures.

Table 2 Main non-financial performance measures

FINANCIAL PERFORMANCE MEASURES	DESCRIPTION
Customer Satisfaction and Loyalty	**Customer satisfaction** is a measure of how the products and services supplied by the business meet or surpass customer expectation. Measuring customer satisfaction provides an indication of how successful the business is at providing products and/or services to the marketplace. Customer satisfaction is usually measured using a survey. The term 'customer loyalty' is used to describe the behaviour of repeat customers - customers who continue to do business with a particular supplier over a period of time. Customer loyalty is critical to business success and profitability as it costs much more to recruit a new customer than to keep an existing one. Customer loyalty can be measured through the proportion of total sales generated from existing customers; the number of repeat sales made by customers; the percentage of customers renewing contracts or subscriptions, etc. An increase in customer loyalty can significantly decrease costs and increase profits.
Market Share	Market share is defined as "the percentage of all sales within a market that is held by one brand / product or company". Market share is important as it has a direct relationship with profitability; i.e., the higher the market share, the higher the return on investment. Market share can be measured in several ways. However, the two most important measures are 'sales revenue' and 'sales volume' (number of units sold) – an increase in either of these will indicate an increase in market share.
Innovation and Product/Service Quality	Innovation is important to the long-term prosperity of any business as it improves production processes resulting in more efficient and effective production. It contributes to increased productivity, growth and improved competitiveness. Innovation also leads to the development of new products, improvements in product/service quality and business relationships. The level of product innovation may be measured through the number of innovations during a period compared with those of competitors; the percentage of sales attributable to recent product innovations; the number of patents; the number of innovations that are brought successfully to the market, etc.
Employee Satisfaction and Motivation	This is the measure of employees' attitudes towards various aspects of the job such as the degree of autonomy that is given, the level of recognition and reward received, the level of participation in decision-making, the degree of support received in carrying out tasks, salary and compensation packages, etc. Employee satisfaction is usually measured through the use of employee surveys. A high measure of employee satisfaction and motivation will have a direct positive impact on customer service, business efficiency and effectiveness as well as brand and corporate image.

Improve your grade

Exam questions may require you to show how performance measures affect each other. You, therefore, need to have a good understanding of the inter-relationships between different types of performance measures.

FINANCIAL PERFORMANCE MEASURES	DESCRIPTION
Brand Image and Reputation	Brand image is the perception of a product or a brand by the consumer. It is the collection of ideas and beliefs that people have about a brand/product or service. A positive brand image is important to the success of a business as it improves customer loyalty, market share and ultimately profit. Brand image is usually measured through customer surveys.
Labour Turnover and Absenteeism Rate	Labour turnover is the rate at which an employer gains and loses employees. In other words, it is "how long employees tend to stay with an employer". Turnover costs for many businesses can be very high and can significantly affect its financial performance. Costs include recruitment, selection and training of new employees. Other associated costs include increased workloads and overtime expense for co-workers as well as reduced productivity arising from low morale. Turnover rate is calculated by dividing the number of annual terminations by the average number of employees in the work force. The business can then compare this to the national average. Labour turnover can be reduced by hiring and developing the right people, good compensation packages, flexible working arrangements, service recognition etc.
Leadership Effectiveness	Effective leadership is a critical factor in business success. Effective leadership positively impacts on productivity, staff motivation, labour turnover, absenteeism as well employee satisfaction. Leadership effectiveness is mainly measured using a **leadership index**, which is a type of survey completed by people who report to the leader. It can also be measured by productivity levels.

The importance of non-financial performance measures

Non-financial measures can help managers gain a deeper understanding of the business and the key factors needed for success. They can also be used to indicate the future financial performance of the business, as shown in the following examples:

- **A 5% increase in customer complaints** may negatively impact on brand image, customer loyalty and repeat sales, therefore, reducing sales revenue.
- **A 10% increase in market share** may positively impact on production level and average costs, therefore, increasing sales revenue and profits.

A financial value can also be put on the impact of non-financial performance indicators. For example, if a company with sales revenue of £500,000 experiences a 5% increase in customer complaints, then this could possibly result in a 10% decrease in sales revenue during the next 6 months. This means that sales turnover could potentially fall by £50,000.

1.4 Leading and Lagging performance measures

Performance measures can be categorised as either:

- Lagging performance measures
- Leading performance measures

Lagging performance measures

'Lagging' performance measures inform the business about its *past performance*. These measures focus upon the results at the end of a time period; for example, total sales for the previous 3 months; total gross profit for the last financial year. They can be used to assess how far the business has achieved its targets. However, they cannot provide early warnings if the business is not on track to achieving its objectives.

Leading performance measures

'Leading' performance measures inform the business about its *potential future performance*. These measures focus upon a prediction of future performance outcomes e.g. number of customer enquiries, current order book, and the number of new leads.

Leading measures enable managers to take preventative actions to improve the chances of achieving the business's strategic goals.

A performance management system should have a combination of lagging and leading performance measures.

1.5 Key Performance Indicators (KPIs)

Performance measures form the basis for Key Performance Indicators (KPIs). A performance measure becomes a KPI when it is defined and quantified by a business organisation as one of its critical success factor in achieving its missions and business objectives.

The following are some features of a good KPI:

- Suitable to the specific business organisation and industry
- Related to the business's strategic goals and objectives
- Relatively easy to understand and measure
- Linked to relevant data and be measurable over time
- Leading (not lagging) indicators of performance desired by the organisation
- Have a dedicated, committed owner
- Lead to action and balance with other KPIs
- Is achievable

Improve your grade

Do not get confused about KPIs and performance measures. A KPI is a performance measure that is relevant and appropriate to the business and its strategy and has been chosen by the business as an important factor to its success.

Businesses should only have a few KPIs and they should be reviewed over time to ensure that they are still relevant to the business.

KPIs are likely to be set for all the functional areas. Table 3 shows examples of KPIs that may be used in the different functional areas.

Table 3: KPIs in the main functional areas

FUNCTIONAL AREA	EXAMPLES OF KEY PERFORMANCE INDICATORS
Human Resources	▪ Number of staff vacancies ▪ Conversion rates from vacancy query to number of applications received ▪ Staff turnover rates ▪ Staff absenteeism rates
Finance	▪ Gross profit margin ▪ Net profit margin ▪ Return on Capital Employed (ROCE)
Production	▪ Production targets ▪ Productivity rate
Purchasing	▪ Average costs ▪ Level of stock ▪ Stockturn
Sales and Marketing	▪ Total sales ▪ Sales turnover ▪ Market share

KPIs are important in the performance measurement process for the following reasons:

- They make performance measurement less complex as they help businesses to focus on a small number of important indicators
- They help businesses to measure what is most important in their individual context
- They help businesses to understand how well they are performing in relation to their strategic goals and objectives.
- They help the business to spot potential problems or opportunities
- They are used to set targets for departments and employees that will deliver the business's strategic goals

1.6 Contribution of target-setting to the performance measurement process

Target-setting is central to performance management and monitoring systems. SMART targets enable the business to determine the actions required to achieve business targets which are Specific, Measurable, Achievable, Realistic and set within a Timescale.

2 Performance management and improvement models

2.1 The Balanced Scorecard Framework

The Balanced Scorecard Framework is a strategic planning and management system that is used to:

- align business activities to the vision and strategy of the business
- improve internal and external communications
- monitor the business performance against strategic goals.

The aims of the Framework are to:

- Strike a balance between 'hard' financial measures and 'soft' non-financial measures
- Balance the external measures relating to customers and shareholders with the internal measures relating to internal business processes and learning growth
- Strike a balance between 'lagging' measures and 'leading' measures

The Balanced Scorecard involves setting objectives and developing appropriate measures and targets in four main areas:

1. Financial
2. Customer
3. Internal business processes
4. Learning and Growth

Diagram 1 shows the Balanced Scorecard framework with the four themes / perspectives.

Diagram 1 The Balanced Scorecard Framework

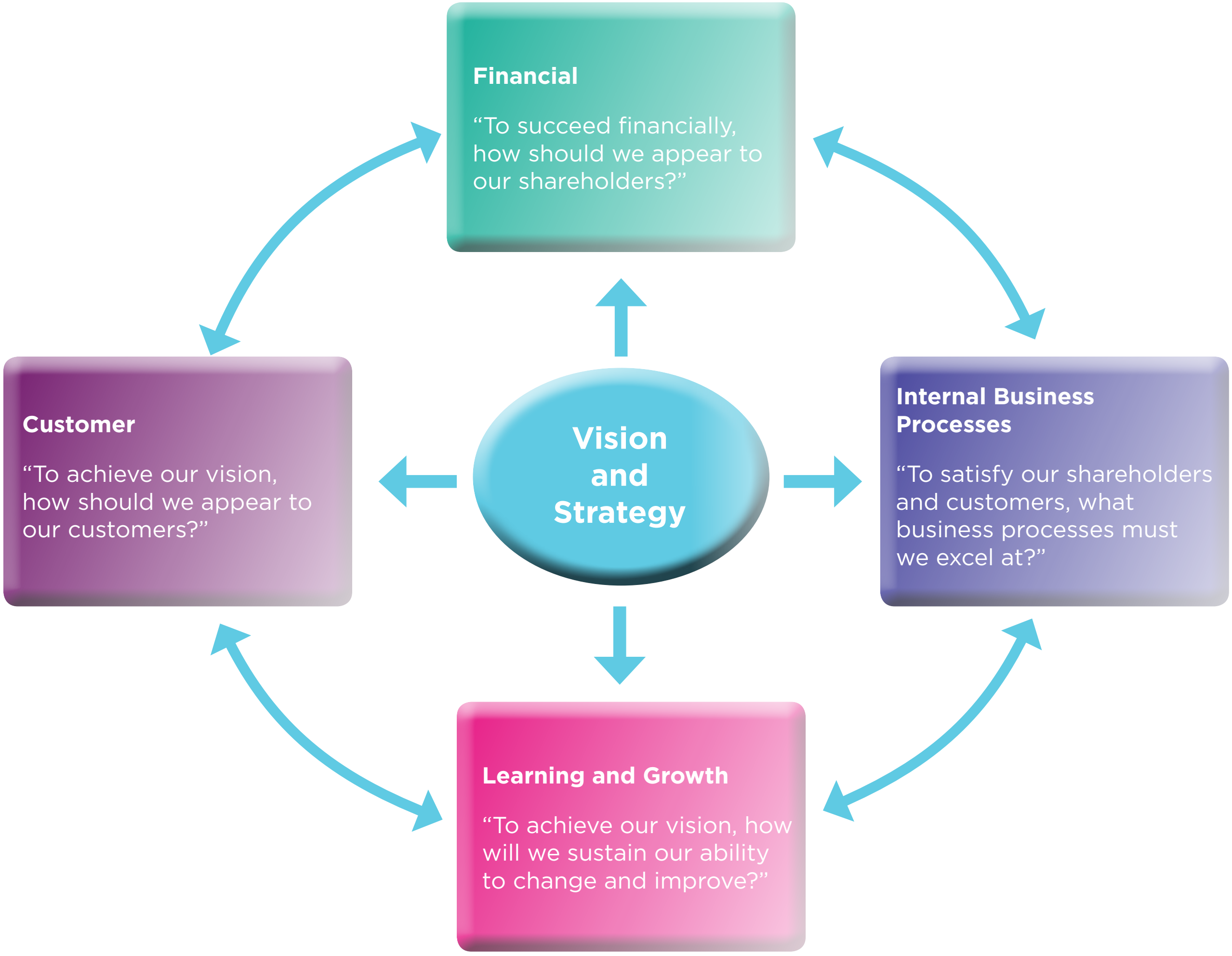

Table 4 provides a description of each of the 4 perspectives.

Table 4: Balanced Scorecard Perspectives

THE BALANCED SCORECARD PERSPECTIVES	DESCRIPTION
Financial perspective	This area specifies the financial returns required by shareholders. It includes the use of financial measures such as gross and net profit, profit margins and the percentage sales growth. It deals with questions such as: ▪ How should we appear to our shareholders to succeed financially? ▪ How do we control costs? ▪ How do we increase our sales revenues?
Customer perspective	This area specifies the kind of customer and/or markets the business wishes to service. It includes the use of measures such as customer satisfaction, new customer growth levels and deals with questions such as: ▪ Who are our customers? ▪ How should we appear to customers in order to achieve our vision? ▪ How do we create value for our customers?
Internal business processes perspective	This area specifies those processes that are important to the success of the business (e.g. innovation, after-sales service, etc.). It includes the use of measures such as percentage sales of new products, time to market for new products, product life cycle and the speed of response to customer complaints. It deals with questions such as: ▪ What are our key business processes? ▪ What must we excel at? ▪ Are there any bottlenecks in our system? ▪ Are our business systems efficient?
Learning and perspective	This area specifies the kind of people, the systems and the procedures that are necessary to deliver long-term business growth. It includes the use of measures such as employee satisfaction and motivation, employee skills profiles and information systems capabilities. It deals with questions such as: ▪ What skills do our managers and staff need to acquire in order to fulfil the vision and take forward our strategy? ▪ How do we create a 'learning environment' within the business for our managers and staff to ensure effectiveness and efficiency?

Improve your grade

When answering questions on the use of the Balanced Scorecard, focus your thinking on the fact that it combines financial and non-financial as well as leading and lagging performance measures. Also, think about the benfits of using it and its positive impact on stakeholder engagement.

Importance of the Balanced Scorecard Framework in performance management

The Balanced Scorecard makes use of both financial and non-financial measures of performance, therefore, providing managers and executives with a more 'balanced' view of the business's performance. It also uses a framework that not only provides performance measurements but also helps those engaged in business planning to identify what should be done and measured.

Successful implementation of the Balanced Scorecard Framework will result in:

- Improved efficiency in businesses processes
- Motivated/educated employees
- Enhanced information systems
- Effective progress monitoring
- Greater customer satisfaction
- Improved financial performance

2.2 Total Quality Management (TQM)

TQM is a quality system that aims at long-term success through customer satisfaction and the involvement of all staff.

It is a way of thinking about business objectives, organisations, processes and people to ensure that the right things are done right first time. This thought process can change attitudes, behaviour and hence improve business performance in the following ways:

- Reduced costs
- Enhanced productivity
- Improved quality and customer service
- Improvement in global competitiveness
- Improved staff morale and participation
- Enhanced relationship with suppliers
- Improved financial performance
- Positive brand image
- Increased and enhanced organisational knowledge

TQM is based upon five key principles:

- An extension of quality assurance
- Customer is at the centre of all business operations
- Includes the idea of both internal and external customers
- All managers and staff are responsible for quality
- Targets are set and monitored in order to continuously improve quality and business performance

3 Management and business practices used in improving business performance

3.1 Management and business practices

Staff development and training

It is the responsibility of the Human Resources function to implement a HR strategy to ensure that the business has sufficient skilled staff to meet its business needs.

The HR strategy will involve aspects such as an external labour market analysis and an internal training needs analysis in order to identify any skills gaps which will impact upon business performance. A staff development programme and training plan can then be drawn up to address these skills gaps.

Staff development and training plans should be based on the overall strategy of the business and should aim to create a 'learning environment' within which the business can continuously improve.

Multi-skilling

Multi-skilling provides the workforce with the opportunity of gaining new skills which are not directly related to the specific job for which they were originally trained or employed.

Multi-skilling is a business response to the rapidly changing business environment, which is likely to result in the workforce having to acquire new skills. Without the skills the business will be at a competitive disadvantage. The business may lose customers who will transfer their loyalty to other businesses that may have the capacity to produce the innovative products that the consumer wants.

The benefits of multi-skilling include:

- Employees become more flexible and adaptable
- Reduces recruitment costs
- Promotes opportunities for career enhancement
- May improve employee motivation, which may positively impact on staff retention, turnover and absenteeism

Customer service

Good customer service includes four main elements:

1. Providing accurate information about the product or service to customers
2. Providing specialist advice relating to the use of the product or service
3. Making it convenient for the customer to access the product and related services (for e.g. providing handy and secure ways for the customer to pay)
4. Providing an effective after-sales service

The aims of good customer service are to:

- generate repeat purchases through customer satisfaction
- promote customer loyalty
- increase sales
- improve product and service development
- improve the business's competitive advantage
- generate profits

Teamwork

A team is a small group of employees who work together to achieve a common goal. Effective teams and staff work groups can:

- Improve productivity - individuals within the team can work on specialist tasks focused upon their own areas of expertise and specialist skills.
- Improve quality - Quality Circles can take responsibility for setting and monitoring challenging performance targets.
- Maximise the opportunities afforded by new technology - Teamwork can encourage the transfer and sharing of specialist IT skills amongst team members.
- Improve motivation - as organisations become 'flatter structures', decision–making can be delegated to small teams of staff.

Benchmarking

Benchmarking is the process by which a business compares its own performance against other businesses in the same industry. This allows the business to set its performance targets against industry standards and identify 'best practice' in relation to both products and the processes through which those products are created and delivered.

The aim of benchmarking is to understand and evaluate the current position of the business in relation to 'best practice' and to identify areas and ways of improving performance.

3.2 Difference between monitoring and forecasting

The business will need to assess the impact of its business practices on the achievment of its objectives and targets. This can be done by:

- Continuously monitoring business activities
- Identifying any variances against targets
- Forecasting the future outturn based upon current or past performance
- Remedying any variances in performance

Monitoring involves the systematic collection of data on KPIs in order to assess the achievement of agreed targets. Monitoring provides managers with early warning of the lack of progress in the achievement of business targets.

Forecasting stems directly from the results of the monitoring undertaken by the business. Forecasting is method or a technique for estimating future business performance based upon current performance. For example, if current profit levels (one of the business's KPIs) are 10% below target, the business is able to forecast or predict the end of year financial results. A recovery plan can then be put in place to improve financial performance.

4 The role and importance of management information in monitoring business performance

4.1 Management Information

In order to monitor current performance and forecast whether the business is on track to meet its targets, management must have access to:

- Data – raw facts
- Information – processed data

Characteristics of useful business information

In order for information to be of use to the business, it must meet the following criteria:

- Accurate
- Timely
- Relevant
- Complete
- Consistent

New technology, if used effectively, can be used to satisfy all of these criteria within a comprehensive Management Information System (MIS).

4.2 Management Information System (MIS)

A Management Information System (MIS) consists of:

- **People**: specialist staff to process data and prepare the information
- **Equipment**: business equipment which can transmit and communicate the information to designated staff
- **Procedures**: an agreed framework for the production and distribution of the information to designated managers and staff.

The functions of a Management Information System can be summarised as:

- Gathering data (e.g. sales figures)
- Sorting data (e.g. grouping sales figures by geographical region)
- Processing data (e.g. identifying sales trends over the last three years)
- Analysing information (e.g. undertaking a comparative analysis of different products within the product range and identifying 'cash cows' and 'dogs')
- Evaluating results (e.g. comparing sales results and sales trends against business targets)
- Distributing information in a timely manner to managers (preparing specific management information reports for the functional areas - e.g. the Finance function would want information about profit levels and profit margins whilst the Production function would want information relating to productivity rates).

Access to reliable management information allows the business to make informed decisions which reduces the level of business risks. Therefore, reliable management information is central to the monitoring and forecasting of business performance. Access to such information will provide the business with a clear understanding of whether or not planned targets will be met based upon current performance.

5 The contribution of managers, teams and the individual to business performance

5.1 Advantages of organising staff into work groups

The workforce of the business should be regarded as a resource, since a skilled workforce contributes towards improving business performance.

The way in which the workforce is managed and organised will have a direct impact upon the individual employee and their overall contribution to the success of the business.

Organising staff into groups and teams provides advantages such as improved teamwork, learning from each other and encouraging a collaborative approach to problem-solving. It also:

- Promotes multi-skilling as individuals may have the opportunity to work in a range of different roles
- Results in new ways of working, for example, the use of Quality Circles
- Can be used as training for future managers
- Improves productivity and output through specialisation
- Encourages good working relationships, which may result in lower labour turnover.

5.2 Contribution of individual employee to achieving targets and objectives

Employees are stakeholders in the business and, as such are affected by the business's activities. They are also engaged in a contractual relationship with the business in that they are rewarded with a wage or salary in return for their efforts.

A well-motivated and committed employee, who has a professional approach to their work role within the workplace, will exhibit the following qualities and characteristics:

- Will engage in personal development planning – assessing strengths and weaknesses and taking actions to improve
- Will act upon the constructive feedback provided by their line manager
- Be willing to learn and participate in team activities which aim to improve performance and quality
- Develop knowledge and skills through acquiring appropriate qualifications and training

- Be willing to accept increased responsibilities in the decision-making process and to contribute constructive suggestions which would improve business performance.

It is the responsibility of managers to establish a culture in which these individual qualities can be promoted and supported. A motivated and committed employee will have a direct positive impact on business performance through good customer service skills and the willingness to take a constructive role in team decision-making.

5.3 Staff appraisal

Staff appraisal is a performance management system which evaluates an individual employee's contribution to the business against those targets which have been previously agreed with their line manager. It takes the form of a confidential 'one-to-one' meeting between the individual employee and their line manager.

Evidence provided by the employee and their manager is used to assess the individual's performance and may involve financial rewards to the individual if they have met their targets. Conversely, actions can be identified which can support any necessary improvements in individual performance.

Table 5 provides an overview of the benefits of staff appraisal for the individual employee and managers.

Table 5: Advantages of staff appraisal

FOR THE INDIVIDUAL	FOR THE MANAGER
▪ Employee can raise concerns about work-related issues ▪ Training needs can be identified ▪ Opportunity for the employee to feedback on the manager's performance and management style **(360 degree appraisal)** ▪ May result in financial rewards (performance appraisal)	▪ The manager gets to know individual employees ▪ Employees contributions can be recognised ▪ Increased employee motivation ▪ Can be used to identify potential candidates for promotion ▪ Can be used to evaluate business recruitment and training strategies ▪ Can be used to identify areas of under-performance

Improve your grade

Draw up a glossary of business terms used in this book.

Key Performance Indicator (KPI)	Multi-skilling
Financial performance measures	Customer Service
Non-financial performance measures	Benchmarking
Lagging performance measure	Monitoring
Leading performance measure	Forecasting
Balanced scorecard	Staff appraisal
Total Quality Management (TQM)	Staff training

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