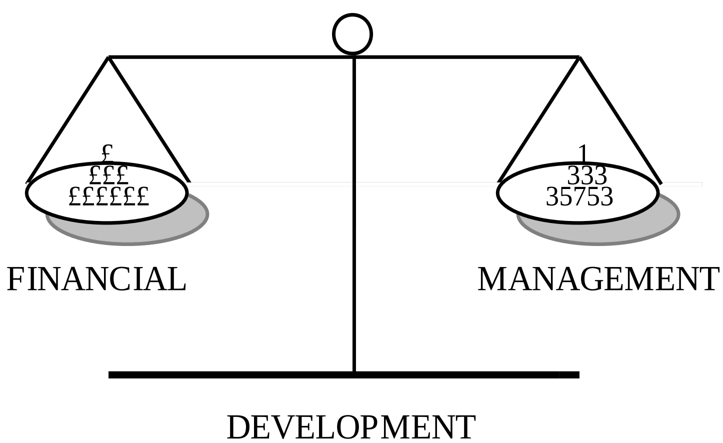
FINANCIAL MANAGEMENT DEVELOPMENT

DISCUSSION TOPICS

NO 805

THE FINANCIAL CASE FOR TRAINING

A financial justification for investment in people



ONE OF A SERIES OF GUIDES FOR

FINANCIAL MANAGEMENT DEVELOPMENT

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This is one of a series of documents produced by David A Palmer as a guide for managers on specific financial topics to assist informed discussion. Readers should take appropriate advice before acting upon any of the issues raised.

THE FINANCIAL CASE FOR TRAINING

A financial justification for investment in people

This paper helps training managers and training suppliers:

- **Understand the need for the financial justification of training**
- **Quantify the benefits and costs of training programmes**
- **Gives examples to help practice identification of financial benefits from training**

and thereby to be better able to contribute to the financial success of their organisations or clients by promoting profit **enhancing** training solutions.

WHY USE A FINANCIAL JUSTIFICATION?

Businesses exist as a mechanism for parting their customers from money, providing goods and services in return (if necessary). The business owners invest money in the business in the expectation of receiving more money back.

In the current corporate environment, business only pays out money in order to yield future benefits. Since resources are limited, all expenditure competes with all other potential expenditure for the scarce funds which are available. Creating profit creates more funds which can potentially be reinvested. Even Charitable organisations will wish to ensure income is maximised and expenditure on activities is minimised whilst achieving their "not for profit" objectives.

It is the role of the finance department to assist managers evaluate the likely costs and benefits of any planned activity and compare the net result with other alternatives. Effectively their job is to say no too all planned expenditure until the proposer comes up with a financially justifiable business case which helps achieves the Business' Goals

The main goal in business is to maximise Return on Capital Employed. Concepts like Shareholder Value and Economic Value Added are variants on this approach, and their use yields the same conclusions in most instances.

Capital Employed in a business is invested in the assets thus ROCE may be described as

$$\frac{\text{PROFIT}}{\text{NET ASSETS}}$$

which can be expressed as:

$$\frac{\text{PROFIT}}{\text{SALES}} \text{ (Margin)} \quad \times \quad \frac{\text{SALES}}{\text{NET ASSETS}} \text{ (Asset Turnover)}$$

A simple example may help:
Assume you buy goods costing £3 and sell them for £4. You make a profit of £1 which is a margin on sales of 25% (1/4). If you employ £10 of capital in the business i.e. the net assets (e.g. your car) are £10 then your Asset Turnover is 0.4 (4/10).
Thus the Return on Capital employed is 10% (£1 on the £10 invested) = 1/4 X 1/10. Since 10% is better than the rate on putting money in the bank this is a successful business. If it can improve its ROCE it could be said to be even more successful.

ROCE is improved by any combination of:

1. Higher price per item
2. Lower cost per item
3. More Sales Volume
4. Lower Net Assets required* (efficiency)

*Net Assets include not just fixed assets: buildings, machinery vehicles etc. but also stocks and debtors. These can be reduced by having creditors e.g. payments in advance, which saves the business having to provide money. Note that People are not seen as an asset by Accountants, which is a fault in accounting but not one that is easily rectified.

REMEMBER: Accountants only consider cashflows. That is their job and it includes rejecting proposals which fail to demonstrate potential improvements to cashflow like more cash in or less cash out. Never tell an accountant that training will make people happier (who cares?). Tell them that because they are happier they will produce more or work for less money and you will see their eyes light up!

Training costs are just one of the many calls on the corporate purse and unless you wish to lose out to the wonderful capital expenditure proposals produced by the Production Director or the wonderful marketing proposals produced by the Sales Director, you have to fight for funds by using the only language that accountants understand........Money. After all the accountants hold the purse strings.

A FINANCIAL JUSTIFICATION FOR INVESTMENT IN PEOPLE

People have a value to the business they work for. It can even be calculated. It can be added to, by investing in people, or it can be destroyed by them leaving their employer. Just because people are not shown on the Company Balance Sheet does not mean that they have no value. Just because training is treated as a charge against profits does not mean that it is money wasted.

Sometimes training money is wasted and that is wrong because what is wasted is not just the money but the time and effort which could have gone into a proper training investment which yields real, quantifiable rewards.

So how can we ensure that we invest in people rather than waste their time and the organisation's money?

SEVEN KEY STEPS

1. Identify their Current Value

2. Identify how that value could be increased

3. Identify the actions necessary to increase their value

4. Calculate the cost, including the cost of time, of the necessary actions

5. Compare the relative benefits and costs with other alternatives

6. Implement the most cost effective actions

7. Review the impact of the actions to gain information to assist future decisions

Each of these will be considered in turn but it is stressed that approximations are not only acceptable, but highly desirable. There are no precisely right answers, merely numbers which are sufficiently accurate to help make decisions. When in doubt make an informed estimate.

1. Identify their Current Value

The value of an employee to an organisation is simple to describe.

It is the excess of the value of the work they perform over their total employment cost, treated as arising in each of the remaining years of their expected working life.

In practice this is difficult to quantify precisely. But this is a management not a financial accounting exercise so approximations are perfectly appropriate. To take two examples: a Salesperson and a Credit Analyst. Both have an all-in employment cost of £20,000 p.a.

The Salesperson creates value by introducing new business which results in additional profit to the organisation. If new business gives rise to a 10% profit then the value to the business of a Salesperson who sells £300,000 is £30,000 - £20,000 = £10,000 p.a.

The Credit Analyst is more difficult to value but that should not deter us. Assume that they review 250 deals each year. 25 are rejected. If the deals were not reviewed then those deals would have been approved. 10 would have proved good payers and 15 would have not paid. The good deals would have made a profit of £500 each and the bad deals would each have resulted in a loss of £4,000. The value of the credit analyst is thus the loss prevented (15 x £4,000) £60,000, less the profit which would have been made (10 x £500) £5,000, less the salary cost of £20,000 = £35,000 p.a.

If you cannot work out an approximate value for every individual then how did you justify employing them in the first place? What other possible criteria could a Job evaluation committee use?

2. Identify how that value could be increased

Using our two examples it is not difficult to consider how value can be increased.

Salesperson:	Sell more
	Sell more or profitable business (better prices)
Credit Analyst	Review more deals
	Reduce the percentage of good deals rejected

3. Identify the actions necessary to increase their value

Training is only part of the process, but it is an important part. It needs the commitment of the individual and their line manager if the right actions are to be identified to produce the desired outcome. The training needs analysis is a key part of this process. To be successful both the individual and the organisation must understand how they can add value and be sure that the outcomes are feasible as well as desirable. There is no point in investing in training the Salesperson to sell more, if the additional business cannot be processed because the Credit Analyst is at full capacity. There is no point in training the Credit Analyst to be able to process deals faster, if there is no backlog. Training must be viewed as part of the Strategic Plan. Thus a good start point is "What stops the organisation making more money?"

4. Calculate the cost, including the cost of time, of the necessary actions

The full cost includes not just the out of pocket costs of training and accommodation, but also the opportunity cost of the participant being away from work. Opportunity cost is the benefit lost by the participant being unable to do something which would have added to profit. However the costs will be a one-off; the benefit will be for many years.

5. Compare the relative benefits and costs with other alternatives

Specifically the alternatives should include other ways of achieving the same objective: New procedures, automation, additional staff etc. The avoidance of the cost of some of these alternatives can be the key financial justification for training. However since training budgets are limited, it is vital that the line manager identifies the financial benefit anticipated from proposed training, so that the training manager can gain maximum return on investment.

6. Implement the most cost effective actions

There seems little point in identifying the appropriate action and then not doing it. If the benefit from investing in people can be shown to outweigh the cost then you are wasting money by not implementing it. A training proposal should never be rejected. If it is viable then it should be accepted. If it is not viable then it should not be proposed.

7. Review the impact of the actions to gain information to assist future decisions

"As with any management action, it is vital that the actual results are compared with the planned results so that blame can be apportioned." NO!...
The only reason to review the results against plan is to assist future decisions. Examples include:

If benefits always prove to be over estimated, reduce them by an appropriate factor in future analyses.
If costs are always underestimated, adjust future forecasts accordingly.
If the expected results are not achieved then identify why not, and take action to rectify that in the future.
If the training is not translated into improved performance in the workplace it is often necessary to consider how to amend working practices. This is why the participant's line manager needs to be fully involved.

Training is not a charitable activity. It is a key part of business, just as important as machine acquisition and maintenance. All businesses have induction training and "Sitting by Nellie" may be the most cost effective method of training. You will not know until you have correctly evaluated it against the alternatives.

THREE AREAS ARE WORTH EXPLAINING IN DETAIL

1. ESTIMATION OF COSTS

For any activity, not just training, the true cost to the business is the opportunity cost of the time. That is “The net benefit which would have arisen from the use of the time in the next best alternative occupation.”

For example, the true cost to your organisation of you reading this is the benefit you have failed to obtain from the time which you are now spending. Thus if you could have been clinching a deal saving £1,000,000, which you now cannot do - the cost is £1,000,000. If you would have gone and got a cup of coffee, then the cost is nil. In fact you could argue that the organisation has saved the cost of the coffee.

As a general guide the cost of an individual’s working time can be treated as the Annual Salary divided by 600. Thus an individual earning £10,000 p.a. should be expected to recover at least £16.66 per hour and this therefore is the cost to the business of their not being available due to training/sickness etc.

This is based on studies which indicate that typically consultants are charged out at three times their salary (one for salary, one for overheads, one for profit/interest/risk etc.) In a typical year, with six weeks holiday (inc. statutories) there are 1,840 working hours (46 x 40 hr week). This divided by three gives approximately 600.

As a rough guide:

ANNUAL SALARY £	REQUIRED RECOVERY RATE £/HOUR
10,000	16.66
20,000	33.33
30,000	50.00
40,000	66.66
50,000	83.33
60,000	100.00

It must be noted that this is an average. An employee recovering this amount each hour is being averagely productive.

In some organisations the opportunity cost is known as it represents the existing charge out rate. Care needs to be taken with this. For example, a consultant attending a three day training event would deliberately schedule their workload to avoid the training days. If, therefore, the three days are at a time which would otherwise have been unchargeable the opportunity cost is zero. (You may now understand why accountants never take a holiday. They can't stand the idea of not making money.)

2. ESTIMATION OF BENEFITS

For any proposed training activity identify how the trainee's job value would be enhanced through successful implementation of the training. Concentrate on the impact of major changes in behaviour on financial results. You will find it not only helps justify the training, but the process will assist in identifying any additional activities which need to take place to ensure the training achieves the desired effect.

Identify the improvements under one or more of the following headings:

1. Increased Sales Volume
2. Increased Sales Price
3. Reduced Costs
4. Increased Efficiency
5. Improved Cashflow

Draw up an outline calculation for each benefit you have identified and compare the results with the cost. In most situations you will find that training can be financially justified.

To assist you here are eight examples to try to identify benefits - answers at the foot of the page:

1. Negotiation skills training for Salespeople
2. Negotiation skills training for Purchasing Managers
3. Appraisal training for Managers
4. MBA for trainee managers
5. Word Processing training for Managers
6. Financial training for Project Managers
7. Correct Lifting techniques training for warehousemen
8. Redundancy counselling

3. FORMULATING THE BUSINESS CASE

A good business case should contain:

Overview and Executive Summary (if a major proposal)
The current financial situation
The necessary rectifying action
The training solution as a prelude to the action
The benefits
The costs
The administration

Example:

The organisation is experiencing a downturn in sales. Since most of its costs are fixed, the volume drop has an immediate impact on profit. For every £1,000 reduction in sales, profit falls by £500. A training programme for sales staff is proposed to increase their conversion rate of enquiries from 10% to 20%, through development of their product knowledge, negotiation techniques and order processing efficiency. This will take the form of a two day workshop. An increase in conversions would result in £500,000 additional sales thus improving profit by £250,000. The cost of the course, covering 12 people is £10,000 (including all out of pocket costs but excluding the cost of their time). Provided agreement can be reached by 31 May the course can be run during July with sales increases being apparent for the last quarter of the year. It is believed that the profit from the increased sales in the fourth quarter alone will be at least double the cost of the course.

Some potential answers

1. Higher prices, more sales
2. Lower prices, better payment terms
3. Failing employees identified earlier saving costs of errors , potential leavers persuaded to stay saving recruitment costs
4. Better decisions in their areas, saving on recruitment costs later - but only if they stay!
5. Lower secretarial costs, faster sales proposals/documents helping cost savings
6. Earlier identification and rectification of errors saves costs
7. Less sick pay, less lost time (what is current experience and set targets for the future)
8. I don't know either - unless it reduces the ultimate payoff.

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David is an experienced financial professional who has devoted his skills to management training in practical understanding and utilisation of financial information. A Graduate, Chartered Accountant, and Associate of the Institute of Taxation, he is also a Member of the Chartered Institute of Personnel and Development and has been an Ordained as a Deacon in the Catholic Church.

He has worked as a Financial Controller and Company Secretary in the Finance industry and as a Director of Finance and Administration in the Computer Services industry. Since 1990 he has conducted management development programmes for over forty major organisations including Arla Foods, Blue Circle, BP, CSC Computer Sciences, Conoco, Ernst & Young, Lloyds Bowmaker, Royal Mail, Unilever and Zeneca. He also runs programmes for the Leadership Foundation and the management teams at a number of Universities. International training experience includes work in Belgium and Holland for CSC, in Denmark, Kenya and the Czech Republic for Unilever, in Holland and the US for Zeneca, in Dubai for Al Atheer, in Bahrain and Saudi Arabia for Cable & Wireless.

He specialises in programmes in financial management for both tactical and strategic decision making. In addition he has run courses in acquisition evaluation (The Economist, Eversheds, Blue Circle and Hays Chemicals) and in post-acquisition management (Unilever). All training is specifically tailored to the needs of the organisation with the emphasis on practical applications to enhance profitability and cashflow. He has developed material for delivery by in-house personnel (Royal Mail, Lloyds Bowmaker and Conoco), computer based training packages (The Post Office, Unilever and BP), and post course reinforcement self-study workbooks (CSC and Zeneca). He has also produced a training video on Cashflow Management.

He is a prolific writer of case studies, role plays and course material. He has also published articles on the financial justification of training, financial evaluation of IT investment proposals, the use of Activity Based Costing and Customer Profitability statements, commercial considerations for consultants, the need for taxation awareness training for general managers, evangelisation and Christian business ethics.

Many of his generic documents are freely available on his website: **FinancialManagementDevelopment.com** including papers on Charity Management.

In addition to his Diaconal work in the Church, he has held a number of voluntary positions including University, College and School Governor, Hospice Treasurer and Trustee of various charitable institutions. He continues to provide ad hoc commercial advice to several other charitable organisations. He has been married for over 35 years and has one daughter and three granddaughters.

This series of papers is designed to help managers by providing a basic understanding of key financial concepts to assist them in their work. It is provided at no cost since this knowledge is a Gift from God and thus to be shared (Matthew 10:8).

