The Institute of Chartered Accountants of Bangladesh (ICAB)

VOLUME - I

STRATEGIC BUSINESS MANAGEMENT

STUDY MANUAL

CA Advanced Level

CA BANGLADESH

THE INSTITUTE OF CHARTERED ACCOUNTANTS OF BANGLADESH

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Strategic Business Management
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The Study materials have been prepared by the Education and Student Affairs Division of the Institute of Chartered Accountants of Bangladesh (ICAB)

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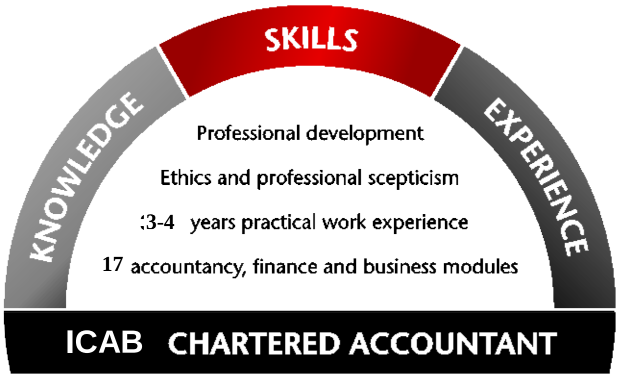
1 Introduction

CA Overview

The ICAB chartered accountancy qualification, the CA, is one of the most advanced learning and professional development programmes available. Its integrated components provide you with an in-depth understanding across accountancy, finance and business. Combined, they help build the technical knowledge, professional skills and practical experience needed to become an ICAB Chartered Accountant.

Each component is designed to complement each other, which means that students can put theory into practice and can understand and apply what they learn to their day-to-day work. The components are:



Professional development

ICAB Chartered Accountants are known for their professionalism and expertise. Professional development prepares students to successfully handle a variety of different situations that they encounter throughout their career.

The CA qualification improves your ability and performance in seven key areas:

- Adding value
- Communication
- Consideration
- Decision making
- Problem solving
- Team working
- Technical competence.

Ethics and professional scepticism

Ethics is more than just knowing the rules around confidentiality, integrity, objectivity and independence.

It's about identifying ethical dilemmas, understanding the implications and behaving appropriately. We integrate ethics throughout the CA qualification to develop students' ethical capabilities – so they will always know how to make the right decisions and justify them.

3–4 years practical work experience

Practical work experience is done as part of articleship with one of the ICAB member in practice. Students need to complete articleship for a period of three to four years. The knowledge, skills and experience they gain as part of their articleship agreement are invaluable, giving them the opportunity to put what they're learning into practice.

17 accountancy, finance and business modules

Each of the CA modules is directly relevant to the work that students do on a day-to-day basis. They will gain in-depth knowledge across a broad range of topics in accountancy, finance and business.

There are 17 modules over three levels. These can be taken in any order with the exception of the Case Study which has to be attempted last. Students must pass every exam (or receive credit) – there are no options. This ensures that once qualified, all ICAB Chartered Accountants have a consistent level of knowledge, skills and experience.

Certificate Level

There are seven modules that will introduce the fundamentals of accountancy, finance and business.
They each have a 2 hours examination except 'Principle of Taxation' which will be of 3 hours, and Business Law, IT each will be 1.5 hours duration. Students may be eligible for credit for some modules if they have studied accounting, finance, law or business at degree level or through another professional qualification.

Professional Level

The next seven modules build on the fundamentals and test your understanding and ability to use technical knowledge in real-life scenarios. Each module has a 3 hour exam, which are available to sit two times per year. These modules are flexible and can be taken in any order. The Business Planning: Taxation and Business Strategy modules in particular will help you to progress to the Advanced Level.

Advanced Level

The Corporate Reporting and Strategic Business Management modules test students' understanding and strategic decision making at a senior level. They present real-life scenarios, with increased complexity and implications from the Professional Level modules.

The Case Study tests all the knowledge, skills and experience gained so far. It presents a complex business issue which challenges students' ability to problem solve, identify the ethical implications and provide an effective solution.

For more information on the CA qualification exam structure and syllabus, visit ICAB.org.bd/students

2 Strategic Business Management

2.1 Module aim

To enable candidates to demonstrate quantitative and qualitative skills, in order to make realistic business recommendations in complex scenarios. Business awareness will need to be demonstrated at strategic, operating and transactional levels.

To achieve this aim, candidates will be required to use technical knowledge and professional judgement to apply appropriate models and to analyse data from multiple sources, including corporate reports, in order to evaluate alternatives and determine appropriate solutions.

On completion of this module, in a national or global context, and for a range of different business structures and industry scenarios, candidates will be able to:

- Analyse and identify the external environment and internal strategic capability of an entity; evaluate the consequences of strategic choices; recommend strategies to achieve stakeholder objectives, recommend appropriate methods of implementing strategies and monitoring strategic performance; manage business risks; and advise on corporate governance.
- Identify and advise upon appropriate finance requirements; evaluate financial risks facing a business and advise upon appropriate methods of managing those risks; provide valuations for businesses and securities; and advise upon investment and distribution decisions.
- Identify and explain ethical issues. Where ethical dilemmas arise, candidates will be able to recommend and justify and determine appropriate actions and ethical safeguards to mitigate threats.
- Interpret and apply corporate reporting information in evaluating business and financial performance; recognise and explain the corporate reporting consequences of business and financial decisions; apply corporate reporting information in appropriate models to determine asset, equity and entity valuations, demonstrating an understanding of the usefulness and limitations of accounting information in this context.
- Appraise and explain the role of assurance in raising new equity and debt funding and in the subsequent monitoring of such funding arrangements; understand, explain and evaluate the role of assurance in selecting and implementing key business decisions including acquisitions and strategic alliances; understand and explain the role of assurance in financial and business risk management.

2.2 Specification grid

This grid shows the relative weightings of subjects within this module and should guide the study time spent on each. Over time the marks available in the assessment will be within the ranges of weightings below, while slight variations may occur in individual assessments to enable suitably rigorous questions to be set.

Syllabus area	Weighting (%)
Business and management	35–45
Financial strategy	25–35
Corporate Reporting	15–20
Assurance	10
Ethics	5–10
	100

Your exam will consist of two questions, and ethical issues and problems could appear in either question.

CHAPTER 1

Strategic analysis

Introduction

Topic List

1. Strategic management
2. Organisational goals and objectives
3. The external business environment
4. Internal factors and strategic capability
5. Analysing strategic position and performance
6. Levels of strategy in an organisation

Summary and Self-test

Technical reference

Answers to Interactive questions

Answers to Self-test

Introduction

Learning objectives

Tick off

- Describe and explain the strategic objectives of an entity considering the interests of stakeholders ☐
- Analyse and evaluate, for a given scenario, the external economic, market and industry environment which may impact upon the performance and position of a business ☐
- Identify and evaluate the significance of the internal factors in a given scenario that may influence the ability of an entity to achieve its chosen strategic objectives ☐
- Analyse and evaluate the current position and performance of an entity, from both a financial and a non-financial perspective, using a variety of internal and external information sources ☐
- Demonstrate how strategic analysis tools can be used in a complex scenario ☐
- Demonstrate how business strategy and financial strategy can interrelate in a complex scenario ☐
- Evaluate and advise upon the strategic capability of an entity ☐
- Evaluate strategy at corporate, business unit and operational levels ☐

Knowledge brought forward

This chapter reviews a number of analysis tools that were covered in the Business Strategy paper at Professional level. Detailed knowledge of these techniques will be critical at the Advanced Level where you will need to demonstrate not only your knowledge of them, but also your ability to apply them to complex scenarios.

Although the technical content in this chapter should largely be revision, their **application** at Advanced Level will be more complex than at previous levels. For example, based on the issues highlighted in the scenario, you will need to identify which tools or models are appropriate to use, and then apply them to the scenario to help evaluate an organisation's strategic position. However, the question requirement will not tell you which models you need to use.

You should refer to earlier materials for an in-depth analysis of any model or techniques you are not comfortable with.

1 Strategic management

Section overview

- This section reviews the 'process' of strategic management, which was covered in the Professional Level Business Strategy paper. Having a good understanding of the processes by which strategies are developed and implemented is critical at the Advanced Level, and you should refer to earlier materials for a more detailed analysis of them.

1.1 What is strategy?

The question, 'What is strategy?' is a useful starting point for this Study Manual, but it is a very big question indeed. There are probably also nearly as many definitions as there are companies.

A basic assertion is that business strategy is concerned with the **long-term direction** of an organisation. In their seminal text, *Exploring Corporate Strategy*, Johnson, Scholes and Whittington expand on this idea to suggest that:

> 'Strategy is the **direction and scope** of an organisation over the **long term** which achieves **advantage** in a changing **environment** through its configuration of **resources** and **competences**, with the aim of fulfilling **stakeholder** expectations.'

Item	Comment	Example
Direction and scope	Strategy gives at least an **initial deliberate direction**, range of **activities** and **future** for the company to aim at, even if environmental circumstances conspire to send it off course and demand corrective management action.	Shell is in the oil and energy business.
Long term	Most organisations are in business for the **achievement of objectives** that will go beyond short-term profit targets. What constitutes 'long term' in business strategy is open to debate. Bear in mind that: • Time horizons are culturally determined; the 'long-term' means different things in different cultures. • The 'long-term' varies from industry to industry: compare fashion retailing with mining. A turnaround strategy for a fashion retailer depends on one or two seasons for success.	For an oil company, sources of supply are very necessary. These are called 'reserves', and provide for Shell's long term existence.
Achieves advantage	Strategy affects the overall **health** of the organisation and its **position against competitors**.	Shell competes with other oil companies.
Changing environment	An organisation is inextricably linked with its environment, and strategy can help the organisation to cope with **changes** and **complexity**. An organisation's strategic position needs to be appropriate to its environment, so that it 'fits' with that environment.	Shell plans to spend CU100 billion between 2011-2014 to support new energy production, such as energy from natural gas. A range of energy sources will be needed to meet demand over the coming decades, and Shell has estimated that up to 30% of the world's energy mix could come from renewable sources by 2050.

Item	Comment	Example
Changing environment		The global population is expected to increase by around 40% by 2050, and vast amounts of extra energy will be needed to support economic growth. The challenge is to meet demand in economically, environmentally and socially responsible ways.
Configuration of resources and competences	Strategies require **processes** to guide the **effective utilisation** of resources and competences.	An oil company needs to manage its oil reserves, and the way it extracts, refines, distributes and sells its oil.
Stakeholder expectations	Satisfying market demands (customers) is a key factor in any business strategy. '**What business are we in?**' and **'Who are our customers?'** are important starting points. As well as **customers**, other stakeholders (in particular **shareholders**) have their own interests in the organisation. Should the pursuit of shareholder wealth be the main concern of management? What about staff? What are their expectations?	The oil business? The energy business? In a period of rising oil (and fuel) prices, customers' 'wealth' is certainly not maximised. High prices benefit shareholders if profits are maintained, but they also benefit governments through tax revenues from fuel duties.

Characteristics of strategic decisions

Having identified what strategic decisions are about, Johnson, Scholes and Whittington also describe some **important characteristics of the strategic decisions** themselves.

(a) Decisions about strategy are likely to be **complex** since there are likely to be a number of significant factors to take into consideration and a variety of possible outcomes to balance against one another.

(b) There is likely to be a high degree of **uncertainty** surrounding a strategic decision, both about the precise nature of current circumstances and about the likely consequences of any course of action.

(c) Strategic decisions have extensive impact on **operational decision-making**; that is, decisions at lower levels in the organisation.

(d) Strategic decisions affect the organisation as a whole and require processes which cross operational and functional boundaries within it. An **integrated approach** is therefore required.

(e) Strategic decisions are likely to lead to **change** within the organisation as resource capacity is adjusted to permit new courses of action. Changes with implications for **organisational culture** are particularly complex and difficult to manage.

1.2 Elements of strategic management

Strategic management is concerned with taking and implementing strategic decisions. The perspective is the organisation as a **whole**, not just the view from that of individual business functions.

Strategic management involves three types of activity which are often described as phases in a sequence. The table below summarises some of the terminology and follows, broadly, the sequence of the three types of activity:

Analysis – analysis of current strategic position, including objective setting and the influences on an organisation's strategy (external environment, internal capabilities, and the expectations of stakeholders).

Choice – formulation and evaluation of agreed strategies.

Implementation, monitoring and control (with control information feeding back into the system).

The three elements of strategic analysis, strategic choice and strategic implementation respectively provide a framework for the first three chapters of this text. However, this linear sequence of analysis, choice and implementation is not necessarily an accurate description of **how strategies** are actually made and implemented in all organisations.

In particular, although strategic planning addresses the long-term direction of an organisation, a strategic plan should not be set in stone. It is likely to require frequent adjustments, since circumstances may change, the competitive environment will evolve and some events simply cannot be foreseen. Moreover, strategic planning is not a process which involves a one-off implementation, but rather one that goes hand in hand with continuous improvement – seeking to improve all the functions of a business in an ongoing manner.

It is also important that the overall sequence of strategic management activities does not obscure the reality that different aspects of strategic management are likely to be important in different contexts. For example, strategic management in public sector organisations is likely to be very different to that in a multinational listed company.

Nonetheless, the three types of activity (analysis, choice and implementation) provide a useful starting point to begin our study of strategic business management.

Element of strategic management	What it is	Where it fits in the strategic management process
		ANALYSIS
Mission	The organisation's fundamental purpose in society, in terms of how it satisfies its stakeholders.	Part of the analysis phase. These elements set the direction of the organisation and what it does.
Vision	Desired future state for the industry or organisation.	
Strategic intent	Similar to vision, but focused on the organisation's future state and related to the consideration of resources needed to achieve it.	
Goals	Desired achievements, implying action is needed to reach them.	There may be gaps between desired corporate goals and objectives and the outcomes that are likely to be achieved.
Aim	A goal which is not quantified.	
Objective	A quantified goal.	
External environment	Everything outside the boundaries of the organisation. • Macro environment: general political, economic, social, ecological/environmental and technological factors affecting an industry. • Task environment: direct impact on the organisation.	A review of the external environment and internal capabilities is part of the analysis process. These might be combined in a corporate appraisal or SWOT analysis.
Competences	Resources, processes and skills; a core competence is fundamental to the success of the organisation.	
		CHOICE AND EVALUATION
Strategy	Long-term plan that integrates an organisation's policies, goals and action sequences into an agreed whole.	Strategic options are generated.
		CHOICE AND EVALUATION
Evaluation criteria	This suggests that organisations have to choose which strategies to adopt. Evaluation criteria are decision rules that enable organisations to make such a choice. Often based around suitability, feasibility and acceptability.	Strategies are evaluated before they are implemented in practice (ie before anybody really knows what the outcome will be). We will look at the evaluation of strategic options in more detail in Chapter 2.

Element of strategic management	What it is	Where it fits in the strategic management process
		IMPLEMENTATION
Tactics	Deployment of resources in an agreed strategy.	Tactical and operational strategies need to be aligned to, and support, the overall corporate strategy.
Strategic architecture	Combination of resources, processes and competences to put the strategy into effect. This, in turn, will need to be translated into specific actions and tasks that link broad direction to specific operational issues.	
Strategic business	This is part of an organisation for which there is a distinct external market for goods and services.	The strategy may result in the need to develop or change the organisation's structure.
		CONTROL
Control	Obtaining feedback and monitoring actual performance in light of strategies and objectives. Strategic control has two parts: • Monitoring the effectiveness of strategies and actions; • Modifying either the strategy or the actions if adjustments are required.	This activity provides feedback information for the analysis activity. The nature of this feedback can be questioned.

1.3 Prescriptive vs emergent approaches to strategy

The structured 'process' of strategic management that we have illustrated in Section 1.2 is characteristic of the formal, **rational model approach** to strategic planning. However, there is a marked contrast between this prescriptive approach to strategic planning and the **emergent approach**.

The rational planning model, originated by Ansoff, involves strategic analysis, strategic choice, implementation of the chosen strategy, followed by review and control. Strategy, in the context of the rational model, involves senior management setting goals initially and then designing strategies for the organisation to follow in order to try to achieve these goals.

However, Mintzberg criticised this rigid approach to strategic management, and proposed an alternative emergent approach. The emergent approach views strategy as continuously and incrementally evolving from patterns of behaviour within an organisation. Managers have the power to develop and adapt strategies in response to changes in circumstances or as new opportunities and threats arise.

The emergent approach still involves the same degree of strategic analysis as the rational planning model, but the processes of choice and implementation take place together rather than sequentially.

In addition to formal and emergent approaches to strategy, it is also important to note a third potential approach to business planning: **freewheeling opportunism**.

This approach suggests that firms should not bother with formal plans at all, and should simply exploit opportunities as they arise. The advantages of this approach are claimed to be: that good opportunities are not lost; it is easier to adapt to change; and it encourages a more flexible, creative attitude.

However, the lack of formal planning in freewheeling opportunism means that there is no co-ordinating framework for an organisation, so that some opportunities get missed anyway. This approach can also mean that an organisation ends up **reacting** all the time, rather than developing its own strategies proactively.

2 Organisational goals and objectives

Section overview

- Goals and objectives derive from an organisation's mission, and support it.
- By definition, stakeholders have an interest in an organisation and its strategy. Therefore, an organisation needs to bear the interests of its stakeholders (and possible conflicts between them) in mind when it develops its mission and objectives.

2.1 Brought forward knowledge

One of the learning outcomes of the Business Strategy paper at Professional Level is that candidates should be able to 'Evaluate the purpose of a business in terms of its stated mission and objectives.' Therefore, candidates studying at Advanced level are assumed to already have this ability.

Organisational goals

For **profit-seeking organisations**, the underlying organisational purpose is to deliver economic value to their owners, ie to increase shareholder wealth. Goals such as satisfying customers, building market share, cutting costs, and demonstrating corporate social responsibility are secondary objectives that enable economic value to be delivered.

Not-for-profit organisations: The primary goals of not-for-profit organisations vary enormously, and include meeting members' needs, contributing to social well-being, and pressing for political and social change. Secondary goals will include the economic goal of not going bankrupt and, in some cases, generating a financial surplus to invest in research or give to the needy. Often the goals of not-for-profit organisations will reflect the need to maximise the benefit derived from limited resources, such as funds. Their objectives may be more heavily influenced by external stakeholders such as the government.

2.2 Mission and values

The mission statement of an organisation describes its basic purpose, and what it is trying to achieve.

The following are the mission statements for some well known companies:

Coca-Cola – 'To refresh the world… To inspire moments of optimism and happiness… To create value and make a difference.'

Google – 'To organize the world's information and make it universally accessible and useful.'

Starbucks – 'Our mission: to inspire and nurture the human spirit - one person, one cup and one neighbourhood at a time.'

eBay – 'To provide a global trading platform where practically anyone can trade practically anything.'

Microsoft – 'To help people and businesses throughout the world realise their potential.'

2.3 Goals, objectives and targets

An understanding of an organisation's mission is invaluable for setting and controlling the overall **functioning and progress** of that organisation.

However, mission statements themselves are open-ended and are not stated in quantifiable terms, such as profits or revenues. Equally, they are not time bound.

Therefore, mission statements can only be seen as a general indicator of organisational strategy. In order to start implementing the strategy and managing performance, an organisation needs to develop some more **specific** and **measurable objectives** and **targets**.

Most people's work is defined in terms of specific and immediate **things to be achieved.** If these things are related in some way to the wider purpose of the organisation, it will help the organisation to function more effectively.

Loosely speaking, these 'things to be achieved' are the goals, objectives and targets of the various departments, functions, and individuals that make up the organisation. In effective organisations, **goal congruence** will be achieved, such that these disparate goals, objectives and targets will be **consistent** with one another and will **operate together** to support progress with the overall mission.

However, whilst mission statements are high-level, open-ended statements about a firm's purpose or strategy, **strategic objectives** translate the mission into more **specific milestones and targets** for the business strategy to follow and achieve.

2.3.1 A hierarchy of objectives

A simple model of the relationship between the various goals, objectives and targets is a **pyramid** analogous to the traditional organisational hierarchy. At the top is the **overall mission**; this is supported by a **small number of wide ranging goals**, which may correspond to overall departmental or functional responsibilities. Each of these goals is supported, in turn, by **more detailed, subordinate goals** that correspond, perhaps, to the responsibilities of the senior managers in the function concerned. This pattern is cascaded downwards until we reach the work targets of individual members of the organisation.

As we work our way down this pyramid of goals, we will find that they will typically become **more detailed** and will relate to **shorter timeframes**. So, the mission might be very general and specify no time scale at all, but an individual worker is likely to have very specific things to achieve every day, or even every few minutes.

Note that this description is very basic and that the structure of objectives in a modern organisation may be much more complex than this, with the pursuit of some goals involving input from several functions. Also, some goals may be defined in very general terms, so as not to stifle innovation, co-operation and informal ways of doing things.

An important feature of any structure of goals is that there should be **goal congruence**; that is to say, goals that are related to one another should be **mutually supportive**. This is because goals and objectives drive actions, so if goals aren't congruent, then the actions of one area of the business will end up conflicting with those of another area of the business.

Goals can be related in several ways:

- **Hierarchically**, as in the pyramid structure outlined above
- **Functionally**, as when colleagues collaborate on a project
- **Logistically**, as when resources must be shared or used in sequence
- In **wider organisational senses**, as when senior executives make decisions about their operational priorities

A good example of the last category is the tension between short- and long-term priorities in such matters as the need to contain costs whilst at the same time increasing productivity by investing in new machinery, or trying to increase market share through marketing activity.

2.3.2 Management by objectives

The contrast between objectives and mission statements can be highlighted by the fact that objectives should be 'SMART'.

Specific **M**easurable **A**chievable **R**elevant **T**ime-related

Relevant is sometimes replaced with **realistic**; but 'realistic' and 'achievable' could be seen as meaning similar things. An objective is relevant if it is appropriate to an organisation's mission.

There are other variants: *achievable* may be replaced with *attainable*, which has an almost identical meaning. Achievable is also sometimes replaced with 'a*greed*'; denoting that objectives should be agreed with those responsible for achieving them. However, note that whichever version you prefer, a SMART objective corresponds very closely with our description of the way the word *target* is commonly used.

(a) **S**pecific: An objective must be a clear statement, and must be easy to understand. Whereas mission statements tend to be vague, objectives must be specific.

(b) **M**easurable: Again, in contrast to mission statements, objectives must be measurable so that performance against the objectives can be assessed. Measuring performance against objectives is a key element of control in organisations.

(c) **A**chievable: If the objectives set are not achievable, people will not bother trying to achieve them, so there is little point setting them.

(d) **R**elevant: An objective is relevant if it is appropriate to an organisation's mission, and will help it fulfil that mission. (This reiterates the link between an organisation's mission and its objectives.)

(e) **T**ime-related: Whereas mission statements tend to be open-ended, an organisation needs to define a specific time period in which objectives should be achieved. Again, this is very important for enabling management to judge whether or not the objective has been achieved. For example, if an organisation has an objective such as, 'To increase sales revenue by 5%', how will managers know the time period over which this sales increase is expected to be achieved? However, if the objective is, 'To increase sales revenue by 5% per year', the time frame is clearly identified.

2.3.3 Primary and secondary objectives

Some objectives are more important than others. In the hierarchy of objectives, there is a **primary corporate objective** and other **secondary objectives** which should combine to ensure the achievement of the overall corporate objective.

For example, if a company sets itself an objective of growth in profits, as its primary aim, it will then have to develop strategies by which this primary objective can be achieved. An objective must then be set for each individual strategy. Secondary objectives might then be concerned with sales growth, continual technological innovation, customer service, product quality, efficient resource management or reducing the company's reliance on debt capital.

Corporate objectives should relate to the business as a whole and can be both **financial** and **non-financial**:

- Profitability
- Market share
- Growth
- Cash flow
- Asset base
- Customer satisfaction
- The quality of the firm's products
- Human resources
- New product development
- Social responsibility

Equally, when setting corporate objectives, it is important that an organisation considers the needs of all of its **stakeholders**, to try to ensure that these are met wherever possible.

Long-term and short-term objectives

It is also important to remember that objectives may be long-term or short-term. A company that is suffering from a recession in its core industries and making losses in the short term, might continue to have a long-term primary objective of achieving a growth in profits, but in the short term, its primary objective might be survival.

Trade-offs between long-term and short-term objectives

Just as there may have to be a trade-off between different objectives, so too might there be a need to make trade-offs between short-term objectives and long-term objectives. This is referred to as short/long (S/L) trade-off.

Decisions that involve the **sacrifice of longer-term objectives** include the following:

(a) Postponing or abandoning capital expenditure projects (or marketing expenditure) that would eventually contribute to growth and profits, in order to protect short term cash flow and profits.

(b) Cutting research and development (R&D) expenditure to save operating costs, thereby reducing the prospects for future product development. In this respect, cost leadership could be seen as a short term strategy, because it is looking to minimise operating costs rather than develop new products or capabilities as a basis for competitive advantage in the future.

(c) Reducing quality control to save operating costs (but also adversely affecting reputation and goodwill).

(d) Reducing the level of customer service to save operating costs (but sacrificing goodwill).

(e) Cutting training costs or recruitment (so the company might be faced with skills shortages).

This relationship between short-term and longer-term objectives also has significant implications for the way organisations **measure performance** and the performance measures they use to do so.

The phrase, '**What gets measured, gets done**', is an important one in relation to performance measurement, and its implications are key here as well. For example, if Return on Investment (ROI) is one of a company's key financial performance measures, then its managers will have a keen interest in maximising the company's ROI. As a result, however, this choice of performance measure may also encourage the managers to focus on short-term, rather than longer term performance. For example, they may decide to dispose of some machinery that is not currently in use, thereby reducing depreciation charges and asset values, and in doing so, immediately increasing ROI. However, the potential flaw in such a short-term plan could be exposed if the managers later realise they need to use the machinery again and so have to buy some new equipment (at a higher cost than the equipment they had previously disposed of).

Case example: British Airways

In its 2009/10 Annual Report and Accounts, British Airways summarised its strategy and objectives:

We have lived through unprecedented market conditions over the last 18 months. Throughout this, we have remained focused on our strategy to become the world's leading global premium airline.

The actions we are taking now to make our cost base more efficient and our unstinting focus on customer service are critical parts of this long-term vision. They will determine how strongly we emerge from the current downturn and will help us to create a sustainable and profitable future for the business, benefiting our customers, colleagues and shareholders.

The overall strategy of British Airways highlights three key points:

- A desire to be **global**; to appeal to customers internationally, whether they are individual or business travellers
- **Premium** – to offer customers a unique premium service that which they are willing to pay a higher price for
- **Airline** – British Airways will remain focused on its core business: moving people and cargo.

The focus on 'premium' is important here, because it shows how British Airways (BA) is looking to differentiate itself from the budget airlines such as EasyJet. As if to reinforce this point, BA goes on to identify five strategic goals that it believes are the key steps it needs to take to achieve its vision of being the world's leading premium airline:

1 *Be the airline of choice for long-haul premium customers* – so that people will want to fly with BA whenever they can. Long-haul premium customers are key to BA's profitability. BA aims to use its understanding of customer requirements to drive its design choices on product, network and service.

2 *Deliver an outstanding service for customers at every touch point* – through the way it leads, trains and rewards colleagues, on the ground and in the air, BA aims to ensure that customers, on all routes and classes, enjoy a premium experience. Two key steps towards achieving this goal are embedding a customer-centric outlook in the company's reward framework and the increased use of performance-related pay.

3 *Grow presence in key global cities* – to provide the best global connectivity for customers. BA aims to build its presences in the top tier global cities, either directly or through its expanding network of airline partnerships. While established global cities such as London and New York remain critical to the company's success, BA also places a special emphasis on developing its position in the global cities of tomorrow.

4 *Build on its leading position in London* – London is not only BA's home city, it is also the world's biggest and most competitive international air market. Ensuring Heathrow remains a world-class hub is vital in order to give BA a strong London base to service the largest international long-haul markets. BA will look to influence government policy decisions, and work with Heathrow Airport's owners on the continued development of its infrastructure.

5 *Meet customers' needs and improve margins through new revenue streams* – airline revenue streams are the core of BA's business. However, it looks to augment these revenues by building profitable ancillary services that offer value to customers and reinforce BA's brand. In particular, BA is exploring how it can develop new products and services that exploit its assets and capabilities, meet the needs of its core customers, and enhance loyalty.

Interactive question 1: British Airways

[Difficulty level: Intermediate]

One of the big strengths of British Airways has always been the Heathrow hub and its dominance of lucrative business traffic across the Atlantic. In 2007/08, the final year of the financial-services boom, BA posted a record result. Corporate lawyers, merchant bankers and highly-paid executives thought nothing of paying CU4,000 or more for a return trip to America, so the cash rolled in for BA.

BA's profit in 2007/08 was CU922 million, and it achieved an operating margin of 10% (something which had eluded BA managers for the previous two decades). BA even paid a dividend to shareholders for the first time since 2001.

However, a year later, the position had changed dramatically. As the Chief Financial Officer's report in the 2008/09 Annual Report and Accounts noted: 'Last year we said that record profitability has put us in a good position to weather economic slowdown. This has been invaluable as we face the sharpest downturn in our Company's history.' The credit crunch and recession revealed the reliance on Heathrow and Atlantic business traffic not to be a strength but actually, a weakness. Business traffic dried up, with companies, and in particular the big banks, slashing their travel budgets.

BA's results for the 2009/09 financial year showed how hard and fast the downturn had hit. The airline recorded a CU401 million pre-tax loss – CU331 million of which came in the final quarter of the year alone – and scrapped the dividend.

BA's lifeblood 'premium traffic' – first and business class – fell by 17% in April 2008 and by the same amount in May. Business class fares across the Atlantic also dropped sharply. Independent figures showed that premium traffic across the industry as a whole declined by around 19% in the first three months of 2009.

BA said it would reduce capacity in the winter of 2009 by a further 4%, having reduced its schedule by 3% in the same period in 2008 by grounding 16 planes, including eight jumbo 747s.

However, BA noted that, despite a number of carriers going out of business or being forced into rushed mergers, competition remained fierce, particularly at Heathrow and on important transatlantic routes. This meant that the need to deliver world-leading customer service and operational performance remained, and if anything, becoming more important than ever before. This was emphasised in the key goals that BA published, including one to, 'Deliver an outstanding service for customers at every touch point.'

Requirement

What could BA do to respond to these tough conditions?

See **Answer** at the end of this chapter.

2.3.4 Financial objectives

For commercial businesses, the primary objective is making a **return;** maximising the wealth of its ordinary shareholders.

(a) A satisfactory return for a company must be sufficient to **reward shareholders adequately** in the long run for the risks they take. The reward will take the form of **profits**, which can lead to **dividends** or to **increases in the market value** of the shares.

(b) The size of return considered adequate for ordinary shareholders will vary according to the risk involved.

There are different ways of expressing a financial objective in quantitative terms. Financial objectives would usually include the following.

- Profitability
- Return on investment (ROI) or return on capital employed (ROCE)
- Share price, earnings per share, dividends
- Growth

We will look in more detail at how organisations measure their performance later in this text.

However, as with business objectives, it is important to recognise that financial objectives may be short-term as well as long-term. Maximising shareholder value is a long-term objective. However, short-term objectives, such as working capital management to ensure a business has sufficient cash to satisfy its day-to-day requirements, are equally important for the on-going success of the business.

2.3.5 Business strategy and financial strategy

Highlighting the importance of financial and non-financial objectives also reminds us of the importance of considering how business and financial strategy interrelate.

Although the primary focus of the early chapters of this Study Manual is on business strategy, it is important to remember that business strategy decisions must be taken in conjunction with financial ones. For example, does a company have sufficient funds to support a proposed business strategy, or how can it raise the additional funds needed to support that business strategy?

Competitive strategy, financial strategy and investment strategy

In essence, there are actually three inter-related elements to a business strategy: competitive strategy, financial strategy and investment strategy.

These three elements must work together for the strategy of a firm to be successful. We can display these crucial elements in the following diagram.

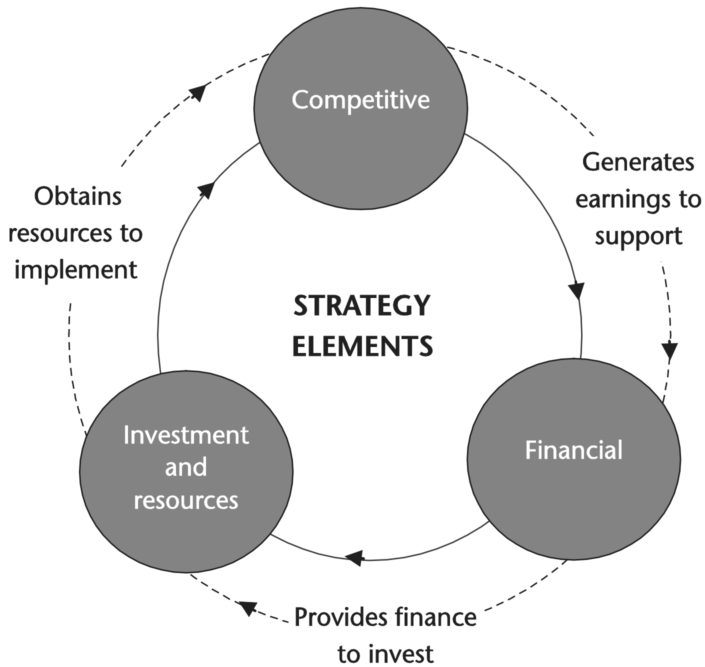


Figure 1.1: Elements of business strategy

The three types of strategy are described in the box below.

Strategy	Comment
Competitive strategy	This determines how and where the firm competes in the market (customers, products) in order to achieve a sustainable position, and thereby generate profits and cash flows. The results of competitive strategy determine the level of profits and cash flow available for financial and investment strategies.
Financial strategy	This is concerned with maintaining relationships with shareholders and other providers of finance. It is also about the use of the cash and earnings generated by the competitive strategy, and specifically how financial resources are invested for the future of the company.
Investment strategy	This aims to provide the resources (such as non-current assets, working capital, training, marketing, branding, research and development expenditure) for the competitive strategy to be carried out.

Financial strategy decisions

In their text Corporate Financial Strategy, Bender and Ward suggest that ultimately there are four key financial strategy decisions any company has to make:

(a) How large should the company's asset base be?
(b) How much of the finance should be debt, and how much should be equity?
(c) How much profit should be paid out as dividends, and how much should be retained?
(d) How much new equity should be issued?

The life cycle model

The product (or industry) life cycle model highlights the importance of integrating business and financial strategies.

The life cycle model illustrates that during the introduction and growth phases, a company's cash flow is likely to be negative, due to the investment in assets and working capital required to support growth. However, early-stage businesses are also risky, because there are many unknowns about their performance.

It would be unwise then to attempt to finance the business with debt, because this would increase their financial risk (gearing) and would lead to outflows of cash (interest) from companies that are already cash negative. Thus, companies in the early stages of their life cycle should seek equity funding as far as possible.

However, companies in the early stages of their life cycle often pay no dividends to their investors. As has already been noted, these companies are likely to be cash negative but, perhaps more importantly, they are likely to have exciting growth prospects. Therefore, they are better able to earn value for the shareholders by reinvesting any profits back into the company rather than paying money out by way of dividend.

Value drivers

Definition

Value drivers: In general terms, value drivers are crucial organisational capabilities that provide a competitive advantage to an organisation.

Rappaport's value drivers: In relation to the shareholder value approach (as set out by Rappaport) – the value of a company is dependent up on seven drivers of value. In effect, the drivers enable management to estimate the value of an investment by discounting forecast cash flows by the cost of capital.

A company's overall aim is to create shareholder value. This is done by selecting a business strategy which it believes will be successful, with that strategy being derived from an analysis of external forces and of the company's internal resources and competences.

However, that strategy also needs to link to those factors that drive value in the business. Rappaport identified seven value drivers:

(a) Increase sales growth
(b) Increase operating profit margin
(c) Reduce cash tax rate
(d) Reduce incremental investment in capital expenditure
(e) Reduce investment in working capital
(f) Increase time period of competitive advantage
(g) Reduce cost of capital

The first five drivers can be used to prepare cash flow forecasts for a suitable period. The length of this period should be defined according to the likely period of a company's competitive advantage (driver (f)). Discounting these cash flows at the cost of capital (Driver (g)) leads to the value of the business' operations.

Identifying the value drivers in a company is also important when deciding what performance measures are the most meaningful to measure. One way to ensure that a company uses meaningful performance metrics is to link those metrics to value drivers. For example, a metric of 'new product sales' could be useful to measure how well a company is achieving sales growth.

In this respect, the drivers should not all be treated equally. Different drivers will be more important than others in different business. For example, for a hotel business, with a high fixed cost base, the most important driver is sales, meaning that occupancy rates are a key performance measure for hotels. By contrast, for a bank lending to corporate customers, profits are driven by the margin between the rate at which the bank borrows and that at which it lends. That margin is usually slim, so for the bank, more value will be created by improving interest margins and reducing operating costs than by increasing the volume of business.

(We will look at performance measures and performance management in more detail in Chapter 4.)

Value creation does not occur and costs do not arise evenly across an organisation, so managers should have a firm grasp of the key cost and value drivers affecting their operations. Some of these may be located outside the organisation, elsewhere in the value network, so the ability to influence suppliers and distributors may be crucial to success.

More generally, the choice of **generic strategy** interacts with cost and value: strict control of cost is obviously fundamental to cost leadership, while differentiation will inevitably have cost implications associated with such matters as brand communications, product quality and customer service.

Moreover, the structure of costs and value creation is likely to **change over time** as, for example, illustrated by the cost and profit aspects of the **product life cycle**.

2.3.6 Financial management decisions

In seeking to achieve the financial objectives of an organisation, a finance manager has to make decisions on three inter-related topics:

(a) Investment
(b) Financing
(c) Dividends

Investment decisions

The financial manager will need to **identify** investment opportunities, **evaluate** them and decide on the **optimum allocation of scarce funds** available between investments.

Investment decisions may be focused on the undertaking of new **projects** within the existing business, the **takeover** of, or **merger** with, another company or the **selling off** of a part of the business.

Managers have to take decisions in the light of strategic considerations such as whether the business intends to **expand internally** (through investment in existing operations) or **externally** (through expansion).

Financing decisions

Financing decisions include those concerned with both the long term (**capital structure**) and the short term (**working capital management**).

The financial manager will need to determine the **source, cost** and effect on **risk** of the possible sources of long-term finance. A balance between **profitability** and **liquidity** (the ready availability of funds if required) must be taken into account when deciding on the optimal level of short-term finance.

Interaction of financing with investment and dividend decisions

When taking financial decisions, managers will have to fulfil the **requirements of the providers of finance**, otherwise finance may not be made available. This may be particularly difficult in the case of equity shareholders, since dividends are paid at the company's discretion. However, if equity shareholders do not receive the dividends they want, they are likely to sell their shares, in which case the share price will fall and the company will have more difficulty raising funds from share issues in future.

Although there may be risks in obtaining extra finance, the long-term risks to the business of **failing to invest** may be even greater and managers will have to balance these risks. Investment may have direct consequences for decisions involving the **management of finance**; extra working capital may be required if investments are made and sales expand as a consequence. Managers must be sensitive to this and ensure that a balance is maintained between receivables and inventory, and cash.

A further issue managers will need to consider is the **matching** of the **characteristics** of investment and finance. **Time** is a critical aspect; an investment which earns returns in the long-term should be matched with finance that requires repayment in the long-term.

Another aspect is the **financing of international investments**. A company which expects to receive a substantial amount of income in a foreign currency will be concerned that this currency may weaken. It can hedge against this possibility by borrowing in the foreign currency and using the foreign receipts to repay the loan. It may though be better to obtain finance on the international markets.

Dividend decisions

Dividend decisions may affect the view that shareholders have of the long-term prospects of the company, and thus the **market value of the shares**.

Interaction of dividend with investment and financing decisions

The amount of surplus cash paid out as **dividends** will have a direct impact on **finance** available for **investment**. Managers have a difficult decision here: how much do they pay out to shareholders each year to keep them happy, and what level of funds do they retain in the business to invest in projects that will yield long-term income? In addition, funds available from retained profits may be needed if debt finance is likely to be unavailable, or if taking on more debt would expose the company to undesirable risks.

2.4 Shareholder value and value based management

In our discussion of value drivers in Section 2.3.5, we noted that a company's overall aim is to create value for its shareholders.

Shareholders want managers to maximise the value of their investment in a company. Accordingly, the performance measure systems used in the company need to assess how well managers are carrying out this duty.

Many of the performance measures used to assess performance are based on information from a company's published financial statements. However, these could give conflicting messages, or provide misleading information about the company's underlying performance. For example, the figure for earnings per share could be reduced by capital-building investments in research and development and in marketing.

What is more, the financial statements themselves do not provide a clear picture of whether or not **shareholder value is being created.** The statement of comprehensive income, for example, reports the **quantity** but not the **quality** of earnings, and it does not distinguish between earnings derived from operating assets compared to earnings derived from non-operating assets. Moreover, it ignores the cost of equity financing, and only takes into account the costs of debt financing, thereby penalising organisations which choose a mix of debt and equity finance.

The statement of cash flows (cashflow statement) may also fail to provide appropriate information; as large, positive cashflows are possible when organisations underspend on maintenance, or undertake little capital investment in order to increase short-term profits at the expense of long-term success. On the other hand, an organisation can have large negative cashflows for several years and still be profitable.

A shareholder value approach to performance measurement involves a shift in focus away from short-term profits to a longer-term view of value creation; the motivation being that this will help the business stay ahead in an increasingly competitive world.

Individual shareholders have different definitions of shareholder value as different shareholders value different aspects of performance:

- Financial returns in the short-term
- Short-term capital gains
- Long-term returns or capital gains
- Stability and security
- Achievements in products produced or services provided
- Ethical standards

(It is unlikely that the last two alone make a company valuable to an investor.)

These factors, and others, will all be reflected in a company's share price, but stock markets are notoriously fickle and tend to have a short-term outlook.

Perhaps more important though, Johnson, Scholes & Whittington suggest that applying shareholder value analysis requires a whole new approach to performance management: **value based management** (VBM).

Central to VBM is the identification of the cash generators of the business, or **value drivers**, resembling Rappaport's idea of value drivers. These drivers will be both external and internal. For example, competitive rivalry is a major external value driver because of its direct impact on margins.

2.5 Value based management

Definition

Value based management: A management process which links strategy, management and operational processes with the aim of creating shareholder value.

Value based management (VBM) consists of three elements:

(a) **Strategy for value creation** – ways to increase or generate the maximum future value for an organisation

(b) **Metrics** – for measuring value

(c) **Management** – managing for value, encompassing governance, remuneration, organisation structure, culture and stakeholder relationships

Importantly, VBM starts from the premise that the value of a company is measured by its **discounted future cash flows** (not profits). Value is created only when companies invest capital at returns which exceed the cost of that capital.

Consequently, VBM seeks to use the idea of value creation to align strategic, operational and management processes to focus management decision-making on what activities create value for the shareholders.

However, VBM focuses on a company's ability to generate future cash flows, rather than looking at the profits the company has earned or will earn in the short term future. Proponents of VBM argue that profit has become discredited as a performance measure.

Value based management highlights that management decisions which are designed to lead to higher profits do not necessarily create value for shareholders. Often, companies are under pressure to meet short term profit targets, and managers are prepared to sacrifice long term value in order to achieve these short term targets. For example, management might avoid initiating a project with a positive net present value if that project leads to their organisation falling short of expected profit targets in the current period.

Consequently, value based management argues that profit-based performance measures may obscure the true state of a business. By contrast, VBM seeks to ensure that analytical techniques and management processes are all aligned to help an organisation maximise its value. VBM does this by focusing management decision-making on the key **drivers of value**, and making management more accountable for growing an organisation's intrinsic value.

Therefore, whereas profit-based performance measures look at what has happened in the past, VBM seeks to maximise returns on new investments. What matters to the shareholders of a company is that they earn an acceptable return on their capital. As well as being interested in how a company has performed in the past, they are also interested in how it is likely to perform in the future.

2.5.1 Creating shareholder value

Although it is easy to identify the logic that companies ought to be managed for shareholder value, it is much harder to specify *how* this can be achieved. For example, a strategy to increase market share may not actually increase shareholder value.

Good quality information is essential in a VBM system, so that management can identify where value is being created – or destroyed – in a business. For example, continuing the previous example, there is no value in increasing market share if the market in question is not profitable.

An organisation will need to identify its value drivers, and then put strategies in place for each of them. When identifying its value drivers, an organisation may also find that its organisational structure needs reorganising, to ensure its structure is aligned with the processes which create value.

2.5.2 Measurement

Introducing VBM will require a change in the performance metrics used in a company. Instead of focusing solely on historical returns, companies also need to look at more forward-looking contributions to value: for example, growth and business sustainability. The performance measures used in VBM are often non-financial.

2.5.3 Managing value

In today's companies, the intellectual capital provided by employees plays a key role in generating value. VBM attempts to align the interests of the employees who generate value and the shareholders they create value for. Otherwise VBM could drive a wedge between those who deliver economic performance (employees) and those who harvest its benefits (shareholders). In practice, companies try to improve the alignment between employees and shareholders by using remuneration structures which include some form of share-based payments.

Successfully implementing VBM will also involve cultural change in an organisation. The employees in the organisation will need to commit to creating shareholder value. Value is created throughout the company as a whole, not just by senior management, so all employees need to appreciate how their roles add value.

Nonetheless, visible leadership and strong commitment from senior management will be essential for a shift to VBM to be successful.

However, as with any change programme, implementing VBM could be expensive and potentially disruptive, particularly if extensive restructuring is required.

2.5.4 Elements of VBM

A comprehensive VBM programme should consider the following:

- **Strategic planning** – strategies should be evaluated to establish whether they will maximise shareholder value
- **Capital allocation** – funds should be allocated to the strategies and divisions that will create most shareholder value
- **Operating budgets** – budgets should reflect the strategies the organisation is using to create value
- **Performance measurement** – the economic performance of the organisation needs to lead to increases in share prices, because these promote the creation of shareholder wealth
- **Management remuneration** – rewards should be linked to the value drivers, and how well value-based targets are achieved
- **Internal communication** – the background to the programme and how VBM will benefit the business need to be explained to staff
- **External communication** – management decisions, and how they are designed to achieve value, must be communicated to the market. The market's reaction to these decisions will help determine movements in the organisation's share price.

Adopting a value based approach to management is likely to have wide-ranging implications for a company.

Culture: shareholder value must be accepted as the organisation's purpose. This may have greatest impact at the **strategic apex**, where directors may have had different ideas on this subject. However, the importance of creating shareholder value must be emphasised in all parts of the business.

Nevertheless, it is crucial that management do not overlook underlying business processes in the quest for value based metrics. Core business processes (for example, quality management, innovation, and customer service) should still be monitored alongside value based metrics.

Relations with the market: shareholder value should be reflected in share price. The company's senior managers must **communicate effectively with the market** so that their value-creating policies are incorporated into the share price. However, they must not be tempted to manipulate the market. This may be a difficult area to manage as executive rewards should reflect the share price. One way in which management can communicate performance to the market is through key performance indicators. These metrics should then, in turn, form the basis of the performance targets for divisional managers to achieve.

Strategic choices: the maximisation of shareholder value must be the objective underlying all strategic choices. This will affect such matters as **resource allocation** and HR policies, and will have particular relevance to the evaluation of expensive projects such as **acquisitions** and **major new product development**.

2.5.5 Business strategy and shareholder value

The following diagram summarises how strategy drives a business towards increased shareholder value, which is the primary strategic objective for most businesses.

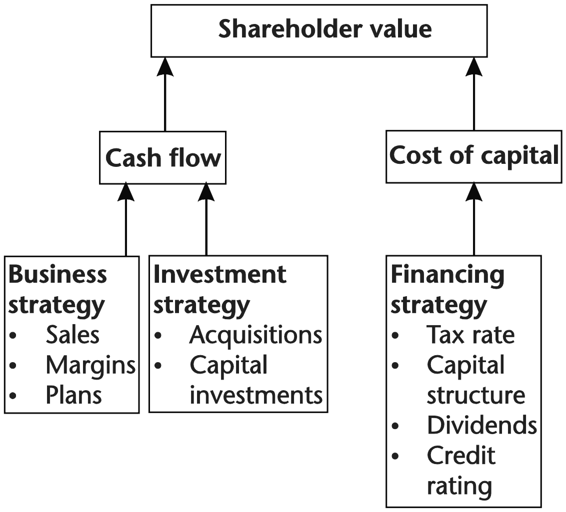


Figure 1.2: Strategy and shareholder value

2.6 Stakeholders and objectives

Although we have spent the previous sections highlighting the importance of creating value for shareholders, and although shareholders are likely to be an important stakeholder group for most organisations, there are also a number of stakeholders whose interests need to be considered when a company plans its strategy and sets its objectives.

Definition

Stakeholders: Groups or persons with an interest in the strategy of an organisation, and what the organisation does.

2.6.1 Stakeholder interests

Organisations have a variety of stakeholders, each of which is likely to have its own interests. When determining its strategy, an organisation needs to consider how well that strategy fits in with the interests of different stakeholders. The organisation should also consider how stakeholders could respond to strategies which do not uphold their interests:

Internal stakeholders	Interests to defend	Response risk
Managers and employees	• Jobs/careers • Money • Promotion • Benefits • Satisfaction	• Pursuit of 'systems goals' rather than shareholder interests • Industrial action • Negative power to impede implementation • Refusal to relocate • Resignation

Connected stakeholders	Interests to defend	Response risk
Shareholders (corporate strategy)	• Increase in shareholder wealth, measured by profitability, P/E ratios, market capitalisation, dividends and yield • Risk	• Sell shares (eg to predator) or boot out management
Bankers (cash flows)	• Security of loan • Adherence to loan agreements	• Denial of credit • Higher interest charges • Receivership
Suppliers (purchase strategy)	• Profitable sales • Payment for goods • Long-term relationship	• Refusal of credit • Court action • End relationship/reduce supplies
Customers (product / market strategy)	• Goods as promised • Future benefits	• Buy elsewhere • Damage reputation (eg bad publicity) • Legal action

External stakeholders	Interests to defend	Response risk
Government and regulatory agencies	• Jobs, training, tax • Investment and infrastructure • Aggregate demand • National competitiveness; protect emerging industries	• Tax increases • Regulation • Legal action • Tariffs
Interest/pressure groups	• Pollution • Social responsibility	• Publicity • Direct action • Pressure on government
Industry associations and trade unions	• Member rights	• Legal action • Direct action
Non-governmental organisations	• Human rights	• Legal action

When considering stakeholders, organisations need to be aware of two important differences in stakeholder focus:

Economic or social focus

Some stakeholders' interests are primarily economic (for example, shareholders are interested in profitability; employees, about salaries) while other stakeholders will care more about social issues (such as social responsibility or environmental protection).

Local or national focus

Often, the interests of local stakeholder groups may be different from national (or international groups). Think, for example, of the debate about whether to build a third runway at Heathrow Airport. Local residents are concerned about increased noise, pollution and traffic, but at a national level politicians have highlighted the economic benefits of expansion.

2.6.2 Stakeholder management

Conflict is likely between stakeholder groups due to the divergence of their interests. This is further complicated when individuals are members of more than one stakeholder group and when members of the same stakeholder group do not share the same principal interest. For example, if some members of a workforce are also shareholders while others are not, the interests of the two groups may be different.

Different stakeholder groups are likely to have a range of responses to possible business strategies. When an organisation is evaluating a strategy, it should consider what impact that strategy will have on key stakeholder groups.

In this respect, Mendelow's matrix is a useful tool for helping an organisation establish its priorities and manage stakeholder expectations, by looking at the relative levels of interest and power that different stakeholder groups have in relation to the organisation or its strategy.

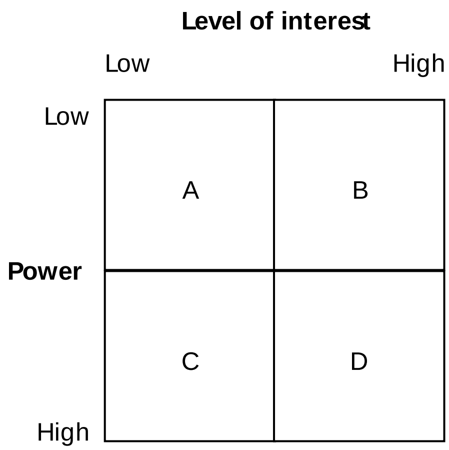


Figure 1.3: Mendelow's matrix

A Stakeholders in this quadrant of Mendelow's matrix have low interest and low power, therefore only **minimal effort** should be given to meeting their needs.

B Stakeholders in this quadrant have important views, but little ability to influence strategy, therefore they should be **kept informed** only.

C An organisation should treat stakeholders in this quadrant with care because while they are often passive, they are capable of moving to segment D. Therefore, it is important to **keep them satisfied**.

D These are **key players** (for example**,** a major customer), so the strategy must be **acceptable** to them at least. Equally, powerful stakeholder groups must have confidence in the management team of an organisation. **Regular communication** with the stakeholder groups can be a good way to help achieve this.

3 The external business environment

Section overview

- Organisations are open systems: they operate within a complex environment, which presents them with opportunities and threats.
- This 'environment' can be analysed at different levels: the macro environment (PESTEL factors); the industry environment (Porter's five forces); and competitors or markets.
- Understanding the nature of the business environment and any changes taking places within it is, therefore, an important part of strategic planning.

3.1 The external environment

The business environment includes the wider political, economic, social, technological, environmental (green) and legal context in which an organisation operates, as well as the more immediate pressures of the business competition it faces. The business environment is both **complex** and subject to constant **change**, to the extent that it is unlikely that a business can ever have a complete understanding of its environment.

However, by analysing the key environmental variables that might affect it, an organisation can identify the **opportunities** which are available to it and the **threats** that it is facing.

3.1.1 Environmental analysis

The following table illustrating **environmental analysis** comes from Lynch's text, *Strategic Management*. It sets out the various **stages** in environmental analysis and the **techniques** to be employed. The sequence of the model fits with the sequence of the rational model of strategic business management.

Stage	Techniques
1. Explore basic characteristics of the environment.	• Market definition and size • Market growth • Market share
2. Consideration of the degree of turbulence in the environment.	General considerations: • Change: fast or slow? • Repetitive or surprising future • Predictability (rate of change; visibility of change) • Complex or simple influences on the organisation?
3. Factors affecting many organisations.	PESTEL analysis and scenario planning.
4. Analysis of market growth.	Industry life cycle.
5. Factors specific to the industry; what delivers success?	Analyse key factors for success (critical success factors).
6. Factors specific to the competitive balance of power in the industry.	Porter's five forces analysis.
7. Factors specific to co-operation in the industry.	Analysis of network relationships and co-operation (referred to as 'Four Links' analysis): • Government links and networks • Informal co-operative links and networks • Formal co-operative links (eg joint ventures) • Complementors (eg computer hardware needs software to go with it to provide value for customers)
8. Factors specific to immediate competitors.	Competitor analysis and product portfolio analysis.
9. Customer analysis.	Market and segmentation studies. (See Chapter 5.)

3.2 Environmental and market analysis tools

3.2.1 PESTEL analysis

The PESTEL framework is used to analyse the macro-environment into the following segments:

- **P**olitical
- **E**conomic
- **S**ocio-cultural
- **T**echnological
- **E**nvironmental protection
- **L**egal

This analysis is a useful checklist for general environmental factors, although in the real world they are obviously all interlinked. Any single environmental development can have implications for all six PESTEL segments. In particular, political, social and economic affairs tend to be closely intertwined. Given that case studies at this level are likely to be quite involved, you should not waste time trying to impose unnecessary divisions on any environmental analysis – the important thing is *substance:* what impact could the opportunities or threats presented by the external environment have on an organisation?

Interactive question 2: Opportunities and threats **[Difficulty level: Intermediate]**

STF Company provides domestic transport services by air and sea between a country's mainland and a group of islands about 50 kilometres offshore. The company operates two ships: one of these transports freight only, and the other transports passengers and freight. This ship has a capacity of up to 250 passengers. The islands are a popular holiday destination, and the passenger service is well-used, particularly by tourists in the holiday season. STF is the only provider of sea transport to the islands for passengers, although wealthy tourists visit in their private boats.

Each ship normally makes a return trip between the mainland and the islands each day. The only exceptions are in the off-peak season when the ships are sometimes taken out of service for repairs and re-fitting and also during bad weather when the seas are rough and it is considered unsafe to sail.

STF also operates a number of aircraft between the mainland and the islands. Unlike its sea service, its air service is not a monopoly and other airlines operate a competing service.

The main industries on the islands are tourism and agriculture. The main agricultural business is the cultivation of fruit, which is sold to retailers and exporters on the mainland. Most of this produce is transported from the islands to the mainland in STF's ships.

Most islanders are employed in businesses linked to the tourist industry, such as hotel accommodation, catering, retail services and boat hire. However the tourist season currently lasts for only seven months in each year. Even so it has been rumoured that a global company in the tourism business is considering whether to establish operations in the islands, and would probably introduce flights direct from other countries to the main airport on the islands.

STF has a good reputation for reliability, safety and passenger care. However, it has been increasing the prices of travel by ship for passengers, although the cost of air travel to and from the islands remains higher.

The increase in prices was prompted by narrowing profit margins in the sea services (freight and passenger).

Business customers have so far successfully resisted an increase in freight charges. The fruit business on the islands is continuing to grow at a fast rate and it is expected that soon, at some times of the year, one boat will be insufficient to transport all the fruit production from the islands to the mainland.

The company has mooring rights on the mainland and the islands for its ships. These are negotiated with the local government authorities for a period of five years, and these rights are due for re-negotiation next year.

In the past year, two hotel complexes have been opened on two of the islands, increasing the amount of tourists to the islands. The additional passenger traffic has been accommodated by STF's ships and by an increase in air services, but the new hotel complexes apparently have plans for further expansion. Another developer has just been granted permission by the government to build a large new holiday complex on one of the uninhabited islands.

The new complex will accommodate up to 500 customers constantly throughout the year, and the average stay is expected to be for between one and two weeks. This complex will include sailing and sports facilities and also two golf courses. Most of the staff needed to operate the complex will be recruited from the mainland and the islands, and about 400 jobs will be created. This island will not be served by its own airport, and people visiting the island will have to go by sea, either directly from the mainland or from the main island.

The developers of the complex have announced that they are considering the negotiation of a ten-year agreement with a transport company for the exclusive rights to transport their customers from the mainland to the island complex.

STF has been very profitable, but the owners have been taking out most of the profits as dividends each year, and the company has only limited capital.

Requirement

Assess the opportunities and threats in STF's external environment, and evaluate its ability to respond to them.

See **Answer** at the end of this chapter.

3.2.2 Porter's five forces

The competitive environment is structured by five forces:

- Threat of new entrants
- Threat of substitute products or services
- Bargaining power of customers
- Bargaining power of suppliers
- Rivalry amongst existing competitors in the industry

These forces influence the state of competition in an industry, which collectively determines the profit potential of the industry as a whole.

Porter argues that the **stronger each of the five competitive forces** is, the **lower the profitability of an industry**. For example, if there are a number of competitors of a similar size in an industry, but the industry is in the mature stage of its life cycle and the rate of market growth is low, there is likely to be high rivalry between the competitors. One firm can only grow by obtaining market share at the expense of its competitors, so firms will be keen to ensure that the price of their products and the quality or features of their products matches that of their competitors. However, the intensity of competition between the firms in this industry is likely to mean that profitability levels are lower than in an industry dominated by a monopoly producer and therefore, in which there is no significant competitive rivalry.

A major factor in the shakeouts that occurred in many industries during and after the financial crisis of 2008/9 was an excessive number of existing competitors in industries. Easy access to capital and buoyant levels of consumer demand had lowered barriers to entry and attracted competitors into industries during the boom years, and they were initially able to succeed even with products exhibiting low levels of differentiation. However, once consumer demand fell, they were not able to sustain their positions.

Note the following caution about using the five forces model though – its very comprehensiveness can encourage users to feel that all factors have been duly considered and dealt with. Unfortunately, this is never the case. Any analysis must pursue as high a degree of objectivity as possible. If there is too much subjectivity, unfounded complacency will result.

Case example: Telecommunications in Zambia

The telecommunications market in Zambia is dominated by mobile network operator Bharti Airtel (formerly Zain) which has a market share of around 65%. However, the fastest growth in subscribers is currently being seen by the second-placed network, MTN (formerly Telecel) from South Africa. It has a market share of around 26%.

The third competitor in the mobile market is Cell Z, which has a market share of around 7%. Cell Z is the mobile division of the national telecommunications provider Zamtel (Zambia Telecommunications Ltd).

However, the government has now cleared the way for a fourth mobile service provider, and by early 2013 bids had been received from five telecom operators, including Vodacom of South Africa.

The entry of a fourth provider would increase competition in the sector, generate sustainable improvements in the quality of services, reduce tariffs and extend service outreach to more areas.

Against this background of growth, Zamtel has been performing poorly in the mobile telecommunications market as well as the fixed-line sector, despite having monopoly rights over the fixed-line sector, including the international gateway. Zamtel's monopoly over the international gateway has limited growth in the internet and broadband sector, with Zambia facing some of the highest prices for international bandwidth on the African continent.

The government has now signalled it is going to end Zamtel's monopoly on the international gateway and restrictions on VoIP internet telephony, and this will make international calls and borderless international roaming much more attractive.

The government also established (through the Information and Communication Technologies (ICT) Act No.15 of 2009) a new licensing regime that will enable more competition in all market sectors, from existing and new players. With penetration rates in all sectors still below regional averages, the growth prospects for telecoms companies in Zambia are excellent.

In mid-2010 a majority stake in Zamtel was sold to LAP Green of Libya (although this sale was subsequently challenged, and Zamtel reverted to be a state-owned company). One of Zamtel's key assets is a national fibre network which includes connections to neighbouring countries and which will provide transit links to international submarine fibre optic cables off the African east and west coasts. However, alternative domestic fibre is already being rolled out by three other companies, and one of them has recently completed the country's first ever connection to an international submarine fibre optic cable. Alternative international fibre links went live in 2010 and 2011, reducing the dependency on a single provider. This will, first and foremost, benefit the broadband sector with cheaper international bandwidth. Zamtel's expensive ADSL service is still dominating this sector, albeit at a very low level. Competition exists from several ISPs that have rolled out WiMAX wireless broadband networks.

Mobile data services using GPRS and EDGE are available but have remained expensive under the current conditions. Third generation (3G) mobile broadband services were launched in Zambia in early 2011.

Five Forces

As you read the case study, try to think about what the key forces are that might influence the profitability of the mobile telecommunications industry in Zambia – for example regulatory environment and structural reform; infrastructure development; competitive rivalry between key players; development of new technologies; pricing trends – and think about how these could affect the profitability of the industry.

Threat of New Entrants – Two main barriers to entry in to the telecoms industry can be distinguished.

Firstly, in order to assume the high fixed costs characteristic of this capital intensive industry, potential new entrants must have a high level of cash in hand. The availability of funds, or the ability to raise funds through capital markets can therefore exert a direct influence on the industry players.

Secondly, regulatory approval and licensing can be seen as a massive barrier to entry. However, the liberalisation of the markets opens up the opportunity for new entrants to join the market.

Suppliers' Power – Key suppliers will be the telecommunication equipment makers (for example, suppliers of fibre optic cables or handset manufacturers). Their bargaining power is likely to be determined by how many alternative suppliers exist for each type of equipment. If there are a number of competing suppliers, this will reduce their bargaining power over the telecoms companies. However, because the manufacturing and delivering of some of these products requires a high degree of knowledge and expertise, this could sometimes increase the suppliers' bargaining power.

Customers' Power – Market liberalisation is likely to increase competition and broaden consumers' choice of supplier. This increased choice is also likely, in turn, to boost technology advances and enhance services, but it will also drive prices down. Therefore liberalisation will increase customers' power in the telecommunications industry. Nevertheless, high switching costs on certain market segments, such as business segments, can reduce buyers' power.

Threat of Substitutes – The threat of multiple products and services from non-traditional telecoms industries has raised serious challenges to telecommunications players. For example, the internet (delivered by Internet Service Providers) has, over the past few years, proved to be an efficient tool for marketing cut rate voice calls, to the detriment of the more traditional phone business (delivered by telecoms companies).

Business Rivalry – Market liberalisation (industry deregulation), breakthrough innovations and new technologies, together with attractive economic indicators (eg growth rates) can contribute to the creation of intense rivalry between players in the industry.

3.2.3 Competitor analysis

As the name suggests, competitor analysis is an assessment of the strengths and weaknesses of current and potential competitors. This is an important strategic tool – it helps management to understand their competitive advantages or disadvantages relative to competitors and provides an informed basis upon which to develop strategies that create or strengthen future competitive advantage.

The main challenge with competitor analysis is determining how to obtain critical information that is reliable, up-to-date and available legally!

Key questions for competitor analysis

One of the first questions that an organisation needs to ask is: Who are the competitors?

Once it has established this, an organisation then has to determine:

What drives the competitor?

- What are its goals or strategic objectives (eg maintaining profitability, building market share, or entering new markets)?
- What assumptions does it hold about itself and the industry (eg trends in the market, products and consumers)?

What is the competitor doing and what can it do?

- What strategies is the competitor currently pursuing?
- What are the competitor's strengths and weaknesses? What key resources and capabilities does the competitor have (or not have)?

Competitor response profiles

Once an organisation has analysed its competitors' future goals, assumptions, current strategies and capabilities, it can begin to ask the crucial questions about how a competitor is likely to respond to any competitive strategy that the organisation might pursue. Trying to assess what the competitors' responses are likely to be is a major consideration in making any strategic or tactical decision.

We will look at competitor response profiles in more detail in relation to marketing strategy in Chapter 5.

Interactive question 3: Competitor analysis [Difficulty level: Intermediate]

LBG is a manufacturer of specialist stage cosmetics that are specifically targeted at the theatre and film industries. Recent developments in the quality of the chemicals used in these products have enabled LBG to expand its product range and to price the products at a premium level.

However, LBG is concerned about the rapid growth of this specialist industry. New competitors have been attracted by the premium prices charged by existing players to the extent that over capacity is an increasing threat.

LBG is keen to protect its market leader status, and its current market share of approximately 40%, despite evidence that the market is maturing. LBG feels it should know more about its competitors, both new and existing in order to maintain its industry status.

Requirements

(a) In what ways would LBG benefit from conducting a formal competitor analysis?

(b) What are the main stages in conducting a formal competitor analysis and what important information should be obtained by LBG at each stage of the analysis?

See **Answer** at the end of this chapter.

4 Internal factors and strategic capability

Section overview

- Although it is important that organisations identify opportunities in the external environment and develop an appropriate strategic position to take advantage of them, an organisation's ability to compete effectively is also determined by its own internal resources and competences. In this section, we will focus on the internal factors that can shape an organisation's strategic success.

4.1 Resource-based approaches to strategy

In the previous section, we looked at the way the external environment influences strategies, through the opportunities and threats which it presents to organisations.

Once an organisation has analysed its external environment, it can then establish an appropriate strategy to achieve a good strategic fit with that environment. This is the essence of the **position-based approach** to strategy: organisations seek to develop competitive advantage in a way that responds to the nature of the competitive environment, and position their strategy in response to the opportunities or threats they discern in the environment.

However, an organisation's internal competences and capabilities also affect its ability to deliver value to customers and achieve competitive advantage in an industry. **Resource-based approaches** to strategy focus on these internal characteristics of an organisation.

In resource-based approaches, rather than being developed in response to the external competitive environment, strategy is developed by looking at what makes a firm unique, and using an understanding of these unique competences to determine what to produce and what markets to produce for. The resource-based view is based on the idea that sustainable competitive advantage can only be attained as a result of possessing **distinctive resources** (either tangible or intangible).

The resource-based approach also suggests that strategic advantage begins with a few key elements that the organisation must concentrate on – its **core competences**, those things that it does better than its rivals.

4.2 Resources and competences

Different authors define the concepts of resources, competences and capabilities differently, so we are not going to provide definitions of them here, and you will not face an exam question specifically asking you to define them at this level either.

However, what is important is to recognise: (i) the relationship between resources and competences; and (ii) the distinction between **threshold** resources or competences and **unique** resources and **core** competences.

Resources are the assets of the organisation; while **competences** are the activities and processes through which an organisation deploys its resources effectively.

An important point to note here is that **resources are not productive on their own**. Therefore organisational capability – an organisation's capacity to successfully deploy its resources to achieve a desired end result – is vital as a basis for achieving competitive advantage. These organisational capabilities could be in a range of different areas:

- Corporate functions (financial control; multi-national co-ordination)
- Research and development, or innovative and adaptive capability
- Product design
- Operations (operational efficiency; continuous improvement; flexibility)
- Marketing
- People and talent management
- Sales and distribution

Johnson, Scholes and Whittington highlight this point in their text *Exploring Strategy* when they note:

> *There would be no point in having state-of-the-art equipment if it were not used effectively. The efficiency and effectiveness of physical or financial resources, or the people in an organisation, depend, not just on*

their existence, but on the systems and processes by which they are managed, the relationships and co-operation between people, their adaptability, their innovatory capacity, the relationship with customers and suppliers, and the experience and learning about what works well and what does not.

Threshold resources and threshold competences are needed to meet customers' minimum requirements and are therefore necessary for the organisation to continue to exist.

Unique resources and **core** competences underpin competitive advantage and are difficult for competitors to imitate or obtain.

The key point to note here is that an organisation needs threshold resources or competences as a pre-requisite in order to operate, but these resources or competences by themselves will not confer any competitive advantage on the organisation.

For example, an airline company needs aircraft and cabin crew in order to operate, but aircraft are not a source of competitive advantage. By contrast, having the most modern aircraft, and having cabin crew who offer the highest quality service to passengers could be a source of competitive advantage (although it may not be a source of sustainable competitive advantage. For example, competitors could also buy new aircraft, and improve the quality of customer service provided by the cabin crew).

Case example: Huawei smartphones

Sales of smartphones are booming, although not all phone makers are sharing this success.

In the three months to July 2012, Nokia made losses of CU1.1 billion as it has battled to remain competitive in a smartphone market dominated by Apple and Samsung, which between them have over 50% of global market share.

Nokia was once the world's leading mobile phone maker, but in the second quarter of 2012 it sold four million Windows phones, which is only a fraction of Apple's expected sales of 30 million iPhones or Samsung's 50 million smartphones.

However, one other big winner has emerged in the smartphone market: Huawei Technologies. Although Huawei were only the seventh largest smartphone maker in 2011, it is thought that they may have surpassed Nokia in the second quarter of 2012 to become the third-largest smartphone maker.

Huawei was founded in 1987, and quickly became a high-tech success story in China by selling telecom products to phone companies, routinely beating rivals such as Alcatel-Lucent Ericsson, and Cisco Systems with good-enough products and great prices. Only in the mid-2000s did it start making mobile phones. However, the Shenzhen-based company's inexpensive, often unbranded models gained market share in China, the Middle East, and Africa.

Huawei kept this low-cost approach as it got serious about smartphones during 2009. It didn't try to build its own software operating system like Apple, or Microsoft; but used Android instead. Furthermore, unlike Samsung, or Motorola, it didn't try to differentiate from Google's mobile software with its own tweaks. It simply installed Android on its hardware and then began to distribute it.

Huawei expected to triple its smartphone sales to 60 million units in 2012, partly as a result of gaining a larger market share of the US. market.

Prior to 2012, Huawei sold handsets costing less than USCU200 to providers such as MetroPCS and Cricket that offer pay-as-you-go plans, mostly to lower-income consumers.

In November 2011, it landed a deal with a top-tier US provider when AT&T started selling Huawei's Impulse phone for CU29. And in July 2012, T-Mobile announced that Huawei would be building two models in the mobile phone operator's MyTouch line of handsets.

'We essentially made the market for affordable smartphones,' says William Plummer, Huawei's US vice president for external affairs. 'We're in a good position because we've established ourselves as a trusted partner to carriers.'

However, succeeding in smartphones is vital for Huawei if it wants to remain a fast-growing company. Its USCU23 billion-a-year telecom equipment business grew only 3.5 percent in 2011, before tumbling due to the slowdown in China's economy this year.

The company re-organised in 2011 to create a separate Huawei Devices unit to drive what executives say is the company's best growth opportunity. The division also makes laptop modems and other functional devices.

Huawei's growth rate may even make it a plausible challenger to Samsung in smartphone sales, according to Horace Dediu of equity research firm, Asymco. Dediu argues that Samsung has prospered largely because of vertical integration: it makes many of the chips and screens that go into its devices. Yet he doubts Samsung has built up enough brand loyalty to withstand a much cheaper alternative, not least because Samsung itself was only the fourth or fifth largest supplier just a few years ago.

So, as smartphones evolve from novelty technology into just another gadget, Huawei will be well positioned to benefit. Although their phones may not be as sophisticated as those of some competitors, they are inexpensive and as one research analyst commented, 'Their devices don't have to have jet packs to do 90 percent of what most people need.'

Based on: Burrows, P (2012). 'The New Smartphone Powerhouse: Huawei', July 19, www.businessweek.com

Latham, C. (2012) 'Nokia loses CU1.1 bn as rivals steal limelight', July 20, www.metro.co.uk.

4.3 Core competences and strategic capabilities

Hamel & Prahalad suggest that an important aspect of strategic management is the determination of the competences the company will require **in the future** in order to be able to provide new benefits to customers. They say a **core competence** must have the following qualities:

- It must make a **disproportionate** contribution to the **value** the customer perceives, or to the efficiency with which that value is delivered
- It must be '**competitively unique**', which means one of three things: actually unique; superior to competitors; or capable of dramatic improvement
- It must be **extendable**, in that it must allow for the development of an array of new products and services

In many cases, a company might choose to combine competences.

Bear in mind that **relying on a competence is no substitute for a strategy**. However, a core competence can form a basis for a strategy. Here it is important to reiterate that a core competence must be **difficult to imitate** if it is to confer lasting competitive advantage. In particular, skills that can be bought in are unlikely to form the basis of core competences, since competitors would be able to buy them in just as easily. Core competences are more about what the organisation is than about what it does. So it is possible to regard a strong brand as a kind of core competence: it is a unique resource that confers a distinct competitive advantage. (We will look at brands in more detail in Chapter 5.)

4.3.1 Strategic capabilities and competitive advantage

Resources and competences are clearly important in creating and sustaining competitive advantage.

However, if an organisation's strategic capabilities are going to deliver competitive advantage for it, then those capabilities must have four qualities:

Valuable to buyers – They must produce effects or benefits that are valuable to buyers.

Rarity – If a resource or competence is available to an organisation's competitors in the same way as it is to the organisation then it does not confer any advantage to the organisation over its rivals.

Robustness – In order for a resource or competence to confer a sustainable benefit to an organisation, it must be difficult for competitors to imitate or acquire.

Non-substitutability – A resource or competence is no longer a source of competitive advantage if the product or service it underpins comes under threat from substitutes.

4.4 Position audit

The position audit is that part of the planning process which examines the current state of the business entity's strategic capability, in relation to:

- Resources of tangible and intangible assets and finance
- Products, brands and markets
- Operating systems, such as production and distribution
- Internal organisation

- Current results
- Returns to shareholders

The elements of the position audit are:

- Resource auditing
- Analysis of limiting factors
- Identification of threshold resources/competences
- Identification of unique resources/core competences

4.5 Resource audit

As the name suggests, resource audits identify the resources available to an organisation. These resources can be categorised as financial, human, intangible or physical. By determining what resources they have, companies can identify what additional resources are required to pursue their chosen strategy.

Competitive resources

Richard Lynch's text, *Strategic Management* provides a checklist which offers a useful framework for analysing whether an organisation's internal 'resources' can be construed as strengths or weaknesses:

Aspect of resources	Questions to ask
Market share	How does the company's market share compare to competitors? Are there any particular areas in which the company dominates or has a strong market share? How does the level and quality of the company's marketing activity compare to competitors'?
Market growth	Is the company involved in growth markets, or is it involved primarily in mature/declining markets?
Product quality	Do the company's products and services offer good value for money for customers? Does the company have a good quality record in relation to the price of its goods or services? How many customer complaints does it receive?
Leadership	How effective is the company leadership? Is it risk taking or risk averse? Is it ethical?
Purpose and objectives	Are the company's purpose and objectives clearly stated? Are the objectives known to the people responsible for delivering them? Is performance against key objectives measured?
Management and workers	Does the company have a good industrial relations record? How does staff turnover compare to competitors'? How does the quality or experience of management resource compare to competitors?
Financial position	Is the company financially sound or are its financial resources stretched? What has been its profit record and earnings per share record over the past few years? Are they any 'difficult' shareholders?
Profit performance	How does the company's profit record compare to competitors? How do products and distribution costs compare to competitors? Could production and distribution costs be reduced?

Aspect of resources	Questions to ask
Investment practice	How much does the company invest in capital investment? How does this compare to the level of competitors' investment?
R&D; Innovation	How important are research and development, and innovation in the industry? How does the company's record in these areas compare to competitors'? Does the company support innovation and knowledge management?

As we have already suggested (in relation to resources and competences) resources are of little or no value to an organisation unless they are organised into systems, and so rather than simply looking at resources in isolation, a resource audit also needs to consider how well or badly resources have been utilised, and whether the organisation's systems are effective and efficient in meeting customer needs profitably.

4.6 Strategic capability

An organisation's ability to survive and prosper, and to deliver future value, depends on its strategic capability. This can be defined as the adequacy and suitability of the resources and competences the organisation has, and which are necessary for its future success.

So, when evaluating an organisation's strategic capability, the following questions are important:

- Does the organisation have a **suitable business model** to deliver future success, based on an understanding of the sources of competitive advantage that contribute to profitability and growth across the value system of the organisation?
- Does it have the **people, processes and resources** it needs to be able to deliver this success?

When considering resources and competences, it is important to remember that companies often need to acquire assets or competences from outside their own controllable resources and competence-building activities.

These 'external' resources can include:

- Integrated supply chains
- Networks of firms
- Longer-term alliances
- Acquisition of, or merger with, another company

Equally, a resource for a firm could include **access** to supplies and/or distribution networks, so resource management is not simply a matter of ownership and control.

4.6.1 Dynamic capabilities

So far, when looking at resources and competences, we have tended to view them as long-term phenomena, since, for example, resources will be more valuable if they can be counted upon to last for a long time, or because it might take an organisation a long time to develop its core competences.

However, if managers focus on internal resources alone, there is a danger they will overlook the importance of the external environment on their strategy. This could be a particular problem during periods of environmental uncertainty and change.

Critics of resource-based approaches to strategy argue that while the resource-based view can help to explain how firms achieve competitive advantage in a static environment, it does not explain how and why firms can achieve and sustain competitive advantage in situations of rapid and unpredictable change.

Therefore, we could suggest that the traditional resource-based view (of resources and competences) needs to be extended to acknowledge that, in order to sustain competitive advantage, firms may need to renew – or upgrade – their competences in line with the changing business environment. This ability to achieve new forms of competitive advantage, by developing and changing competences to meet the needs of rapidly changing environments is known as **dynamic capability.**

In this context, the distinction between resources, competences and capabilities which we identified earlier is important because it enables us to develop a hierarchical order that we can use to analyse a firm's ability to create and sustain a competitive advantage.

Resources form the base of the hierarchy, the 'zero-order' element. They are the foundation of the firm, and need to be in place before a firm can develop any higher capabilities. However, by themselves resources cannot be a source of sustainable competitive advantage.

Competences or capabilities are the 'first-order' and represent the ability to deploy resources to attain a desired goal. In this way, capabilities are likely to result in improved performance. However, this improved performance will be manifest at an operational level – for example through the performance of business processes – rather than at a strategic level.

Core competences or core capabilities are 'second-order', and consist of those resources and capabilities that are strategically important to a firm's competitive advantage at any given point. However, these core capabilities may not necessarily continue to confer a sustainable competitive advantage if (or when) the environment changes. Depending on the nature and extent of the change, capabilities might either become irrelevant or possibly even become 'core rigidities.' (That is, a potential down side of core capabilities is that they inhibit innovation, because managers prefer instead to concentrate on using resources in the current way, rather than combining them in different ways or re-purposing them for new use, such as producing new product lines.)

Therefore 'third-order' dynamic capabilities emphasise a firm's constant pursuit of the renewal, reconfiguration and re-creation of resources, capabilities and core capabilities in order to address the changing environment. This ability to adapt to changes in markets or the environment sooner and more astutely than competitors is at the heart of dynamic capabilities, and is also a source of sustained competitive advantage.

Case example: Glaxo SmithKline

Since the 1950s, a key resource for large pharmaceutical companies has been patented drugs with regulatory approval. This resource has been continually refreshed through research and development (R&D) activity which has involved testing large numbers of prototype drugs for their effectiveness in treating different illnesses.

Pharmaceutical companies built up dynamic learning capabilities through establishing and developing teams of specialist researchers, and other groups who were skilled in the extensive phases of testing required to gain regulatory approval for new drugs.

At the end of the 20th century, a series of mergers and acquisitions led to consolidation within the industry, for example with GlaxoWellcome merging with SmithKline (which had previously merged with Beecham) to form GSK in 2000.

However, GSK has also acquired some much smaller firms, many of whom have never sold any products, and who operate with quite different technologies and science bases; for example, biotechnology firms. This is because biotechnology is now seen as the main driver of innovation within the pharma sector, and so the big pharmaceutical companies are consequently seeking closer relations with the highly innovative biotech industry.

For example, GSK's acquisition of Corixa in 2005, despite being partially driven by the financial potential of Corixa's Monophosphoryl Lipid A (MPL) (which was contained in many of GSK's candidate vaccines, including its potential blockbuster Cervarix), also dramatically expanded GSK's already lucrative vaccine platform, providing it with much needed additional expertise in the field.

Similarly, in 2007, GSK bolstered its biopharmaceuticals portfolio with the purchase of the UK-based speciality antibody company, Domantis. The acquisition cost CU230 million, but Domantis has become a key part of GSK's Biopharmaceuticals Centre of Excellence for Drug Discovery (CEDD), and helped catapult GSK into the arena of next-generation antibody drugs by more than doubling the number of projects it has in this area.

More recently, GSK has also divested (or outsourced) activities traditionally performed in-house. Pharmaceutical giants have not been immune to the global economic downturn, and they have been forced to adopt cost-saving strategies like organisations across other industries. However, GSK has looked towards more sophisticated approaches beyond simply cutting jobs and shelving expensive projects.

GSK has assigned a group of its scientists and patents to a standalone company dealing specifically with pain relief. 14 of GSK's leading researchers, along with the rights to a number of patents for experimental analgesic medicines, have been moved into a start-up company formed in October 2010: Convergence Pharmaceuticals.

This arrangement has been specifically engineered to reduce the overhead costs involved with research and development, while simultaneously allowing GSK to benefit from any breakthroughs that Convergence might develop and go on to market.

So, Glaxo's original learning processes of R&D have subsequently been augmented by three different phases of reconfiguring its capabilities. The first phase (of mega-mergers) involved similar firms combining; the second phase consisted of the acquisition of innovative biotech companies; and the third, most recent, phase consisted of restructuring and outsourcing activities.

This sequence of phases is evidence of GSK's regenerative dynamic capabilities, triggered by performance problems caused by the declining value of its current resource base as the patents on existing products expired. GSK's existing R&D capabilities were insufficient in themselves to maintain, or expand, the stock of resources. The move into biotechnology acquisitions was triggered by the realisation that the pipeline of new drugs was drying up, as well as the fact that pharmaceutical companies are now operating in an increasingly challenging environment, with high competitive rivalry, price sensitivity among health care providers, and stricter ethical standards.

5 Analysing strategic position and performance

Section overview

- So far in this chapter we have highlighted the importance of analysing an organisation's external environment, and its internal capabilities.
- Tools such as product life cycle, the product/service portfolio (BCG matrix) and the value chain can also help evaluate an organisation's internal position.
- However, the two elements (external and internal) need to be drawn together in order to formulate potential strategies for an organisation. This can be done by combining the internal elements (strengths and weaknesses) with the external elements (opportunities and threats) into a SWOT analysis.

5.1 Product life cycle

The product life cycle concept holds that products have a life cycle and that a product demonstrates different characteristics of profit and investment at each stage in its life cycle. The life cycle concept is a model, not a prediction (not all products pass through each stage of the life cycle). It enables a firm to examine its portfolio of goods and services as a whole.

The stages in a product's life cycle are:

- Introduction
- Development and growth
- Maturity
- Decline

During strategic planning, products should be assessed in three ways:

- The stage of the life cycle the product has reached
- The product's remaining life (how much longer will it contribute to profits?)
- How urgent is the need to innovate (to develop new and improved products)?

An analysis of a product's position in its life cycle can also help an organisation determine what type of strategy might be suitable for that product. For example, once they reach maturity, products become more standardised and differences between competing products become less distinct. Consequently, a strategy based on efficiency may be more appropriate than a differentiation strategy for mature products.

We will return to this idea in Chapter 5 when we look at marketing strategy, and how this can be influenced by a product's position within its life cycle.

Case example: Intel and video streaming

Intel, the world's largest computer chip manufacturer, is set to launch a web-based video streaming service in 2013, as it attempts to find new means of making profit in the face of declining PC sales.

Intel has felt the force of a drop in sales as it struggles to compete with the rise of tablets, smartphones and other mobile devices. The company's fourth quarter income for 2012 suffered a year-on-year decline of 27 per cent.

However, Intel believes it can take advantage of a rise in demand for the online streaming of television shows and other video content. The Corporate Vice President of Intel Media, Erik Huggers said, 'We have been working over the past year to set up Intel Media, a new group focused on developing an internet platform.'

'It's not a value play, it's a quality play where we'll create a superior experience for the end user,' said Huggers, who in a previous job helped launch the BBC iPlayer.

But rather than relying solely on online streaming, Intel's plans revolve around a proprietary set-top box that customers will need if they are to use the service. The hardware doesn't yet have a name or a price, but Huggers revealed that Intel employees are already testing it in their own homes.

In what might be regarded with suspicion by potential consumers, the Intel set-top box contains an in-built camera to observe movements and TV viewing habits in order to personalise the way users watch television.

'My kids may watch programming geared toward them, and I'll watch programming geared toward me,' said Huggers. 'If there's a way to distinguish who is watching what, advertisers can then target ads at the proper parties.'

The move into the living room will see Intel competing with the likes of Amazon, Netflix and LoveFilm, which offer video streaming via computers and games consoles. It also marks a move into Apple territory. Apple TV already allows users to watch television shows and films from the comfort of their living room.

Huggers insists that Intel is serious about internet television streaming and plans to be competing in this space over the long haul. 'Rome wasn't built in a day,' he said. 'It'll take time.'

Based on an article by Palmer, D. (2013), Intel to launch set-top box based video streaming service, 13 February, *computing.co.uk*

Interactive question 4: Product life cycle **[Difficulty level: Intermediate]**

3C is a medium-sized pharmaceutical company. In common with other pharmaceutical companies, it has a large number of products in its portfolio, though most of these are still being developed.

The success rate of new drugs is very low, as most fail to complete clinical trials or are believed to be uneconomic to launch. However, the rewards to be gained from a successful new drug are so great that it is only necessary to have a few on the market to be very profitable.

At present, 3C has 240 drugs at various stages of development; with many still being tested or undergoing clinical trials prior to a decision being made as to whether or not to launch the drug. Currently, 3C has only three products that are actually 'on the market':

- Epsilon is a drug used in the treatment of heart disease. It has been available for eight months and has achieved significant success. Sales of this drug are not expected to increase from their current level.
- Alpha is a painkiller. It was launched more than ten years ago, and has become one of the leading drugs in its class. In a few months the patent on this drug will expire, and other manufacturers will be allowed to produce generic copies of it. Alpha is expected to survive a further twelve months after it loses its patent, and will then be withdrawn.
- Beta is used in the hospital treatment of serious infections. It is a very specialised drug, and cannot be obtained from a doctor or pharmacist for use outside the hospital environment. It was launched only three months ago, and has yet to generate a significant sales volume.

Requirement

Using the product life cycle model, briefly analyse 3C's current product portfolio.

See **Answer** at the end of this chapter.

5.2 Boston Consulting Group (BCG) matrix

The Boston Consulting Group developed a matrix that assesses businesses in terms of potential cash generation and cash expenditure requirements. Strategic business units are categorised in terms of market growth rate and relative market share.

The matrix is as follows:

		Relative market share	
		High	**Low**
Market growth	**High**	Stars	Question marks
	Low	Cash cows	Dogs

Figure 1.4: BCG matrix

A company's portfolio should be balanced: with cash cows generating finance to support stars and question marks, and with a minimum of dogs.

One of the main problems with the matrix is that it is built around cash flows when in fact innovative capacity may actually be the critical resource, particularly in such industries as electronics and cars.

The BCG matrix can be paralleled with the product life cycle as products develop from question marks, through to stars and then cash cows as they enter maturity and finally become dogs as the product declines. Such a development is clearly very stylised.

However, as well as analysing where different products or business units fit into their portfolio, companies also have to determine the strategy appropriate for them.

Stars: In the short term, these require capital expenditure in excess of the cash they generate, in order to maintain their market position, and to defend their position against competitors' attack strategies, but they promise high returns in the future. Strategy: **build**.

In due course, stars will become **cash cows**. Cash cows need very little capital expenditure (because opportunities for growth are low) and generate high levels of cash income. However, products which appear to be mature can be re-invigorated, possibly by competitors, who could come to dominate the market. Cash cows can be used to finance the stars or question marks which are in their development stages.

Strategies: **hold**, or **harvest** if weak.

Question marks. Do the products justify considerable capital expenditure in the hope of increasing their market share, or will they be squeezed out of the expanding market by rival products?

Question marks have the potential to become stars if they are successfully developed. However, if their development is not fruitful, they may end up consuming a lot of investment and management time but end up as 'problem adults' rather than stars, as had been intended.

Strategies: **build, harvest or divest**.

Dogs. They may be ex-cash cows that have fallen on hard times. Although they will show only a modest net cash outflow, or even a modest net cash inflow, they are cash traps that tie up funds and provide a poor return on investment. However, they may have a useful role, either to complete a product range or to keep competitors out. There are also many smaller niche businesses in markets that are difficult to consolidate that would count as dogs but which are quite successful.

Strategies: **divest** or **hold**.

The strategies

Build. A build strategy forgoes short term earnings and profits in order to increase market share.

This could either be done through organic growth, or through external growth (acquisition; strategic alliances etc).

Hold. A hold strategy seeks to maintain the current position, defending it from the threat of would-be 'attackers' as and where necessary.

Harvest. A harvesting strategy seeks short-term earnings and profits at the expense of long-term development.

Divest. Disposal of a poorly-performing business unit or product. Divestment stems the flow of cash to a poorly performing area of the business and releases resources for use elsewhere.

Interactive question 5: BCG matrix [Difficulty level: Intermediate]

CPH Ltd is a diversified conglomerate with business units in four different industries. The original CPH business was a construction company, however, and the construction division remains the largest business within the group.

CPH Ltd's total revenue for the last financial year was CU12.9 billion, split across the group's four trading companies as follows:

	CU Bn
Construction	5.4
Engineering	3.5
Transport	2.8
Gaming	1.2

The following market information has also been produced by the management accountants of each of the four trading companies:

	Market growth	*T/O of nearest rival*
Construction	2%	CU3.8Bn
Engineering	4%	CU8.7Bn
Transport	11%	CU4.7Bn
Gaming	13%	CU0.7Bn

Requirement

Evaluate CPH Ltd's business portfolio, using the BCG matrix.

See **Answer** at the end of this chapter.

5.2.1 Shell Directional Policy Matrix

The matrix (developed by Shell in the 1970s) resembles the BCG matrix, but measures the attractiveness of the market (based on its potential profitability) and a company's strength to pursue it (based on the company's competitive capabilities).

Recommendations based on the position of these two elements are shown below:

		Business strengths	
		High	**Low**
Market attractiveness	**High**	Invest	Grow
	Low	Harvest	Divest

Figure 1.5: Shell Directional Policy Matrix

5.3 Value chain analysis

Michael Porter (who developed the value chain) argues that competitive advantage arises from the way an organisation uses its inputs and transforms them, through value activities, into outputs that customers are willing to pay for.

The value chain describes those activities of the organisation that add value to purchased inputs. Primary activities are involved in the production of goods and services; support activities provide necessary assistance to support the primary activities; and linkages are the relationships between activities.

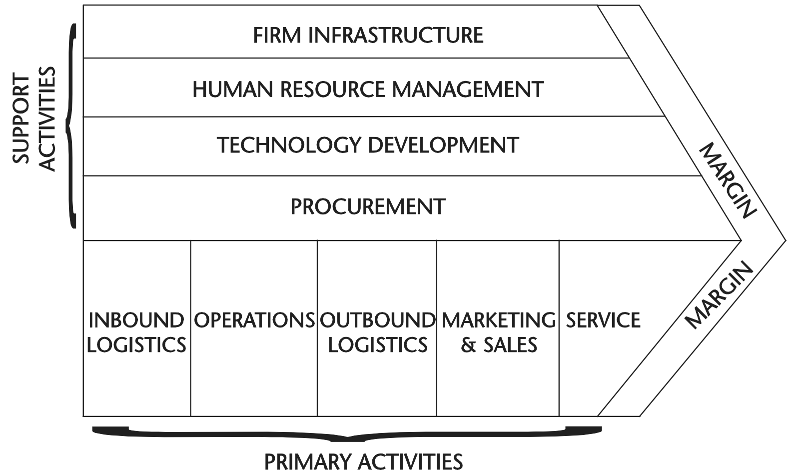


Figure 1.6: Porter's Value Chain

As well as using the value chain to establish where it creates value for the customer, an organisation can also use the model in other strategically beneficial ways, including the identification of critical success factors and opportunities to use information strategically. For example, an organisation can use the value chain to contribute towards competitive advantage by:

- Inventing new or better ways to perform activities.
- Combining activities in new or better ways.
- Managing the linkages in its own value chain to increase efficiency and reduce cost. (For example, could some activities be outsourced, or could cost-savings be made by changing the way activities are structured through combining fragmented purchasing activities into a central procurement system for instance?).
- Managing the linkages in the value system.

The idea of linkages in the value system raises the issue of supply chain management, which we will look at in more detail later in this Study Manual.

The value chain helps managers identify those activities which create value for a firm's customers. As a result, value chain analysis can also help managers to identify the key processes and areas in which a firm has to perform successfully in order to secure a competitive advantage.

These key areas are the firm's critical success factors (CSFs). Therefore, it is important to note the potential link between this area of the syllabus and CSFs, targets and key performance indicators as elements of performance management (which we will look at in Chapter 4 of this Study Manual).

Interactive question 6: Value chain **[Difficulty level: Intermediate]**

A private college, ABC Ltd, provides training for professional accountancy qualifications. It generates the majority of its funds from employers and self-financing students. For most qualifications there are a number of stages that students need to go through before attaining full accreditation; this can take up to four years.

In recent years, the college has placed emphasis on recruiting lecturers, who have achieved success by delivering good academic knowledge of the syllabuses in class. As a result, ABC Ltd's students have had good pass rates. This has led to the college further improving its reputation within the academic community, and applications from prospective students for its courses have increased significantly.

The college has good student support facilities, including online learning support, student helpdesks and excellent material. They have recently implemented a sophisticated online student booking system.

Courses at the ABC college are administered by well-qualified and trained non-teaching staff who provide non-academic (that is, non learning-related) support to the lecturers and students.

The college has had no difficulty in filling its courses. The college has also noted a significant increase in the number of students transferring from other training providers in the last year.

Requirement

Apply value chain analysis to the college's activities and evaluate how value chain analysis could be used to assess why the rate of transfer to ABC from other providers is increasing.

See **Answer** at the end of this chapter.

5.3.1 Value system

Activities that add value do not stop at the boundaries of the organisation. For example, when a restaurant serves a meal, the quality of the meat and vegetable ingredients is determined by the farmer who supplies them. The farmer has added value. The farmer's ability is as important to the customer's ultimate satisfaction as the skills of the chef. A firm's value chain is connected to what Porter calls a value system.

The value system offers the potential to improve efficiency and reduce cost through negotiation, bargaining, collaboration and vertical integration.

Vertical integration provides an opportunity to increase profitability by migrating to the part of the value system that has the most potential for adding value.

Note also that Information Technology (IT) can transform the value chain, and a number of current improvements in value chain activities have been IT driven. (We will look at the strategic significance of IT, including its impact on the value chain, in Chapter 9 of this Study Manual.)

We will look value chains and value systems in an international context in Chapter 2 of this Study Manual.

5.3.2 Strategic value analysis

One of the benefits of value chain analysis for managers is that it enables them to understand how the processes they manage add value for the customer. In turn, they can then help identify where the amount of value added can be increased, or else costs lowered, with a view to enhancing the competitive position of their organisation.

However, gaining and sustaining a competitive advantage requires an organisation to understand the entire value delivery system, not just the portion of the value system in which it participates. For example, the upstream value chain (suppliers) and the downstream value chain (distributors, retailers) are a crucial part of a manufacturer's value system.

Moreover, the upstream and downstream portions of the value system also have profit margins that will be important when identifying a company's cost/differentiation positioning, since the end user consumer ultimately pays for the profit margins along the entire value chain.

Strategic value analysis (SVA) highlights the need to analyse business issues and opportunities across the entire value chain for an industry. Such analysis is critical for multi-stage industries because change in one stage will almost inevitably have an impact on other businesses all along the chain.

SVA prompts companies to ask four key questions:

- Are there any new or emerging players in the industry (in any portion of the value chain) that may be more successful than existing players?
- Are these companies positioned in the value chain differently from existing players? (In particular, are companies emerging which specialise in single activities within the value chain, eg marketing or logistics, rather than trying to cover all activities?)
- Are new market prices emerging across segments of the value chain?
- If we used these market prices as transfer prices within our company, would it fundamentally change the way any of the operating units behave?

SVA is particularly relevant to vertically integrated companies, because it encourages them to consider whether it would be more profitable for them to outsource certain functions or activities rather than continuing to perform them all in-house.

We will discuss outsourcing in more detail in Chapter 3 of this Study Manual.

5.4 Gap analysis

This tool enables organisations to study what they are doing currently and where they want to go in the future. Gap analysis can be conducted from the perspective of the organisation, the direction of the business, the processes of the business, and Information Technology. It provides a starting point for measuring the amount of time, money and human resources required to achieve a particular outcome. It can also be used for new products, or to identify gaps in the market.

Importantly also, if an organisation has identified that it has a 'gap' between the profit it expects to generate and its target profit, then this may indicate the need to identify new strategies or initiatives which can help fill that gap.

Ansoff's matrix summarises the product-market strategies which are available:

		PRODUCT	
		Present	*New*
MARKET	*Present*	Market penetration	Product development
	New	Market development	Diversification • related • unrelated

Figure 1.7: Ansoff's product-market matrix

5.5 Benchmarking

Benchmarking enables organisations to meet industry standards by copying others. It is less valuable as a source of innovation but is a good way to challenge existing ways of doing things. It involves comparing your own performance with recognised targets, such as industry averages, and allows you to identify areas where you are performing relatively well as well as areas where your relative performance is below expectations.

5.5.1 Benchmarking and strategic position

In this respect, benchmarking can be useful in helping an organisation assess its current strategic position (as in a SWOT analysis). For example, if an organisation believes that one of its strengths is the reliability of its products, how can it be sure of this unless it has tested the reliability of its products against the reliability of other organisations' products?

Equally, however, if a benchmarking exercise identifies that the organisation's products are more reliable than a competitor's products, the organisation could use these findings as the basis for an advertising campaign.

5.5.2 Benchmarking and competitive strategy

Benchmarking could also be useful for assessing an organisation's generic competitive strategy (cost leadership or differentiation). For example, before an organisation decides to implement a cost leadership strategy it would be useful for the organisation to know what its competitors' costs are, and therefore, whether it can beat them. If the organisation cannot produce a product or service at a lower cost (or at least the same cost) as its competitors, then it would not seem to be sensible for it to implement a cost leadership strategy.

The same logic applies to differentiation. Whatever an organisation wants its differentiating factor to be, it needs to measure its performance in that area against its competitors before deciding whether or not to use it as the basis for its competitive strategy.

When carrying out benchmarking exercises, you should be asking such questions as:

- Why are these products or services provided at all?
- Why are they provided in that particular way?
- What are the examples of best practice elsewhere?
- How should activities be reshaped in the light of these comparisons?

5.6 Business process analysis

This tool helps organisations improve how they conduct their functions and activities with a view to reducing costs, improving the efficient use of resources and giving better support to customers. The idea is to concentrate on and re-think activities that create value for customers whilst removing any activities that do not add value.

We will look at the related topic of business process re-engineering in more detail in Chapter 3.

5.7 Strategic risk analysis

This involves recognising and assessing risks faced by the organisation, developing strategies to manage them and mitigating risks using managerial resources. Strategies include transferring risk to other parties, avoiding the risk altogether, reducing negative effects of the risk and accepting some or all of the consequences of a particular risk.

Case example: Tesco – Principal risks

In the corporate governance section of its 2013 Annual Report and Financial Statements, Tesco provides a summary of the principal risks it faces, and for each risk, it identifies key controls and mitigating factors.

The principal risks identified are:

Business strategy risk – if the Group follows the wrong direction, or if strategic direction is not effectively communicated or implemented, the business may suffer.

Financial strategy risk – risks relate to an incorrect or unclear financial strategy and the failure to achieve financial plans.

Competition and consolidation risk – failure to compete on areas including price, product range, quality and service in growing overseas retail markets could impact on the Group's market share and adversely affect its financial results.

The consolidation of competitors, key geographical areas or markets through mergers or trade agreements could also adversely affect Tesco's market share.

Reputational risk – Failure to protect the Group's reputation and brand in the face of ethical, legal
Performance risk in the business – Risk that business units underperform against plan and against competitors, and that business fails to meet the stated strategy.

Property risk – Continuing acquisition and development of property sites carries inherent risk; targets to deliver new space may not be achieved; challenges may arise in relation to finding suitable sites, obtaining planning or other consents, and compliance with design and construction standards in different countries.

Economic risks – In each country where it operates, Tesco is affected by the underlying economic environment and the fiscal measures which apply to the retail sector.

Political and regulatory risks – In each country in which it operates, Tesco could be affected by legal and regulatory changes, increased scrutiny by competition authorities, and political developments relevant to domestic trade and the retail sector.

Product safety – Failures to ensure product safety could damage customer trust and confidence, affecting Tesco's customer base and therefore, financial results.

IT systems and infrastructure – Any significant failure in the IT processes of Tesco's retail operations would impact on its ability to trade. Failure to invest appropriately in IT could increase its vulnerability to attack, constrain the growth of the business, and fail to safeguard personnel, supplier or customer data.

People – Failure to attract, retain, develop and motivate the best people, with the right capabilities at all levels could limit the Group's ability to succeed.

Group Treasury – Failure to ensure the availability of funds to meet the needs of the business, or to manage interest or exchange rate fluctuations, could limit the Group's ability to trade profitably.

Tesco's **financial risks** are separately identified as: funding and liquidity, interest rate risk, foreign currency risk, and credit risk.

Tesco Bank – the impact on the Group of financial risks taken by Tesco Bank.

Pensions – The Group's IAS 19 deficit could increase if there is a fall in corporate bond yields that is not offset by an increase in the pension scheme's assets. There are also risks of legal and regulatory changes introducing more burdensome requirements.

Fraud, compliance and internal controls – As the business develops new platforms and grows both in size and geographical scope, the potential for fraud and dishonest activity by their suppliers, customers and employees increases.

Business continuity and crisis management – A major incident, or activism, could have an impact on staff and customer safety, or the Group's ability to trade.

Risk appetite

Alongside risk analysis it is also important for companies to articulate their **risk appetite**. If companies do not articulate their risk appetite, how can they set suitable strategic goals? For example, can a company that is only prepared to take a very low level of risk expect to achieve as rapid growth as a company that is prepared to accept a higher level of risk?

5.8 Balanced Scorecard

The Balanced Scorecard (developed by Kaplan & Norton) emphasises the need for a broad range of key performance indicators (KPIs) and builds a rational structure that reflects longer-term prospects as well as immediate performance.

The Balanced Scorecard focuses on **four different perspectives**.

Perspective	Question	Explanation
Financial	How do we create value for our shareholders?	Covers traditional measures such as growth, profitability and shareholder value but set through talking to the shareholder or shareholders directly.
Customer	What do existing and new customers value from us?	Gives rise to targets that matter to customers: cost, quality, delivery, inspection, handling and so on.
Internal business	What processes must we excel at to achieve our financial and customer objectives?	Aims to improve internal processes and decision making.
Innovation and learning	Can we continue to improve and create future value?	Considers the business's capacity to maintain its competitive position through the acquisition of new skills and the development of new products.

The scorecard is balanced in the sense that managers are required to think in terms of all four perspectives to prevent improvements being made in one area at the expense of another.

We will look at the Balanced Scorecard and performance management in more detail in Chapter 4 of this Study Manual.

5.8.1 Financial indicators and ratios

As the Balanced Scorecard illustrates, it is important for companies to monitor non-financial performance metrics as well as financial ones.

Nonetheless, financial performance measures are still important, and the measures used should cover a balanced range of perspectives:

- Growth
- Profitability
- Liquidity
- Gearing

Equally, when an organisation operates in a competitive environment, it should try to obtain information about the financial performance of competitors, to make a comparison with the organisation's own results.

Competitor financial information that could be obtained:

- Total profits, sales and capital employed.
- ROCE, profit/sales ratio, cost/sales ratios and asset turnover ratios.
- The increase in profits and sales over the course of the past twelve months and prospects for the future, which will probably be mentioned in the chairman's statement in the report and accounts.
- Sales and profits in each major business segment that the competitor operates in.
- Dividend per share and earnings per share.
- Gearing and interest rates on debt.
- Share price, and P/E ratio (stock exchange information).

5.9 SWOT analysis

SWOT analysis is a key technique for analysing the strategic position of a company. SWOT analysis identifies an organisation's strengths and weaknesses (based on its internal resource and capabilities) along with the opportunities and threats which have been identified from environmental analysis.

By combining environmental analysis with internal appraisal, SWOT analysis provides a means of assessing an organisation's current and future strategic fit (or lack of it) with the environment.

A complete awareness of the organisation's environment and its internal capacities is *necessary* for a rational consideration of future strategy, but it is not *sufficient*. The threads must be drawn together so that potential strategies may be developed and assessed.

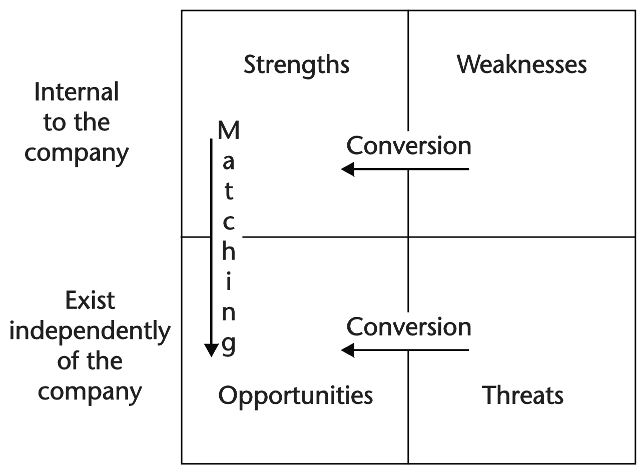


Figure 1.8: SWOT analysis

Remember that strengths and weaknesses identified by internal personnel are only relevant if they are perceived as such by the **organisation's consumers**. Strengths that cannot be matched with an available opportunity are of limited value; and likewise, with opportunities that cannot be matched with strengths. Threats can sometimes be converted into opportunities which can then be matched with strengths. Weaknesses may also be converted into strengths which can be matched with opportunities.

The organisation should look to **match** strengths with opportunities, **neutralise** threats, and **overcome** weaknesses. This 'matching' is expressed in the TOWS matrix.

However, an organisation also needs to consider whether its strengths, resources and capabilities support its strategy and provide it with a source of competitive advantage. For example, if an organisation aims to be a cost leader, do its processes provide it with cost advantages over its competitors?

In this context, it could also be useful to carry out a **benchmarking** exercise alongside a SWOT analysis. In order to assess an organisation's strengths and weaknesses more objectively, it could be useful to compare aspects of the organisation's performance against competitors or against leading practitioners of key activities. For example, if an organisation considers that the quality of its customer service is one of its strengths, it would be useful to have comparator information to confirm how well the organisation is actually performing in this area.

5.10 Corporate reporting and management commentary

Definition

Management commentary: 'A narrative report that relates to financial statements that have been prepared in accordance with IFRSs. Management commentary provides users with historical explanations of the amounts presented in the financial statements, specifically the entity's financial position, financial performance and cash flows. It also provides commentary on an entity's prospects and other information not presented in the financial statements. Management commentary also serves as a basis for understanding management's objectives and its strategies for achieving those objectives.'

[IFRS Practice Statement: *Management commentary – A framework for presentation*]

Thus far, in Section 5 of this chapter, we have discussed a number of frameworks which can be used to analyse an organisation's position and performance. However we have not, so far, highlighted the link between an organisation's performance and strategy, and the financial information published in its financial statements.

In this respect, the business review (or 'management commentary' under IFRS) in an entity's annual report is important.

As the IFRS Practice Statement notes:

> The '*management commentary provides a context within which to interpret the financial position, financial performance and cash flows of an entity. It also provides management with an opportunity to explain its objectives, and its strategies for achieving those objectives.*'

Additionally, the management commentary complements the financial statements by explaining the main trends and factors that are likely to affect an entity's **future performance, position and progress**. Importantly, in this respect, the management commentary looks not only at the present, but also at the past and the future.

In particular, the management commentary provides **qualitative information** that helps the users of financial statements to evaluate an entity's prospects and general risks. Equally, the disclosures contained in this kind of business review will help to inform stakeholders about an entity's strategy.

Although the precise focus of the management commentary will depend on the circumstances of an individual entity, it should summarise a number of the key aspects of strategic management we have highlighted in this chapter.

The IFRS Practice Statement indicates that the commentary should include information that is required to understand:

- The **nature of the business** (and of the markets and external environment in which it operates).
- Management's **objectives** and their **strategies** for meeting those objectives (for example, how management intends to address market trends and the opportunities and threats presented by those trends).
- The entity's most significant **resources** (financial and non-financial), risks and relationships (with key stakeholders).
- The entity's **results and prospects**. The commentary should include a description of the entity's financial and non-financial performance, and the extent to which that performance may be indicative of future performance.
- The **critical performance measures** and **indicators** that management uses to evaluate its performance against its objectives and in relation to its critical success factors. Again, the commentary should refer to both financial and non-financial performance measures that are used.

Case example: BHP Billiton

In its Annual Report for 2012, the global resources company BHP Billiton states that its purpose is 'to create long-term shareholder value through the discovery, acquisition, development and marketing of natural resources.' In relation to this, its strategy is 'to own and operate large, long-life, low-cost, expandable upstream assets diversified by commodity, geography and market. This strategy means more predictable business performance over time which, in turn, underpins the creation of value for our shareholders, customers, employees and, importantly, the communities in which we operate.'

BHP's Annual Report contains a section entitled 'Our strategy' that explains this strategy in more detail, and highlights the strategic drivers through which it pursues its purpose: including people; world-class assets; financial strength and discipline; and growth options.

The report also then goes on to detail the external factors and trends affecting BHP's results. 'We operate our business in a dynamic and changing environment and with information which is rarely complete and exact.' Nonetheless, 'management monitors particular trends arising from external factors with a view to managing the potential impact on our future financial condition and results of operations.' The report then details the factors which BHP's management feel could have a material adverse effect on the business. These include: commodity prices, exchange rates, and change in product demand and supply.

> *Concerns surrounding the stability of the Eurozone and the decline of economic activity that accompanied the managed slowdown of growth in China led to significant market volatility in 2012. In China, the government has introduced stimulatory measures aimed at supporting sustainable growth. The successful containment of inflation, looser monetary policy and evidence of a recovery in infrastructure investments should be positive for commodities demand in the short to medium term. Similarly, there are encouraging signs that the US housing market may have stabilised…*
>
> *Our forecast of supply additions to meet anticipated demand varies by commodity. We have analysed whether existing supply up to the end of 2011 and low-cost capacity additions through to 2015 will be sufficient to meet anticipated demand growth through to 2020.*
>
> *In the case of aluminium, we expect the forecast demand growth to be met by capacity additions through to 2015. As such, we see the aluminium market changing at the variable cost of production for the foreseeable future. With iron ore, we expect approximately three-quarters of the demand growth to be met by low-cost supply by 2015. As such, we expect going forward that iron ore supply will meet demand in due course and that the scarcity pricing seen in recent years is unlikely to be repeated. With copper, only about a quarter of demand growth through 2020 has currently been met by existing low-cost supply and even by 2015 40% of this demand growth is not expected to be met by new low-cost supply. Resource depletion and resource degradation continue to constrain the pace of low-cost supply addition, and therefore prices are expected to be at a level high enough to induce additional supply through the development of greenfield mines.*

Case example: Coca-Cola

Management's Discussion and Analysis (MD&A)

The section of the MD&A in Coca-Cola's Annual Report for 2012 entitled 'Our Business' includes the following:

- A general description of Coca-Cola's business and the non-alcoholic segment of the beverage industry
- Our objective
- Our strategic priorities
- Our core capabilities
- Challenges and risks of our business

(Note the potential links between these headings and the sections of this chapter: specifically, objectives – section two; capabilities – section four; challenges and risks – environmental analysis; section three.)

Our Business

Coca-Cola owns or licenses more than 500 non-alcoholic beverage brands, and it makes its products available to consumers throughout the world through its network of company-owned or -controlled bottling and distribution operations, as well as independent partners, distributors, wholesalers and retailers – the world's largest beverage distribution system.

> *We believe our success depends on our ability to connect with consumers by providing them with a wide variety of choices to meet their desires, needs and lifestyle choices. Our success further depends on the ability of our people to execute effectively, every day. Our goal is to use our Company' assets – our brands; financial strength; unrivalled distribution system; global reach; and the talent and strong commitment of our management and associates – to become more competitive and to accelerate growth in a manner that creates value for our shareowners.*

The Non-Alcoholic Beverage Segment of the Commercial Beverage Industry

Coca-Cola operates in the highly competitive non-alcoholic beverage segment of the commercial beverage industry. It faces strong competition from numerous other general and speciality beverage companies.

Along with other beverage companies, Coca-Cola is affected by a large number of factors, including (but not limited to): the cost to manufacture and distribute products, consumer spending, economic conditions, availability and quality of water, consumer preferences, inflation, political climate, local and national laws and regulations, foreign currency exchange fluctuations, fuel prices and weather patterns.

Our Objective

Our objective is to use our formidable assets – our brands, financial strength, unrivalled distribution system, global reach, and the talent and strong commitment of our management and associates – to achieve long-term sustainable growth.

Strategic Priorities

We have four strategic priorities designed to create long-term sustainable growth for our Company and the Coca-Cola system and value for our shareowners. These strategic priorities are: driving global beverage leadership; accelerating innovation; leveraging our balanced geographic portfolio; and leading the Coca-Cola system for growth.

To enable it to deliver on these strategic priorities, Coca-Cola has identified that it needs to further enhance four **core capabilities** of:

- **Consumer marketing** – marketing is vital to enhance consumer awareness of, and increase consumer preference for, Coca-Cola's brands. In turn, this helps to produce long-term growth in demand, and to increase the entity's share of worldwide non-alcoholic beverage sales.
- **Commercial leadership** – The Coca-Cola system relies on millions of retailers who sell or serve its products directly to consumers. Therefore, Coca-Cola focuses on ensuring that these retailers have the right product availability and delivery systems, as well as promotional tools, merchandising and displays, so that the retailers can deliver enhanced value both to themselves and Coca-Cola.
- **Franchise leadership** – Growth is an important theme in the MD&A, and Coca-Cola's bottling partners play a key part in that growth.

  > *The financial health and success of our bottling partners are critical components of the Company's success. We work with our bottling partners to identify system requirements that enable us to quickly achieve scale and efficiencies, and we share best practices throughout the bottling system…We will continue to build a supply chain network that leverages the size and scale of the Coca-Cola system to gain a competitive advantage.*

- **Bottling and distribution operations** – Most of Coca-Cola's beverage products are manufactured, sold and distributed by independent bottling partners. However, in recent years, the amount of products being manufactured, sold and distributed by consolidated bottling and distribution operations has increased. Coca-Cola has often acquired bottlers in under-performing markets where it believes it can use its resources and expertise to improve performance (for example, through improving the bottler's information systems or establishing an appropriate capital structure).

Challenges and Risks

Although being a global company provides significant opportunities for Coca-Cola, it still faces risks and challenges. Five key risks and challenges are discussed in the MD&A:

- **Obesity and Inactive Lifestyles** – Increasing concerns about the health problems associated with obesity and inactive lifestyles present a significant challenge to the beverage industry as a whole. However, Coca-Cola can point to the fact that it has a very broad portfolio, containing beverages to suit almost every calorific and hydration need. Consumers who want low- or no-calorie beverages can choose from a continuously expanding portfolio of more than 800 of these beverages, nearly 25% of Coca-Cola's global portfolio.
- **Water Quality and Quantity** – Water is the main ingredient in substantially all of the entity's products and is needed to produce the agricultural ingredients on which its business relies. Water is also critical to the prosperity of the communities Coca-Cola serves. However, it is a limited natural resource, facing unprecedented challenges from demand, pollution, poor management and climate change. Coca-Cola has

a robust water stewardship and management program, is working to improve water use efficiency, and is working towards its goal of replenishing the water that it and its bottling partners source and use in its finished products.

- **Evolving Consumer Preferences** – Consumers want more choices. Coca-Cola (like other companies) is affected by shifting consumer demographics and needs, on-the-go lifestyles, ageing populations in developed markets, and consumers who are empowered with more information than ever. However, it is committed to generating new avenues for growth through its core brands with a focus on diet and light products, and innovative packaging. It is also committed to continuing to expand the variety of choices it provides to consumers to meet their needs, desires and lifestyle choices.
- **Increased Competition and Capabilities in the Marketplace** – Coca-Cola faces strong competition from some well-established global companies and many local participants. Therefore it has recognised the importance of strengthening its capabilities in marketing and innovation in order to maintain its brand loyalty and market share while it also looks to expand selectively into other profitable segments of the non-alcoholic beverage industry.
- **Food Security** – Increased demand for commodities, and decreased agricultural productivity in certain regions of the world as a result of changing weather patterns, may limit the availability, or increase the cost of, key agricultural commodities, such as sugar cane, corn, coffee and tea, all of which are important sources of ingredients for Coca-Cola's products. However, Coca-Cola is committed to implementing programs focused on economic opportunity and environmental sustainability designed to help address these agricultural challenges.

5.11 Preparing to tackle a case study

While we have recapped a number of theories and models in this section, in reality these models will not be used in isolation. In your exam, you will be expected to demonstrate your ability to apply various tools to evaluate a complex scenario.

It is important to remember that no two cases or scenarios are ever the same – each one must be treated on its own merits. However, there are some fundamental questions that you should ask when reading through the scenario you are faced with in your exam:

- What is the company's main line of business?
- What is its current strategy?
- What are its long-term objectives?
- Are there any potential conflicts in its objectives – for example, financial strategy versus marketing strategy?
- Are there any external issues to consider?
- How is the company performing financially?
- Are there are any obvious areas for improvement?
- Does the company have any particular strengths that could be further exploited?
- Are there any limited resources (or other weaknesses) that may affect the company's ability to fulfil its objectives?
- What are competitors doing?

Try to think about the case study scenarios as you would problems in your own workplace or that of a client – think about how decisions taken to solve one issue affect other areas of the business, whether certain decisions will contradict company strategy or affect market perception, the potential financial implications of different actions, and whether a proposed course of action will align with company culture.

If you are given financial information, make sure you use it – whether to establish profit margins, growth or the general financial health of the company.

We will consider data analysis in more detail in Chapter 8 of this Study Manual.

6 Levels of strategy in an organisation

Section overview

- Strategy exists at a number of levels in an organisation, and it is important that the strategies at each level are aligned with one another.
- We can distinguish three main levels of strategy: corporate-level, business-level and operational.

6.1 Levels of strategy

Strategies can exist at three main levels within organisations: corporate-level strategy, business-level strategy and operational/functional-level strategy.

Corporate-level strategy – is concerned with the overall scope of an organisation and how value is added to the organisational whole. Corporate-level strategy issues include questions around geographical scope and which markets to enter; the diversity of products or services the organisation as a whole will offer; acquisitions of new businesses, or the divestment of existing businesses; and decisions about how resources are allocated between the different elements of the organisation.

Business-level strategy – is concerned with how individual businesses or business units compete in their particular markets. For example, business-level strategy could address competitive strategy, or response to competitors' actions.

Operational (or functional) strategy – is concerned with how the components of an organisation actually deliver the corporate-level or business-level strategies, in terms of resources, processes and people.

In most businesses, successful business strategies ultimately depend, to a large extent, on decisions that are taken, or activities that occur, at operational level. Operational decisions are therefore vital to successful strategy implementation.

Equally importantly though, operational strategies need to be properly aligned with business-level or corporate-level strategy if these higher level strategies are going to be successfully implemented. For example, if a business' competitive strategy is based on delivering the highest quality service to its customers, then its human resource management will need to ensure that it has sufficient, well-trained, and highly-motivated staff to deliver that level of service to its customers.

Although operational strategy may appear to be at the bottom of the strategic hierarchy, this does not mean operational strategies are any less important than corporate strategies. Satisfying the customer is a key task to meet corporate objectives for most businesses; but the businesses will not be able to satisfy their customers if operations are poorly managed, meaning that their strategies will fail.

Levels of strategy

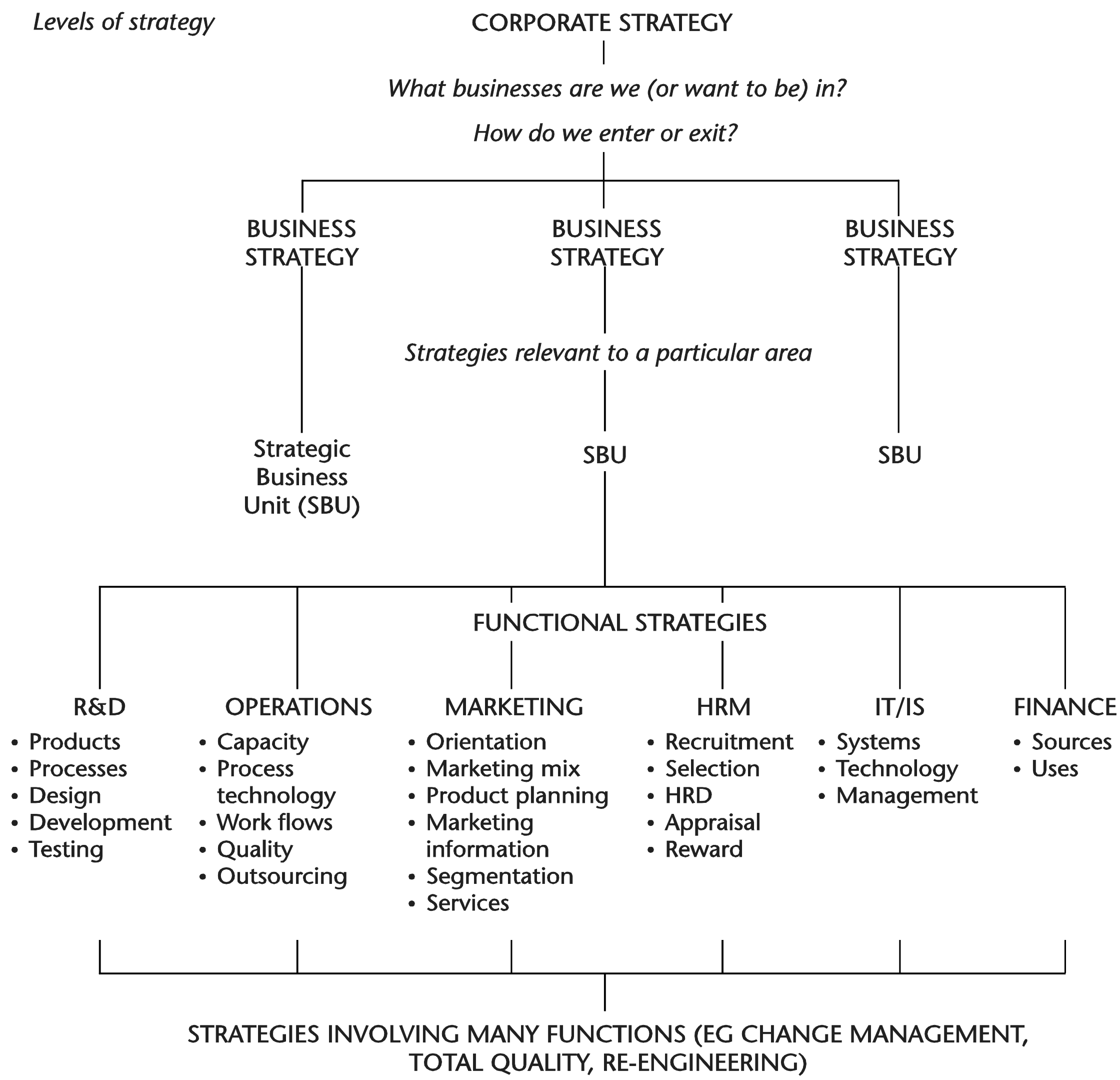


Figure 1.9: Levels of strategy

6.2 Contrasting strategic with operational decisions

The contrasting decisions in organisations can be analysed as in the table below. The contrast between corporate-level and operational decisions is also important because it means that the type of information which is required for decision-making at corporate level is very different from that required at operational level.

We will return to this point in Chapter 9 when we look at information and information systems.

Characteristics	Corporate strategic decisions tend to be:	Operational decisions tend to be:
Clarity	Ambiguous.	Defined.
Complexity	Complex and open-ended.	Simple.
Organisational scope	Whole organisation, or significant parts of it.	Restricted to the business function.
Significance	Consciously fundamental to what the business is doing.	Important, possibly, but does not question the nature of the business.
Time horizon	Long-term, mostly.	Short-term, mostly, but could have long-term implications.

Summary and Self-test

Summary

An organisation's strategy identifies how it will use its resource and competences to achieve competitive advantage and fulfil stakeholder expectations.

The three main elements of strategic management are analysis, choice and implementation.

Organisations can adopt a range of different approaches to strategy, including a prescriptive (rational model) approach or an emergent approach.

Organisations develop goals and objectives to support their underlying mission, but they must also reflect the interests of key stakeholders when setting their objectives.

There are three inter-related elements to a business strategy: competitive strategy, financial strategy, and investment strategy.

Strategy can also be considered at three main levels: corporate-level, business and operational level, and the alignment between these levels is important in order for corporate strategies to be implemented successfully at operational level.

As part of its strategic planning, an organisation needs to develop an understanding of the external environment and the opportunities and threats that environment presents (eg by using PESTEL analysis, Porter's Five Forces, and competitor analysis).

Position-based approaches to strategy focus on the way an organisation responds to the external environment to develop competitive advantage, whereas resource-based approaches focus on the way an organisation can use its own internal resources, competences and capabilities as the basis for competitive advantage.

Analysis of internal resources and capabilities (eg through resource audit, product life cycle, portfolio analysis, or value chain analysis) helps to identify an organisation's strengths and weaknesses.

These strengths and weaknesses (internal factors) can then be analysed in conjunction with opportunities and threats (external factors) to produce a SWOT analysis.

Self-test

Self-test question 1

ZTC, a telecommunications company, has recently been privatised by the government of Zeeland after legislation was passed that removed the state monopoly and deregulated the communications market, opening it up to competition from both national and overseas companies.

Prior to this deregulation, ZTC was the sole supplier of telecommunications in Zeeland and was required to provide 'the best telecommunications service the nation can afford'. At that time the government dictated the performance levels required for ZTC, and the level of resources it would be able to bring to bear to meet its objectives.

Following the privatisation, ZTC's shares were floated on the Zeeland Stock Exchange, with 80% being made available to the population of Zeeland and up to 20% being made available to foreign nationals. The government of Zeeland retained a 'golden share' to prevent the acquisition of ZTC by any foreign company.

However, the privatisation meant that many of the traditional ways in which the industry had operated would need to change under the new regulations. Apart from the money received from the flotation, the government privatised ZTC in recognition of both the changing global environment for telecommunications companies, and the overseas expansion opportunities that might exist for a privatised company. The government recognises that foreign companies will enter the home market but feels that this increased competition is likely to make ZTC more effective in the global market.

Requirements

(a) With specific reference to ZTC, discuss how the external environment can affect an organisation's performance.

(b) Explain why the objectives of ZTC will need to change as a result of its privatisation and the deregulation of the market.

Self-test question 2

DDD is an international bank with retail banking operations in many countries. DDD's retail banking is primarily aimed at individual customers and is provided through branches as well as over the internet. DDD offers a wide variety of retail banking products including savings and cheque accounts, debit and credit cards, insurances, mortgages and personal loans. DDD has a strong international brand image and a long record of success, particularly in Western countries.

DDD has offered retail banking services in country X since 2008. DDD decided to invest in X because, at the time, X had a rapidly growing economy, and DDD considered there were good retail banking opportunities, as only 50% of the population of X had a bank account. DDD initially invested CU200 million in entering X, and it established a network of its own branches there. DDD also purchased a local bank in X for CU150 million, just after the start of the global financial crisis in 2007.

X had liberalised its economy in 1993, which means it now allows the free flow of capital into and out of the country. The banking sector contains some state-owned institutions that compete strongly for retail banking business against private-sector rivals. The largest state-owned bank, BX, has half of X's retail banking business and has a strong position of dominance. This has been strengthened recently due to a reorganisation in its senior management and the launch of some successful new retail banking products. These new products have proved to be very popular with customers and are very profitable.

One banking analyst has recently commented that 'X's government has chosen to energise the banking sector through BX. It is less keen on foreign competition. The potential rewards for retail banking in X are great. There is plenty of growth left in this market and the margins are excellent. However, X's population is very conservative, they don't like change.' Within X, mortgage and consumer lending has grown at 20% per year compound from 2007 to the present day.

DDD's economic intelligence unit has forecast that this growth will continue for the foreseeable future because this reflects the policy of X's government.

There are a number of foreign banks which have been established in X for over 15 years and these are all profitable. Together, they account for 35% of X's retail banking market.

In the last two years, DDD has identified two foreign banks that entered X at the same time as it did but which have now withdrawn from the country. One of the foreign banks has stated its reason for withdrawal as being, 'Our operations in X have reduced group profitability.'

At the last board meeting, one of DDD's directors questioned whether it should also withdraw from X, amidst concerns that DDD's operations in X had reduced its profitability as well.

Requirements

(a) Using Porter's five forces model, evaluate DDD's future potential for a profitable retail banking business within country X.

(b) Using your analysis from part (a), advise DDD on whether it should continue its retail banking business in country X.

Self-test question 3

The Verdant Car Company (VCC) was established six years ago as a commercial venture to exploit the patented inventions of Professor Kamm, a university engineering professor. Professor Kamm has patented processes for the production of lithium-ion batteries to power electric cars that can travel up to 175 kilometres before they need re-charging. With backing from a venture capital firm, Professor Kamm has established a small production plant in his university town, and has started to manufacture an electric car, the Verdant model. Setting up the plant was helped by the fact that another manufacturer in the town had gone into liquidation, leaving vacant premises that VCC was able to acquire for a low rental cost and a large number of unemployed skilled staff that VCC could recruit.

VCC now manufactures three models of the Verdant: Verdant Green, Verdant Eco-Plus and Verdant Eco-Super. The Verdant Eco-Super is a luxury version of the Verdant Eco-Plus and these two models share 95% of the same components. The Verdant Green is a more basic model that has been designed for use in towns. It uses only 75% of the components used in the Verdant Eco-Plus. All three Verdant models can be re-charged from a domestic electricity supply and have no requirement for petrol to drive them.

The table below provides a comparison of the Verdant Eco-Plus model with a similar-sized car that has a petrol-driven engine and a hybrid car that is driven by petrol with assistance from an electric motor.

	Verdant Eco-Plus	**Petrol-driven car**	**Petrol-driven car with assistance from electric motor**
Manufacturing cost	CU15 000	CU12 000	CU14 000
CO_2 emissions	Zero	180 grams/kilometre	90 grams/kilometre
Performance	0 – 100 kilometres per hour (kph): 18 seconds Maximum speed 120 kph	0 – 100 kilometres per hour (kph): 10 seconds Maximum speed 180 kph	0 – 100 kilometres per hour (kph): 12 seconds Maximum speed 170 kph
Economy	CU0.08 per kilometre, electricity cost	CU4 per kilometre	CU2.5 per kilometre
Range	175 kilometres before re-charging	550 kilometres on a full tank of petrol	1,200 kilometres on a full tank of petrol

For VCC, manufacturing costs are kept down by two factors: the low rental cost of the manufacturing premises and low labour costs. The company's operations are based in an area of high unemployment and wage demands in the area are low. Production volumes are low in comparison with other car producers, and low volumes have the opposite effect of keeping unit production costs quite high.

The company spends a substantial amount of money on selling and marketing its products, and the sales and marketing budget is relatively high in relation to total sales revenue, compared with other car producers.

The government has taken some measures to encourage the use of electric cars. It offers tax incentives to businesses for using them and imposes high taxes on petrol and also on cars with large engines (because they emit more CO_2 than smaller cars).

Verdant model cars are purchased largely by 'green' consumers who are willing to pay more for an environmentally-friendly car for short-distance travelling around their homes. They are also popular in the region around the town where the cars are produced. Only 5% of Verdant car production is exported.

Requirement

Analyse the factors that would be considered in a SWOT analysis by the company's strategic planners.

Technical Reference

IFRS Practice Statement: *Management commentary – A framework for presentation*

Overview

- Management commentary is a narrative report that provides a context within which to interpret the financial position and performance of an entity. It also provides management with an opportunity to explain its objectives, and its strategies for achieving those objectives.

Business Strategy texts

Although this Study Manual is designed to provide you with comprehensive coverage of the material you need for your SBM, if you wish to undertake further reading around the areas of business strategy discussed in this chapter, we recommend the following texts:

Johnston, G., Scholes, K. & Whittington, R. (2011) *Exploring Corporate Strategy*, (9th edition), Harlow: Pearson.

Lynch, R. (2012) *Strategic Management*, (6th edition), Harlow: Pearson.

Answers to Interactive questions

Answer to Interactive question 1

One obvious option would to embark upon a round of cost cutting. This is clearly the logic behind BA's decision to cut capacity and ground some of its planes. BA also cut a number of jobs, while other members of staff were asked to reduce their hours or to work some of their hours for free (in effect, taking a pay cut.) BA's Chief Executive summarised the issues when he said that the company's survival depended on everyone across the organisation contributing to changes that permanently removed costs from all parts of the business.

However, alongside measures to control costs, BA could also look at its pricing strategy, which is also something that it chose to do. It found that the strategy of keeping ticket prices high was not compensating for the loss of passengers it was suffering. Therefore, it needed to concentrate on trying to drive up passenger numbers and capacity on its flights – an approach that forms a key part of the strategy adopted by low cost airlines such as Easyjet or Ryanair.

However, BA should not aim to compete directly on price with the low cost airlines, because its business strategy is based on differentiation (for example, through high quality customer service rather than through cost leadership). Consequently, when looking at what cuts it can make, BA must avoid making cuts which would reduce the quality and value it offers its customers.

Answer to Interactive question 2

Opportunities

There are clear opportunities for business growth. The tourist business on the islands is growing. Two new hotel complexes have opened and a new complex is planned for an uninhabited island. The complex on the uninhabited island will require transport services for its customers and also for its staff, who will have to travel from the other islands by sea. This complex intends to negotiate a ten-year agreement with a transport company.

The agriculture business is also growing and the demand for cargo services at certain times of the year should also be expected to grow.

However, if STF is to win some or most of the new transport business, it must address its weaknesses (such as insufficient boats or aircraft) and also exploit its competitive advantages.

The following advantages or competences seem to exist and the company may be able to exploit them:

At the moment, it is the only provider of transport by sea in the area. The complex on the uninhabited island will need sea transport for its customers and staff. Cargo is more likely to be transported by sea to the mainland, since sea transport should be much cheaper than air transport for bulk cargo. The growth in the tourist business generally makes it probable that demand for sea as well as air services will rise in the future. As the only provider of sea transport, STF currently has the advantage of 'monopoly' provider and 'first in the market'. It may be able to exploit this advantage to develop a network of business contacts, and make it difficult for a newcomer to break into the market quickly.

STF has mooring rights. These may be the only mooring rights in existence at the moment. If so, renegotiating them next year will give STF an important strategic asset. On the other hand, the government may create and sell additional mooring rights, so the value of mooring rights may be much less than supposed.

STF may enjoy the intangible benefits of its acquired experience and knowledge of the islands and local transport. It may be able to succeed because its staff have knowledge that other firms may take a long time to acquire. On the other hand, a rival firm could 'poach' key staff by offering them more money.

Therefore, although STF has some competitive advantage at the moment, this may disappear quickly if a rival transport company were to set up in business. STF must plan to expand the capacity of its services so that it can handle the growth in the business. It should also ensure that the general infrastructure of its business is sufficient to provide the standard of service that customers will expect.

STF should investigate the requirements of the company that is building the new complex, to establish what it can do to improve its chances of winning the business for the island's transport. STF may also consider splitting its passenger transport and cargo businesses, so that managers can focus on one side of the business.

Threats

One of the main opportunities for growth is also a threat to STF: the growth in both the agriculture business and the tourist business on the islands.

STF will not be able to meet the growth in demand with its existing ships and air fleet; so if STF does not take action to increase its capacity, it is probable that one or more competitors will fill the expanding gap in the market.

There is a rumour that a global company in the tourism business may establish an operation in the islands, but it is not clear what activities they would undertake. The global company would only create a threat to STF if it decided to fly tourists direct from other countries to the islands (which may reduce passenger traffic between the islands and the mainland) or if it decided to establish its own transport facilities to take people between the mainland and the islands.

Since STF will have to increase the numbers of its ships or aircraft, its lack of capital is likely to be a significant weakness that could affect STF's ability to respond to the opportunities and threats. Without finance it cannot pay for new transport, and banks may be unwilling to lend the money.

There is a threat arising from the possibility that STF will be unable to re-negotiate its mooring rights next year. Without mooring rights, STF will be unable to operate its ships. There may be alternative mooring rights that could be obtained. However, at the moment there does not appear to be a rival for the rights, so it is probable that STF will be able to obtain the rights for a further five years, even if it has to pay substantially more for them.

Answer to Interactive question 3

(a) LBG should gather as much information as possible about its competitors, as both new and existing competitors are one of the main elements in its immediate task environment. A formal process of information gathering and analysis provides the best route to thorough coverage without unnecessary duplication, as such a process can be designed to address specific objectives. Reliance on information gathered on an opportunistic basis is unwise, as there is no guarantee that LBG will obtain the specific information it requires.

The fact that a formal approach to competitor analysis should make LBG more knowledgeable about who its competitors are and what they are doing, can only be advantageous. The philosophy that 'knowledge is power' certainly applies here. In a maturing industry, it is essential that LBG knows who and what pose potential threats to its current position – it is only through this knowledge that LBG will be able to take steps to counteract these threats. As the profitability of a firm is influenced by the competitive environment, it is only through understanding this environment that LBG can hope to continue its success.

The knowledge gained from conducting a formal competitive analysis will allow LBG to adjust its strategy to meet the challenges posed by competitors' behaviour. If, for example, competitors are attempting to reduce margins to attract customers, LBG would have to decide whether competing on price is a strategy it would like to pursue, or whether it would prefer to maintain its reputation for quality, premium products. Even if it decides to maintain its current strategy, it is important that LBG knows what its competitors are doing in order to gauge the threats and potential opportunities that may arise from their behaviour.

(b) The first stage in the competitor analysis process is the identification of who the main competitors are. LBG should be careful here as it is operating in a specialised niche market. Although there are many manufacturers of branded cosmetics, many of these will be aimed at the high street customer. As LBG manufactures specifically for the theatre and movie industry, it should focus only on those firms that produce similar products aimed at the same market.

Once LBG has established who its main competitors are, it should focus on competitors' goals, such as financial goals, attitude to risk and whether managerial beliefs affect their companies' goals. Are competitors more interested in quantity rather than quality? Are their managers more intent on them being renowned for low price rather than premium products? The use of a model such as Porter's five forces might be useful here. Different firms in the same industry will have different strategies, therefore it is important to establish how sophisticated competitors' strategies are and hence, how much of a threat they are likely to pose.

If possible, LBG should try to establish the aims and objectives of its competitors. Many cosmetics companies market to various sectors, such as the high street, catwalk, theatre and movie industries. What is important for LBG to establish is the relative importance of the movie and theatre industry markets to their competitors. Are they just a sideline, in which case the products may be subsidised by the more profitable main product lines, or are they the main focus of the business?

Establishing competitors' assumptions about the industry is essential as this will play a large part in determining their future activity. For example, a competitor that strongly believed that the industry was reaching over capacity might consider leaving the industry altogether. This is linked to the relative importance of the industry to competitors' overall strategy. If movie and theatre cosmetics are only a sideline, the competitor may be more inclined to 'walk away' and concentrate its resources elsewhere. As such assumptions exist mainly in the heads of senior managers, this kind of information may be difficult to obtain, and LBG may have to rely on opportunistic behaviour to gather details.

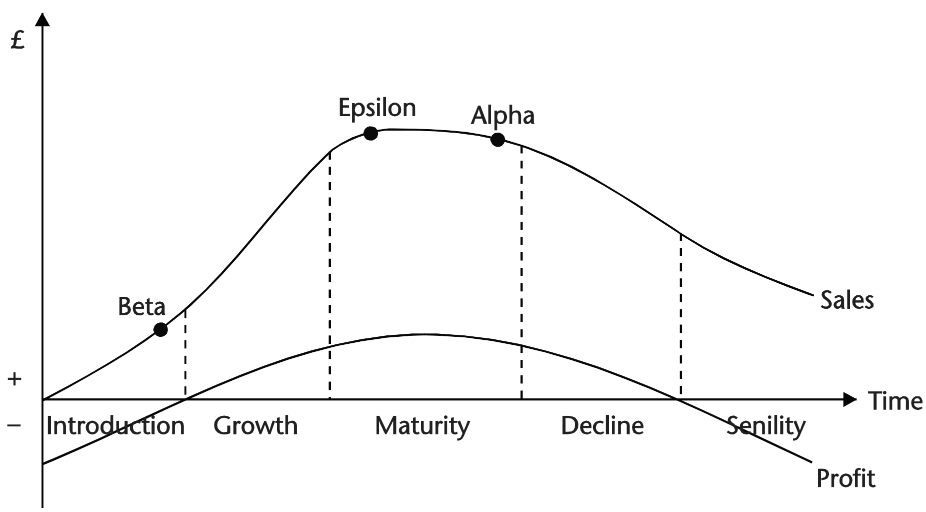
In a specialist industry such as the one that LBG operates in, competitive advantage depends largely on the possession of unique competencies and assets. Establishing the extent to which competitors have these is the next stage in the investigation. In the movie and theatre cosmetics industry, the use of new technologies to develop and bring new and improved products to market is particularly important. The ability to work closely with companies responsible for new cinematic techniques is also essential, to allow knowledge-building of how new techniques can affect the effectiveness of the cosmetics.

Once LBG has gathered the information above, it should be able to begin the process of predicting how competitors might behave in a range of possible future circumstances, including changes brought about by LBG's own potential prospective strategies. What should be borne in mind is that competitor analysis is not a 'once and for all' process – it is a continuous activity that is essential to the future prosperity of LBG.

Answer to Interactive question 4

The product life cycle (PLC) is a simple model of the way that the sales of a product and the profits earned by it vary from its launch to its exit from the market. The model is crude in that a product's progress through the phases can be heavily influenced by marketing activity and, in any case, many products do not follow the standard pattern. Nevertheless, the concept is a useful tool for basic **portfolio analysis**.

The PLC for current product portfolio can be depicted as follows:



(i) **Beta** has been positioned in the introduction phase, because it has only recently been launched, and has not yet generated significant sales volume. However, Beta is likely to have a fairly accelerated Introduction stage, as it is a specialised product, for which there is already demand within the hospital market.

(ii) **Epsilon** is located at the peak of its cycle. Although it has not been available for long, it has already 'achieved significant success' (and its introduction/growth curve may therefore have been steeper than shown in our 'standard curve' model). Sales are not expected to increase (hence its position at the peak).

(iii) **Alpha** is currently just at the point of decline. It has been available much longer than the other products, so its maturity stage may have been longer than our 'standard curve' model suggests. However, Alpha is about to enter the 'decline' stage, because of the expiry of the patent and the entry of low-cost generic competitors into the market. The decline/senility stage is then only expected to last a further 12 months.

As with any portfolio analysis technique, it is important to look for balance in relation to the PLC. Specifically, this means that a portfolio should include products at several stages in their life cycles, so that as one declines, another is emerging to take its place.

3C's current portfolio seems adequate in this respect, in that while Alpha is expected to enter a rapid decline phase, Epsilon is generating high sales in its maturity phase as an acceptable 'cash cow', and Beta has been launched and still has potential for growth.

However, the fact that Beta is unlikely to generate enough sales volume to replace Alpha (because it targets a specialist market niche) is likely to be a concern. Hence, 3C will need to find a 'mass market' product that can act as a successor to Alpha. However, there are currently 240 drugs at various stages of development, so this should increase 3C's chances of continuing the succession into the future.

Answer to Interactive question 5

Company	*Mkt Growth*	*Mkt Share*	
Construction	2% – Low	5.4 / 3.8 = 1.42 High	Cash cow
Engineering	4% – Low	3.5 / 8.7 = 0.40 Low	Dog
Transport	11% – High	2.8 / 4.7 = 0.60 Low	Question mark
Gaming	13% – High	1.2 / 0.7 = 1.71 High	Star

The portfolio of CPH appears to be well balanced with one trading company in each sector of the matrix.

However, we should note that we do not have any information about the profitability of the different trading companies, which would be useful when gauging the strength of CPH's portfolio.

Currently, the Gaming business ('Star') has a significant advantage over its nearest rival, which should enable it to build a strong position in the market. However, we do not know what level of investment (eg in marketing and promotions) will be necessary to maintain its market leadership in the future.

Answer to Interactive question 6

Value chain analysis (VCA) is a method of reviewing all the activities of an organisation and how they interact with each other. Key linkages are identified and areas that create value are focused upon. VCA is not restricted to just the organisation but also the suppliers and customers.

The key 'issue' to address here is identifying which activities in the chain carried out by the college are clearly valued by the students and therefore encourage them to swap to ABC from other training providers. If the college can sustain the elements and linkages in the chain that create value for its students (value drivers) this should help it sustain its competitive advantage over other training providers.

Usefulness of the model

The value chain model was originally designed for used in the manufacturing sector, whereas ABC College is clearly a service-based business. Some of the 'activities' identified in the VCA (eg outbound logistics) may be more obviously relevant to a manufacturing business than a service one.

Nonetheless, value chain analysis will encourage the college's management to think about how and where they add value for their students ('**value drivers**'). In doing so, they should also consider how ABC College differs from the competition and on what basis it will attract staff and students in the future. In this respect, VCA should help the college to identify its order winners or '**core competences'**.

PRIMARY ACTIVITIES

I	Operations	Outbound logistics	Marketing and sales	Service
Student supply Staff supply Facilities supply Course selections and flexibility	Course material production Virtual learning development Classroom technology Structuring of courses	Lecturing styles and quality Provision of material Ease of access to online learning	Marketing mix structure (eg pricing, differentiated product) Website Promotions (brochures, email) Research Price elasticity	Support functions Social aspects Continuing professional development

SECONDARY ACTIVITIES

Procurement	Technology	HRM	Infrastructure
Printed materials Building work Support staff Students & staff	Availability Ease of use Training Innovation (eg online learning) Knowledge sharing	Staff selection processes Staff turnover rates Staff training Admin and staff processes	Culture Layout of premises Organisational structure Facilities Planning systems Control systems (professional bodies)

The points shown in each value chain category are a selection of the things that should be looked at within this context. However, it is equally important to consider the processes of the college, and to see how the linkages within the value chain fit together. All that needs to happen for the chain to fail is for one link within it to break.

Answers to Self-test

Answer to Self-test question 1

Part (a)

Opportunities and threats – ZTC needs to ensure that it understand the ways in which it is affected by the environment in which it operates. In this context, it needs to consider the wider environmental factors (which could be highlighted by 'PEST' analysis) as well as any factors that relate more specifically to the telecommunications industry (which could be highlighted using Porter's five forces model as a guide).

The most significant recent environmental influence on ZTC's performance is likely to have come from a **political factor** – the deregulation of the telecommunications market in Zeeland.

Impact of deregulation – Historically, ZTC held a monopoly position in the telecommunications market in Zeeland. However, now that the market has been deregulated, ZTC's market share is likely to be eroded when new competitors enter the market. Consequently, it seems likely that ZTC will suffer a fall in revenue, at least in the short term until it identifies alternative markets which it could enter as well.

New entrants – It is not clear how many competitors have entered the market so far, but another threat ZTC needs to be aware of is that of additional new entrants entering the telecommunications market in Zeeland in future, and potentially reducing its market share further.

Telephone networks – It is likely that ZTC's monopoly was of the fixed line network in Zeeland, rather than mobile telecommunications networks as well. However, it is also likely ZTC will face competition from mobile phone companies.

In this respect, developments in technology (for example, 4G networks) could also boost the performance of mobile phone companies, and thereby increase the level of competition ZTC is facing.

Overall market growth – The scenario does not indicate whether the telecommunications market overall in Zeeland is growing, or if it is, how high the growth rate is.

However, this will also have an effect on ZTC's performance. For example, if the market is growing rapidly, this could help reduce the impact on ZTC's revenues of its market share declining.

Similarly, if the **global market** is growing significantly, this could provide opportunities for revenue growth. It appears that one of the government's motives behind the deregulation was to make ZTC more competitively internationally, and so the state of the global market is likely to be important for its future performance.

Customer bargaining power – Another consequence of the deregulation is that customers in Zeeland now have increased bargaining power in relation to ZTC. Previously, as ZTC was the sole supplier, customers had little or no ability to influence price or service. However, now that there is increased choice in the market, customers' bargaining power has increased significantly, because if ZTC's tariffs are not competitive against other providers, or its standards of customer service are poor, customers will be able to switch to one of the competitors in the market.

Employees – The deregulation of the market could also affect ZTC's relationship with its employees. In effect, it could increase their bargaining power as suppliers. Previously, telecommunications engineers in Zeeland could only work for ZTC; but it is likely that in future there will be a choice of companies they could work for. Therefore, ZTC will need to ensure that its rewards package is competitive so that it retains its best staff.

Part (b)

As a state monopoly, ZTC's role was expressed in terms of its **service to the nation as a whole**. Its focus was on the public sector aspirations off **efficiency, effectiveness and economy**, but it was **not subject to market discipline** and its finances were controlled by government. The lack of market input and the highly technical nature of its operations make it likely that its main operational concern was **engineering competence**, rather than customer interests. However, the government, as principal stakeholder, imposed requirements around performance and service levels to be achieved.

Shareholders as new stakeholders

ZTC now has a new and important class of stakeholder: its **shareholders**. They will have firm ideas about their requirements in the form of growth, earnings and dividends.

Importance of customers

The company faces a de-regulated market where competition will intensify. It will need to pay great attention to the views and needs of its **customers**: they are a stakeholder group that is likely to wield far more influence than previously, since they will be able to choose new suppliers when new providers of telecommunications services enter the market, following its deregulation.

Impact on objectives

These influences will affect objectives at all levels in the organisation and will require a significant realignment of attitudes. In particular, there will be **pressure to reduce costs; to develop new and attractive products**; and to **improve customer service**, particularly in the matter of installing new equipment and dealing with faults.

The **respective requirements of shareholders and customers** also highlight a potential conflict that will need to be addressed by the directors when setting the company's objectives.

Shareholders will want to **maximise profitability,** which may be achieved by raising prices. But customers will seek the lowest price they can get.

Although the **government** is no longer the main external stakeholder, it will still be interested in ZTC's performance. The company will continue to make a large contribution to the economy of Zeeland as a major employer and taxpayer; it also has the potential to develop as a major centre of technological excellence.

While government will step back from direct involvement in the running of ZTC, it is likely that it will retain an interest in its overall success, and possibly a closer involvement in such matters as the promotion of technological development and overseas expansion, which if successful, could increase ZTC's **tax liability** to the government.

Corporate governance

A final influence on the strategic objectives of the privatised company will arise in the field of **corporate governance**. As a listed company, ZTC will be subject to the normal regulations and codes of practice laid down by its quoting stock exchange. It may also be subject to special **government regulation** designed to prevent it from using its size and current dominant position to discourage competitors. These influences are also likely to have a marked effect on the directors' attitudes and practices.

Overall, the objectives of ZTC will need to change to **focus on profitability and shareholder reward**, as well as customer satisfaction, all of which becomes increasingly important in a deregulated market. Alongside this, the directors will need to ensure the business' controls and governance are adequate to comply with its new regulatory requirements.

Answer to Self-test question 2

Part (a)

Threat of new entrants

The threat of a new entrant is limited by **barriers to entry**.

Capital investment – In this case, the main barrier to entry is the **capital investment** required to enter the banking market. In total, DDD spent CU350 million to enter the market (CU200 million to establish its own branch network, and CU150 million to acquire a local bank).

Dominance of BX – In addition, **BX's dominant position** in the market (being a state-owned organisation, accounting for half of X's retail banking business) might act as a potential disincentive to potential new entrants thinking about investing in X.

Recent withdrawals – The fact that two foreign banks have recently withdrawn from X may also discourage potential new entrants from investing there. The banks' claims that their operations in X served to reduce group profitability suggest that X may not be a very profitable market to invest in.

Competitive rivalry

Strong competition – The state-owned institutions provide tough competition for retail banking business in X. Within this context, BX has established a position of dominance, accounting for half of this business. In addition, a number of well-established foreign banks account for a further 35% of X's retail banking market.

Although the well-established foreign banks are all profitable, it appears the more recent entrants have been less successful. Two of the banks which entered X at the same time as DDD have withdrawn due to the poor levels of profitability their operations in X have generated. Therefore, although there appear to be high margins in the banking industry in X, it appears that banks need to have reached a certain size (a critical mass) before they can begin to earn those margins.

Market growth – Nonetheless, the banking analyst's report indicates there is plenty of growth left in the banking market in X, and the margins are excellent. This suggests the competitive rivalry may not be as intense as it might otherwise be, but the dominant position of the established banks still suggests there is a **high level of rivalry** in the banking market in X.

Bargaining power of consumers

The banking market in X is geared primarily towards personal banking, so individually, customers will only have a low degree of bargaining power.

Choice of bank accounts – However, the degree of choice customers have as to which bank to use, increases their bargaining power. For example, people in X could choose to bank with: BX, one of the other state-owned institutions; DDD, or one of the other foreign owned-banks.

It is likely to be relatively easy for customers to switch from one bank to another, which again could increase their bargaining power.

Conservatism – X's population doesn't like change, which means they are naturally more likely to use one of the established banks than a relatively new foreign entrant such as DDD. In effect, this could reduce the bargaining power of customers on the existing banks. By contrast, though, it could increase their bargaining power over new entrants such as DDD. DDD is likely to have to offer the customers significantly better deals than existing domestic banks in the short term to attract new customers.

Threat of substitute products

Although there are a number of different banks which consumers could use, these reflect the level of competitive rivalry in the industry, rather than the threat of substitute products.

Similarly, there is scope for consumers to switch to internet banking services rather than using the branch network, but again, this represents a switch within the industry, rather than a substitute product.

In this respect, there don't appear to be any substitutes for banking products as a whole, so the threat here is low.

Bargaining power of suppliers

Liberalised market – X has a liberalised economy that allows the free movement of capital in and out of the country. This suggests that DDD (and the other banks in the industry) should easily be able to supply their capital requirements in X under normal market conditions, although the global financial crisis could have an impact on these market conditions overall.

The scenario does not indicate any other key suppliers who could influence DDD's operations in X, so we cannot make any judgement about their strength of their bargaining power.

Potential for future profits

Overall, it appears there is a relatively high level of competitive rivalry in the industry and customers also have a moderate level of bargaining power. However, the threat of new entrants and the threat of substitute products appears to be reasonably weak.

Looking at these forces together suggests that the market should be a profitable one, and this corroborates the analyst's view.

However, the market is not necessarily equally profitable for all the banks in it. Consequently, the potential profitability for DDD's banking business within X is likely to be lower than that of BX's.

Part (b)

Market profitability and growth – The analysis in part (a) suggests that the retail banking market in R should remain a profitable one. There is plenty of growth left in the market, not least because a high proportion of the population do not currently have bank accounts (This figure was 50% in 2008). As more of the population open bank accounts, the size of the banking market in the country will necessarily increase.

Competitive rivalry – However, although the market overall is profitable and growing, there is still likely to be a high degree of competitive rivalry within it.

BX presents the strongest competitive threat to DDD. BX already accounts for half of the retail banking business in X, and its position has been strengthened by its recent re-organisation, and the launch of some successful (and profitable) new products.

Consumer preference – Consumers' attitudes to change should also be a concern to DDD. The customers' dislike of change means they are likely to continue using BX and established banks rather than switching to DDD. Even though DDD has a strong brand image and a long record of success, this may not be sufficient to convince customers to switch to DDD.

Profit levels – The fact that DDD is already successful in a number of other countries means that it should only continue in X if it can sustain an acceptable level of profit there. It appears that the two foreign banks which entered the market at the same time were not able to do this, and so they left.

DDD does not appear to have any sources of sustainable competitive advantage which will enable it to be more successful than these banks, or to reduce BX's dominance in the market.

Advice: Therefore DDD should be advised **not to continue** its retail banking business in country X.

Answer to Self-test question 3

The strategic **strengths** of VCC seem to be as follows.

- The batteries for powering the electric motors of VCC's cars are protected by patent. Competitors wanting to enter the market to produce electric cars will have to develop their own technology or will have to pay VCC for a licence to use its patented technology.
- The company currently benefits from low rental costs for its premises and low wages costs, which both help to keep unit costs of production lower than they otherwise would be. It is not clear whether this advantage for the company is expected to continue for the foreseeable future.

- The use of common components for the three models should reduce the company's inventory requirements and may also reduce unit costs of purchase, since the company can buy in larger volumes for all three models.
- VCC's cars are relatively cheap to run, compared with fuel-driven cars. This is a strength that has implications for potential market demand for the cars.
- The technology is 'cleaner' than for competitive cars. This is another strength that has marketing implications.

The company has several **weaknesses**.

- It has a small product range. Most car manufacturers have a large range of models to appeal to differing customer tastes, and VCC is limited in the variety of model that it can offer.
- It is a relatively low volume producer, which means that unit costs of production are higher than they would be if the company could produce in larger quantities. Inability to produce in larger volumes is therefore a significant weakness because high costs make the company's products more expensive to sell or less profitable.
- High sales and marketing costs relative to sales volume will also reduce net profit margins.

The company enjoys some advantages from conditions in its business environment, and these should be considered **opportunities** for the business.

- Government policy currently favours electric-powered cars, and offers tax incentives to businesses that use them.
- High taxes on fuel mean that it is cheaper to run an electric-powered car than other types of car. This should create opportunities for growth in sales demand as fuel costs get even higher.
- The zero carbon emissions of electric cars will help to give the cars an appeal to environmentally-conscious car buyers and users, and this segment of the car market may increase over time.
- There may also be a sizeable market segment for short-distance users of cars, such as individuals who only use their car for local journeys. For low-usage car drivers, the disadvantages of limited distance before re-charging are not so great. VCC may be able to develop this market segment.

There are also **threats** to VCC's business.

- There is a significant threat from competition. Rival car manufacturers may produce cheaper and more efficient electric cars, using their own technology.
- There is also competition from producers of petrol-driven cars and hybrid cars, which offer better performance and a longer range on a full tank of petrol. Many customers are attracted by these product features and would consider VCC's cars to be an inferior model.
- It is probable that growth in the market for electric cars will remain limited until the range between re-charging of batteries is significantly increased, and more centres are made available to the public where cars can be re-charged – in the same way that petrol tanks can be re-filled.
- There is a general threat to the market for electric cars from a perception that they are an inferior product.
- There may also be an environmental threat, given the fact that electric cars are powered by electricity and electricity generation is currently a polluting technology.

CHAPTER 2

Strategic choice

Introduction

Learning objectives

Tick off

- Assess, advise and propose appropriate business strategies to meet stated objectives ☐
- Identify and evaluate business unit strategies to achieve sustainable competitive advantage ☐
- Explain and demonstrate how financial and non-financial data can be analysed in order to select an optimal business strategy ☐
- Explain and demonstrate how strategic business models can be used in a given scenario, to identify factors that a business can consider in choosing between competing strategies ☐
- Explain international strategies; appraise international value chains and markets; and show the impact on individual and group financial statements in accordance with *IAS 21, The Effects of Changes in Foreign Exchange Rates* ☐

Examination context and knowledge brought forward

The models that an organisation can use to help it select strategies for competitive advantage, or to develop product and market strategies were covered in your *Business Strategy* paper. Porter's generic strategy model and Ansoff's product/market matrix are two key business strategy models.

However, at Advanced Level you will need to apply the models to complex scenarios in order to propose appropriate strategies for an organisation, or to evaluate alternative strategies an organisation is considering.

1 Strategic choices

1.1 Categories of strategic choice

Section overview

- Once an organisation has assessed its current strategic position, it needs to make choices about what strategies to pursue in order to achieve its goals and objectives.

Once an organisation has identified the opportunities and threats in its external environment and its internal strengths and weaknesses, it must make choices about what strategies to pursue in order to achieve its goals and objectives.

It is possible to classify strategic choice into three categories:

(a) **Competitive strategies** are the strategies an organisation will pursue for competitive advantage. They determine **how** an organisation competes.

(b) **Product-market strategies** determine **where** an organisation competes and the direction of growth.

(c) **Institutional strategies** determine the **method of growth**, and how an organisation gains access to its chosen products and markets.

2 Generating strategic options

Section overview

- Before business unit strategies and objectives can be formulated, the overall approach to building and sustaining overall competitive advantage must be agreed. In this regard a decision over whether to pursue a cost or differentiation themed strategy must be made.
- Aside from the overall generic strategy, decisions will also need to be made on the direction and methods of growth.

2.1 Porter's generic strategies

In any market where there are competitors, strategic and marketing decisions will often be taken in order to provide an organisation with a competitive advantage over its competitors.

Competitive advantage is anything that gives one organisation an edge over its rivals. Porter argues that a firm should adopt a competitive strategy that is intended to achieve some form of competitive advantage for the firm. A firm that possesses a **competitive advantage** will be able to make profit exceeding its cost of capital: in terms of economic theory, this is '**excess profit**' or '**economic rent**'. The existence of excess profit tends to be temporary because of the effect of the **five competitive forces** (Porter's five forces). When a company can continue to earn excess profit despite the effects of competition, it possesses a **sustainable competitive advantage**.

Porter highlighted that competitive strategy means:

> *taking offensive or defensive actions to create a defendable position in an industry, to cope successfully with ... competitive forces and thereby yield a superior return on investment for the firm. Firms have discovered many different approaches to this end, and the best strategy for a given firm is ultimately a unique construction reflecting [the firm's] particular circumstances.*

The choice of competitive strategy

Porter believes there are three **generic strategies** for competitive advantage. To be successful, Porter argues, a company must follow only one of the strategies. If they try to combine more than one, they risk losing their competitive advantage and becoming '**stuck in the middle**.'

Remember that Porter identified the importance of *cost* leadership (not price leadership) as one of the generic strategies. Although companies which are pursuing a cost leadership strategy might then choose to compete on price, the focus of Porter's model is on how companies can *produce* goods or services at a lower cost than their rivals, rather than selling price *per se*.

2.1.1 Cost leadership

A cost leadership strategy seeks to achieve the position of lowest-cost producer in the **industry as a whole**.

By producing at the **lowest cost**, the manufacturer could either charge the same price as its competitors knowing that this would enable it to generate a greater profit per unit than them, or it could decide to charge a lower price than them. This could be particularly beneficial if the goods or services which the organisation sells are price sensitive.

How to achieve overall cost leadership:

- Set up production facilities to obtain **economies of scale**
- Use **technology** such as CAD/CAM and computerised inventory and logistics control to reduce costs and/or enhance productivity

  (Supply Chain Management and Business Process Re-engineering, which can both be used to help achieve cost leadership, are discussed in Chapter 3)
- Exploit the **learning curve effect**
- Concentrate on **improving productivity**
- **Minimise overhead costs**
- **Get favourable access to sources of supply** and buy in bulk wherever possible (to obtain discounts for bulk purchases)
- **Relocate to cheaper areas** (possibly in a different country)

Strategy and internal capabilities

Value chain analysis, which we looked at in the previous chapter, could also be useful when considering which generic strategy to pursue. For example, if a business unit wishes to pursue a cost leadership strategy, it will need to ensure that its costs are as low as possible across all the different activities in its value chain (for example, by automating as many activities as possible).

Benchmarking could also be important here. If a company is pursuing a cost leadership strategy, it will need to benchmark its costs or its processes against competitors to assess its cost efficiency compared to theirs.

2.1.2 Differentiation

A differentiation strategy assumes that competitive advantage can be gained through **particular characteristics** of a firm's products. Products may be divided into three categories.

(a) **Breakthrough products** offer a radical performance advantage over competition, perhaps at a drastically lower price.

(b) **Improved products** are not radically different from their competition but are obviously superior in terms of better performance at a competitive price.

(c) **Competitive products** derive their appeal from a particular compromise of cost and performance. For example, cars are not all sold at rock-bottom prices, nor do they all provide immaculate comfort and performance. They compete with each other by trying to offer a more attractive compromise than rival models.

How to differentiate

(a) **Build up a brand image** (eg Pepsi's blue cans are supposed to offer different 'psychic benefits' to Coke's red ones).

(b) **Give the product special features** to make it stand out (eg Russell Hobbs' Millennium kettle incorporated a new kind of element, which boils water faster).

(c) **Exploit other activities of the value chain** (for example, quality of after-sales service or speed of delivery).

We looked at the value chain in Chapter 1. If you cannot remember the activities described in the value chain, you should refer back to it to refresh your memory.

Case example: Bang & Olufsen

The audio and television equipment manufacturer, Bang & Olufsen, has used a differentiation strategy, based on style, to distinguish its products from those of its competitors.

Bang & Olufsen has built an international reputation for quality, and has developed a very loyal customer base. Its sleek, tastefully discreet designs and high standards of production have earned it elite status in the market. For decades, these factors have formed the basis of Bang & Olufsen's advertising and marketing strategy, and the company has recognised that 'style' needs to be displayed distinctively in retail outlets.

This has led to the creation of 'concept shops' where subtle images are projected onto walls and products are displayed in free-standing areas constructed from translucent walls.

The company's view is that one cannot sell Bang & Olufsen equipment when it is sandwiched amongst a densely-packed range of electrical goods or domestic appliances. By contrast, the concept shop gives the right look and feel to make the most of the products.

Bang & Olufsen has focused on the importance of style and aesthetics rather than technology or low prices in buying decisions. It sells products on the basis of ambience as much as sound.

However, one of the key challenges Bang & Olufsen faces is to keep its brand (and strategy) relevant in a world where customers' audio-visual habits (eg listening to music via downloads and portable devices) are changing. At the same time, Bang & Olufsen also needs to maintain its style distinction in the face of high-end equipment being produced, for example, by Samsung and Sony.

(Based on a case study in: Jobber, D. (2010), *Principles and Practice of Marketing*, (6th edition), Maidenhead, McGraw-Hill)

2.1.3 Focus (or niche) strategy

In a focus strategy, a firm concentrates its attention on one or more particular segments or niches of the market, and does not try to serve the entire market with a single product. For example, a firm could look to establish a niche based on: location, market segment and consumer type, product quality or product features.

Information technology (IT) can be useful in establishing the exact determining characteristics of the chosen niche, using existing customer records.

(a) A **cost-focus strategy:** aim to be a cost leader for a particular segment. This type of strategy is often found in the printing, clothes manufacture and car repair industries.

(b) A **differentiation-focus strategy:** pursue differentiation for a chosen segment. Luxury goods suppliers often employ this kind of strategy.

(We will look at market segmentation and positioning in more detail in Chapter 5.)

Case example: Tyrrells crisps

The crisp manufacturer, Tyrrell's, has successfully implemented a focus differentiation strategy, by seizing an opportunity to produce better-quality potato chips than those traditionally found in the supermarkets. Tyrrell's has targeted its chips at a market segment that would be prepared to pay a higher price for good quality produce. A major feature of its strategy is to sell mainly through small retailers at the upper end of the grocery and catering markets – thereby avoiding direct competition with the market leader (Walkers crisps).

Tyrrell's differentiates itself by cooking its potato chips by hand using the finest home-grown potatoes. All the chips are produced on the farm where the potatoes have been grown, so Tyrrell's are in total control of the process 'from seed to chip'. (The company was set up by a potato farmer, who saw crisp production as a way to add extra value to his basic product, potatoes.)

- **Branding**. Tyrrell's marketing taps into the public's enthusBASm for 'authenticity' and 'provenance'. Its crisp packets tell the story of Tyrrell's. Pictures of employees growing potatoes on the Herefordshire farm and then cooking them illustrate the journey from 'seed to chip'.
- **Quality**. Tyrrell's chips are made from traditional varieties of potato and 'hand-fried' in small batches.
- **Distribution**. Tyrrell's sells directly to 80 per cent of its retail stockists. Students from a local agricultural college were employed to trawl through directories and identify fine-food shops to target with samples. After winning their business, Tyrrell's develops the relationship through personal contact.
- **Diffusion strategy**. Selling to the most exclusive shops creates a showcase for Tyrrell's to target consumers who are not sensitive to price, allowing it to grow profitably.
- **New product development**. The Tyrrell's product family consists of sixteen potato chip varieties, including exciting seasonal editions, a 'Best of British' range, and several locally inspired seasonings such as Ludlow Sausage & Wholegrain Mustard, and Worcester Sauce & Sundried Tomatoes. However, in addition to potato chips, they also now produce Root Vegetable Chips: 'Beetroot, Parsnip and Carrot Chips cooked to perfection'.
- **Exporting**. This has created a further sales channel through fine-food stores. Yet it has also forced greater dependency on distributors, introducing an unwelcome layer between itself and its customers.

2.1.4 Using the generic strategies

Porter's three generic strategies can help managers in their strategic planning in a number of different ways.

(a) **Encourage them to analyse competitors' positions**. For example, firms that are competing as cost leaders will need to analyse rivals' cost structures and value chains to identify if there are any areas where cost savings can be made. By contrast, firms that want to pursue differentiation strategies should undertake market research information to get an understanding of brand perceptions in the market.

(b) **Choose a competitive strategy**. This is the key point behind Porter's model: to be successful, a firm needs to follow one of the generic strategies.

(c) **Analyse the risks of their present strategy.** Porter identifies that each generic strategy has some inherent risks. For example:

Differentiation

– The brand loyalty underpinning differentiation may fail if the cost between the price of the 'differentiated' product and cost-leading products becomes too great.

– Buyers may value the differentiating factor less, and so may become more willing to buy generic products instead of differentiated products.

Cost leadership

– Technological change could mean that existing low-cost technology becomes superseded by newer, cheaper technology.

– Inflation or exchange rates may destroy cost advantages.

Focus

– The distinctions between segments narrow so that individual segments are no longer clearly identifiable.

– Segment collapses and leaves the firm with no other source of earnings.

The value of Porter's model is in reminding managers they need to focus on these threats and risks, and develop strategies to deal with them and to maintain their competitive advantage.

Interactive question 1: Generic strategies [Difficulty level: Intermediate]

BMK is a small restaurant chain, consisting of eight restaurants, in an attractive part of a European country that is popular with tourists. BMK has been owned by the same family for the previous 15 years and has always traded at a profit. However, a number of factors have meant that BMK is now in danger of making a trading loss. There has been a substantial drop in the number of tourists visiting the region whilst, at the same time, the prices of many of the foodstuffs and drinks used in its restaurants has increased. Added to this, the local economy has shrunk, with several large employers reducing the size of their workforce.

The owners of BMK commissioned a restaurant consultant to give them an independent view of their business. The consultant observed that the eight restaurants were all very different in appearance. They also served menus that were very different, for example, one restaurant which was located on a barge in a coastal town specialised in fish dishes, whereas another restaurant 20 miles away had a good reputation as a steak house. The prices varied greatly amongst the restaurants: one restaurant in a historic country house offered 'fine dining' and was extremely expensive; yet another located near a busy railway station served mainly fast food and claimed that its prices were 'the cheapest in town'. Three of BMK's restaurants offered a 'middle of the road' dining experience with conventional menus and average prices. Some of the restaurants had licences that enabled them to serve alcohol with their meals but three restaurants did not have such licences. One restaurant had a good trade in children's birthday parties, whereas the restaurant in the historic country house did not admit diners under the age of 18.

The consultant recommended that BMK should examine these differences but did not suggest how. The owners responded that the chain had grown organically over a number of years and that the location, style and pricing decisions made in each restaurant had all been made at different times and depended on trends current at that time.

Requirement

Advise the owners of BMK how the application of Porter's Three Generic Strategies Model could assist them in maintaining or improving the profitability of their restaurants.

Note: You are not required to suggest individual generic strategies for each of BMK's restaurants.

See **Answer** at the end of this chapter.

2.1.5 Limitations of Porter's model

In practice, it is rarely simple to draw hard and fast distinctions between the generic strategies as there are conceptual problems underlying them.

(a) **Problems with cost leadership**

(i) **Internal focus.** Cost refers to internal measures, rather than the market demand. It can be used to gain market share, but it is the **market share that is important,** not cost leadership as such. Economies of scale are an effective way to achieve low costs, but they depend on high volumes. In turn, high volumes may depend on low prices, which, in turn, require low costs. There is a circular argument here.

(ii) **Only one firm.** If cost leadership applies across the whole industry, only one firm will pursue this strategy successfully. However, more than one firm might **aspire** to cost leadership, especially in dynamic markets where new technologies are frequently introduced. Firms competing across the industry as a whole might have different competences or advantages that confer cost leadership in different segments.

(iii) **Sustainability of competitive advantage.** Even if a company manages to reduce costs below those of its competitors in the short term, it is debatable whether this will enable it to achieve a sustainable competitive advantage. Unless the company has an inherent cost advantage over its competitors, they respond to a company becoming the cost leader by trying to reduce their own costs.

(iv) **Higher margins can be used for differentiation.** Having low **costs** does not mean you have to charge lower prices or compete on **price**. A cost leader can choose to 'invest higher margins in R&D or marketing'. Being a cost leader arguably gives producers more freedom to choose other competitive strategies.

There is often confusion about what cost leadership actually means. In particular, cost leadership is often assumed to also mean low price. However, '**cost leadership**' and '**low price**' **are not necessarily the same thing**.

(b) **Problems with differentiation**. Porter assumes that a differentiated product will always be sold at a higher price.

(i) However, a **differentiated product** may be sold at the same price as competing products in order to **increase market share.**

(ii) **Choice of competitor.** Differentiation from whom? Who are the competitors? Do they serve other market segments? Do they compete on the same basis?

(iii) **Source of differentiation**. This includes **all** aspects of the firm's offer, not only the product. For example, restaurants try to distinguish themselves from their competitors through their ambience and the quality of their service as well as by serving high quality food.

Focus probably has fewer conceptual difficulties, as it ties in very neatly with ideas of market segmentation. In practice most companies pursue this strategy to some extent, by designing products/ services to meet the needs of particular target markets.

'Stuck-in-the-middle' is therefore what many companies actually pursue quite successfully. Any number of strategies can be pursued, with different approaches to **price** and the **perceived added value** (ie the differentiation factor) in the eyes of the customer.

In this way, Porter's model no longer reflects the full range of competitive strategies an organisation can choose from.

Case example: Tesco

Tesco has established itself as the largest retailer in the UK, and is the third largest retailer in the world (by revenue) behind Walmart and Carrefour.

One of Tesco's guiding principles is: If you want to be a supermarket superpower, you have to 'be everywhere', and so it actively seeks out new locations in pursuit of the best sites.

But being everywhere isn't enough. The second key idea which Tesco follows is that to be a supermarket superpower, you have to sell to everyone and to appeal to all segments of the market.

In order to appeal to different segments of the market, Tesco offers three distinct ranges of own-brand products: from Value to Finest, priced to attract all types of shoppers to its stores.

Tesco's 'Value' ranges appeal to customers who are looking for a low price option, while the 'Finest' range appeals to more upmarket customers who are prepared to spend more.

One commentator wrote, 'Whether you're a prince or a pauper you can go into Tesco and find something you want.'

2.2 Bowman's strategy clock

The idea that firms can successfully pursue a number of strategies based on price and perceived added value has led to a re-assessment of Porter's original arguments. Moreover, the emphasis on **price** and **added value** recognises the importance of the customer – in a competitive situation, rational customers will seek **value for money** in their purchases, and value for money is provided through the combination of **price** and **perceived product/service benefits**.

To this end, it is worth considering Bowman's strategy clock as a successor to Porter's generic strategies. The strategy clock identifies eight different strategies a firm can take in terms of price and adding value.

The eight strategies on the clock represent different approaches to creating value for the customer, with the logic being that each customer will buy from the provider whose offering most closely matches their own view of the proper relationship between price and perceived benefits.

Each position on the clock has its own **critical success factor**, since each strategy is defined in market terms. Positions 1 and 2 will attract customers who are price conscious above all, with position 2 giving a little more emphasis to serviceability. These are typical approaches in commodity markets. By contrast, strategies 4 and 5 are relevant to consumers who require a customised product. For example, professional service firms have often used these strategies as a basis for competition.

The Strategy Clock

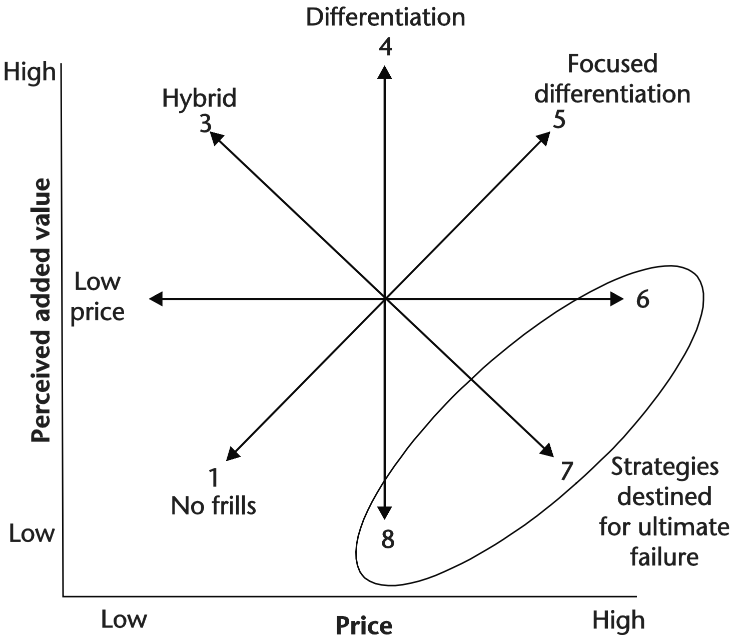


Figure 2.1: Bowman's Strategy clock

A firm pursuing a **hybrid strategy** (position 3) seeks both differentiation and a lower price than its competitors. Such a strategy can be advantageous when a firm seeks to differentiate on the basis of its core competences, but then seeks to reduce costs elsewhere. For example, *Ikea* builds differentiation on the basis of its product range and design logistics, store operations and marketing, but can save costs because customers are prepared to transport and build their products themselves.

If a firm wants to pursue a differentiation strategy, it will need detailed and accurate market intelligence about strategic customers, and the key competitors. The strategic customers and their preferences and values must be clearly identified, as must the firm's competitors and their likely responses to its strategy.

The chosen basis for differentiation, which will probably need to be developed over time, should be inherently difficult to imitate so that it gives the firm a basis for a sustainable competitive advantage.

One way a firm can create sustainable advantage is by creating strategic lock-in (establishing its product or service as the industry standards, like Microsoft Windows has done for computer operating systems).

A differentiation strategy can, however, still be vulnerable to price based competition. There may be occasions when differentiation is not sufficient to affect customers' purchasing decisions in the face of lower prices. For example, in the economic slowdown that affected Western economies from 2008–9, a number of customers have changed their shopping patterns from branded goods to own-label goods in an effort to curtail their spending. (Interestingly, this example also illustrates why a hybrid strategy can be so effective: allowing firms to offer superior products at lower prices than competitors.)

Failure strategies

Combinations 6, 7 and 8 on the strategy clock are likely to result in failure. A strategy which does not provide customers with perceived value for money – either with respect to product features, or price, or both – is likely to be unsuccessful, and therefore to be a failure strategy.

2.3 Overall limitations of the generic strategy approach

Problems in defining the 'industry' - Porter's model depends on clear notions of what the **industry** and **firm** in question are, in order to establish how competitive advantage derives from a firm's position in its industry. However, identifying the industry and the firm may not be clear, since many companies are part of larger organisations, and many 'industries' have boundaries that are hard to define. For example, what industry is a car manufacturer in? Cars, automotive (cars, lorries, buses), manufacturing, transportation?

Defining the strategic unit – As well as having difficulties in defining the industry, we can also have difficulties in determining whether strategies should be pursued at **SBU** or **corporate level**, and in relation to exactly which category of products. For example, Proctor and Gamble have a huge range of products and brands: are they to follow the same strategy with all of them? Similarly, the Volkswagen-Audi Group owns the Seat, Audi, Bentley and Skoda car marques.

Porter's theory states that if a firm has more than one competitive strategy, this will dilute its competitive advantage. But does this mean that Volkswagen-Audi's strategy for its Skoda brand needs to be the same as for its Bentley brand? Clearly not, and this is a major problem with Porter's theory.

It is impractical to suggest that a whole group should follow a single competitive strategy and so it seems more appropriate to suggest that the model should be applied at business unit level. Yet if the theory is only applied at individual SBU level, then it could lead managers to overlook sources of competitive advantage which emerge from being part of a larger group – for example, economies of scale in procurement.

Another criticism which is sometimes levelled at Porter's model is that it doesn't look at how firms might use their competitive advantages and distinctive competences to **expand into new industries**, perhaps as the result of creative innovation. Porter only looks at how a firm might use its resources to develop strategy in its existing line of business. However, we could argue that this criticism isn't really valid. Although Porter doesn't talk about expansion into new industries, his model does not preclude it, and his arguments about following a competitive strategy would still ultimately need to be applied in the new industry.

Case example: Contrasting strategies in the supermarket industry

The following case studies provide an insight into how two companies that operate within the same market have chosen markedly different strategies. In each instance, the key aspects of *how* these strategies are employed are illustrated.

Cost Leader – Walmart (which operates Asda stores in the UK)

Low prices – the company attempts to have lower prices for everyday brands than any competitors. This means it avoids costly loss-leaders and the associated local press adverts to advertise these. Walmart actually delivers on its low prices promise at the cost of lower gross margins to itself, made up for by higher throughput and increased yield for each square foot of retail space it occupies. Prices are naturally used to drive higher sales volume which, in turn, leads to greater buyer power for Wal-Mart in relation to its suppliers.

Consumer-based store design – After consulting consumers, Walmart introduced initiatives such as wider aisles, warm coloured carpeting, smiley faces on store displays and friendly greeters in store. These have all helped raise sales.

Economies of scale in procurement – Walmart uses its large scale and geographical diversity to negotiate lower prices from suppliers. Its advantage is so large that on some items it is not possible for rival retailers to compete. Although this has created a PR backlash, Walmart's customers have come to expect and demand the lower prices that this allows the company to pass onto them. It does, however, remain a potential threat to the company in the medium to long term.

Inventory control – Every store is linked to Head Office where a record of every item scanned for sale is recorded. This information is passed to the large regional warehouses (see below) automatically ensuring that fast selling items are immediately shipped to stores. This ensures no store sells out of product that is selling well, allowing Walmart to respond to customer demand in a way that few other stores can.

Innovative warehousing – Walmart operates a regional network of large warehouses, ensuring that at all times, no store is more than a six hour drive away. This helps ensure the continuity of supply that is a key plank of their strategy. Any new store to be opened must be within access of a warehouse with this being a key part of site selection for new superstores.

Use of superstores – Along with its rivals such as K-Mart and Home Depot, Walmart uses a 'large store' format. These merge the warehouse and retail operations to maximise the floor space used for selling. This in turn allows for larger stock levels to be held on-site, reducing operational expenses which, in turn, leads to lower prices for customers. Consumers are also attracted by the convenience of being able to purchase clothing, groceries and electrical items from the same store.

Differentiation focus – Waitrose

Waitrose strategy – 'To promote the convenience of a supermarket with the expertise and service of a specialist food shop'.

Market segmentation – Waitrose carefully targets the upper socio-economic groups. This is done by considering store location (where rich people live), offering a narrow range of premium branded foods stocked and very selective promotional techniques.

Food and drink only – Waitrose has not diversified into electrical, clothing, home wares and financial services, unlike its largest competitors. Instead it attempts to offer a narrow range of high quality foods not available in other stores.

In town stores – The company has only recently started to open out-of town stores. Its traditional focus has remained in-town where it operates much smaller stores than its rivals. This allows Waitrose to promote the convenience of its service offering.

Brand loyalty – Traditionally supermarkets try and encourage customer switching by focusing on prices or loyalty schemes (Tesco Club card, Sainsbury's Nectar card etc). Although Waitrose offer an account card, it is not well advertised and offers no financial incentives, merely discounted tickets for concerts consistent with its target market. The brand itself promotes values such as 'freshness, quality, choice and value'. Waitrose also derives 55% of its revenues from own-branded items, much higher than its mainstream rivals (excluding Marks & Spencer which, is 100% own brand).

Honest prices – Waitrose makes little or no attempt to compete with its rivals on price. A comparative survey in 2007 showed it was Britain's most expensive supermarket, with its standard basket of goods costing CU53.16, compared to Asda (Walmart owned) at CU45.23. It is therefore 17.5% more expensive than the cost leader for the same basket of branded goods. Waitrose calls its prices 'honest' and argues it delivers a higher level of service than its rivals. Interestingly, Marks & Spencer cannot be directly compared to the supermarkets as it does not sell branded goods, but the CEO of Waitrose claims that M&S are 27% more expensive than Waitrose on like-for-like purchases.

Ethical trading – Waitrose has been a leader in ethical trading. Initiatives it has launched include Bag for Life, Environmental reporting, Fairtrade foods, partnerships with farms and dairies, and a clear effort to 'Buy British', therefore reducing 'food miles' ie all turkeys, most lamb, and 80% of its bacon is sourced from the UK.

2.3.1 Assurance and generic strategies

In our discussion of cost leadership strategies (above) we noted that if an entity is pursuing a cost leadership strategy, it will need to benchmark its costs or its processes against competitors to assess its cost efficiency compared to theirs.

Equally, however, if an entity is intending to pursue a differentiation strategy based, for example, on the quality of its product or the quality of service it provides customers, it will need some way of assessing the quality of its product or service compared to the quality of the offering provided by its competitors.

In this respect, benchmarking could again be valuable, but equally, it could be useful for the entity to obtain some independent assurance of its quality performance indicators compared to those of its competitors.

In turn, if the entity can be confident that the quality of its product exceeds that of its competitors, then it can make use of this point of differentiation in its marketing material.

The 'Assurance Sourcebook' published by the ICAEW includes the following short vignette to illustrate how assurance could be used in relation to benchmarking and performance indicators:

> *A company wanted assurance to increase the credibility of the claims it was making about its performance relative to competitors. The company was using KPI data to benchmark its performance against other companies in the industry. The assurance set out criteria to regulate the methodology used for calculating the KPIs, and ensured that the KPIs were based on independently collated data.*

2.4 Product/market matrix

The product/market matrix is a short hand term for the **products/services** a firm sells (or a service which a public sector organisation provides) and the **markets** it sells them to.

Ansoff's **growth vector (product/market) matrix** provides a simple way of describing how a combination of a firm's activities in existing and new markets, together with existing and new products/services, can lead to **growth**.

The resulting strategies depend on whether the firm looks to continue in its existing markets or expand into new markets, and whether it continues to offer its existing products/services, or to introduce new ones.

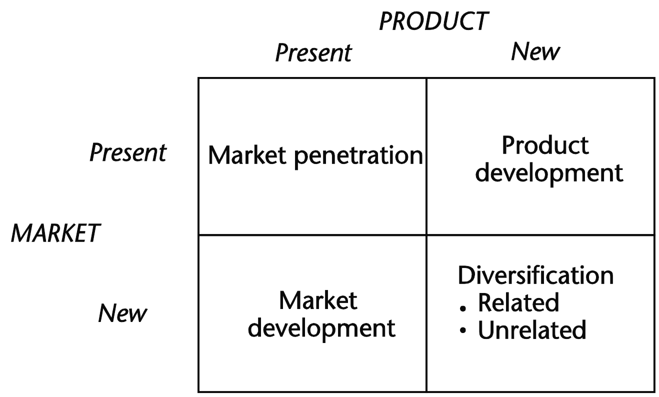


Figure 2.2: Ansoff's product-market matrix

Lynch has produced an enhanced model that he calls the **market options matrix.** This adds the external options shown in this second diagram.

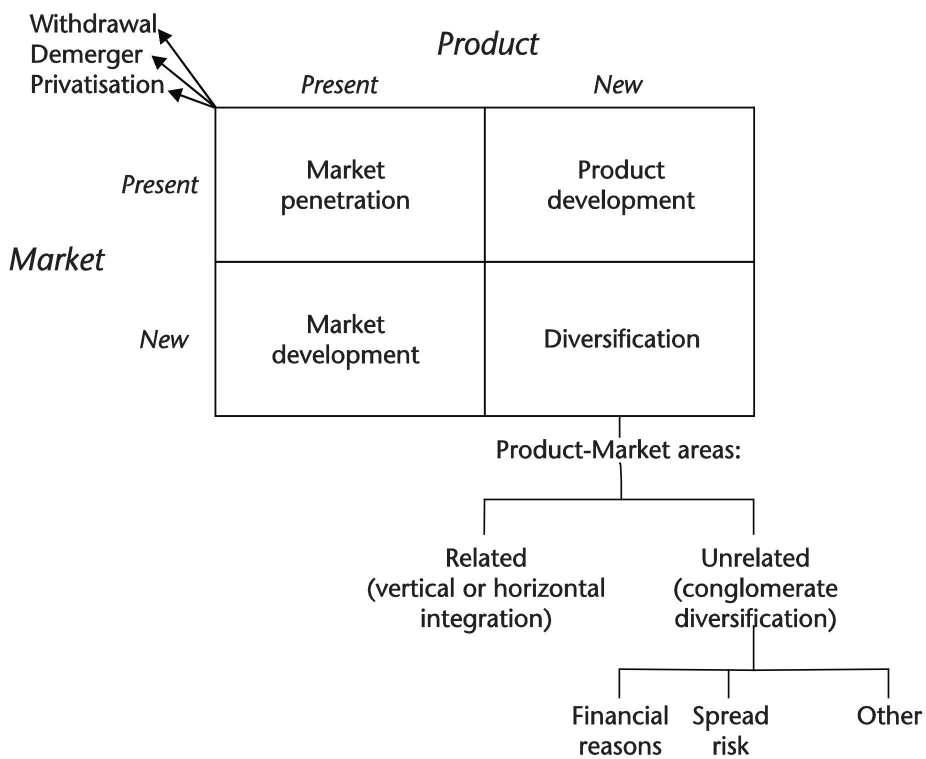


Figure 2.3: Lynch – Market options matrix

However, as well as noting the different types of strategies identified in Ansoff's matrix, it is also important to note an underlying point behind any of the strategies – that an organisation needs to develop product/market strategies to help close a profit gap identified through **gap analysis**.

A related question is what to do with spare capacity – go for market penetration, or try to expand into new markets. Many companies begin exporting into new overseas markets to use surplus capacity. The strategies in the Ansoff matrix are not mutually exclusive though. A firm can quite legitimately pursue a market penetration strategy in some of its markets, while aiming to enter new markets.

Remember that **divestment** can also be a product-market option to close the profit gap, if the business being divested is creating losses.

Another important point to note in relation to the matrix is the different levels of risk attached to the different strategies. Market penetration is seen as being the lowest risk strategy, whilst diversification involves the highest risk. In this way, it is likely that the **risk appetite** of an organisation will play an important part in determining the organisation's growth strategy.

Since diversification is the highest risk strategy, it is particularly important for a company to have a clear idea of what it expects to gain from diversifying, before deciding to do so:

(a) **Growth**. New products and new markets should be selected which offer prospects for growth which the existing product-market mix does not.

(b) **Investing surplus funds** not required for other expansion needs. Alternatively, however, these funds could be returned to shareholders, so the company needs to consider which course of action will be more acceptable to its shareholders.

Interactive question 2: Ansoff's matrix [Difficulty level: Intermediate]

Sleepway Hotels ('Sleepway') is a family-run business that operates a small chain of nine five-star luxury hotels worldwide. These are located in major cities in the USA, Europe, East Asia and Australia, catering for a mix of business and private customers. The past few years have been difficult for the hotel's business due to the depressed global economy, and profit margins have been low due to relatively low occupancy rates.

The company has pursued a long-term strategy of slow growth, opening a new hotel in a city when a suitable opportunity arises. It is now four years since Sleepway opened a hotel, and the CEO believes that an opportunity exists for the company to seek a faster rate of growth. The business has large cash resources, and there are opportunities to borrow for investment at low rates of interest.

The CEO has asked the board to consider three strategic options:

1 Opening three new luxury hotels, one in East Asia and two in the USA. Properties have been identified that would be available for purchase.

2 Opening a small chain of four or five three-star hotels, in cities where the company already has luxury hotels, to attract customers who are increasingly looking for cheaper accommodation than five-star hotels.

3 Opening two golf and country clubs in Eastern Asia, where economic growth is still strong and demand for recreational facilities is rising, especially among wealthy individuals.

It is estimated that the time required to implement each of these strategies might be two to three years. By this time, the CEO believes that global economic conditions will have improved and demand for hotel accommodation will be on the increase.

The CEO is the grandson of the founder of Sleepway, and took on the role of CEO about one year ago, when his father retired. His father remains as a non-executive director of the company.

Requirement

Analyse the three options for strategic development in terms of Ansoff's product-market development strategies. Indicate (with brief reasons) which option, if any, you would recommend on the basis of the information available.

See **Answer** at the end of this chapter.

2.5 Method of growth

Once a firm has made its choice about which strategies it wants to pursue, it needs to choose an appropriate **mechanism** to deliver that strategy.

- Develop the business from scratch
- Acquire or merge with an already existing business
- Co-operate in some way with another firm

The main issues involved in choosing a method of growth are these.

- **Resources.** Does a firm have enough resources and competences to go it alone, or does it have plenty of **resources** to invest?
- Two different businesses might have **complementary skills**
- **Speed**. Does a firm need to **move fast**?
- A firm might wish to **retain control** of a product or process
- **Cultural fit.** Combining businesses involves integrating **people and organisation culture**
- **Risk**. A firm may either increase or reduce the level of risk to which it is subject. External growth often involves more risk than organic (internal) growth.

The type of relationships between two or more firms can display differing degrees of intensity.

- **Formal integration**: Acquisition and merger
- **Formalised ownership/relationship**, such as a joint venture
- **Contractual relationships**, such as franchising

2.5.1 Expansion method matrix

Lynch summarised possible expansion methods in a matrix that analysed them on two axes: **internal-external** development, and **home country-international** location.

(a) Internal development in the home country is simply organic growth

(b) Internal development internationally

(i) Exporting
(ii) Overseas office
(iii) Overseas manufacture
(iv) Multi-national operation
(v) Global operation

(c) External development in the home country or internationally

(i) Merger
(ii) Acquisition
(iii) Joint venture or alliance
(iv) Franchising or licensing

Company

Location		Inside	Outside
	Home country	Organic growth	Merger Acquisition Joint venture Alliance Franchise Licence
	International	Exporting Overseas office Overseas manufacture Multi-national operation Global operation	Merger Acquisition Joint venture Alliance Franchise Licence Contract manufacturing

Figure 2.4: Lynch – Expansion method matrix

2.6 Organic growth

Organic growth (sometimes referred to as **internal development**) is the primary method of growth for many organisations, for a number of reasons. Organic growth is achieved through the development of internal resources.

2.6.1 Reasons for pursuing organic growth

(a) **Learning.** The process of developing a new product gives the firm the best understanding of the market and the product.

(b) **Innovation.** It might be the only sensible way to pursue genuine technological innovations, and exploit them. (For example, compact disc technology was developed by Philips and Sony, who earn royalties from other manufacturers licensed to use it.)

(c) There is **no suitable target for acquisition**.

(d) Organic growth can be **planned more meticulously** and offers little disruption.

(e) It is often **more convenient** for managers, as organic growth can be financed easily from the company's current cash flows, without having to raise extra money.

2.6.2 Problems with organic growth

(a) **Time –** sometimes it takes a long time to descend a **learning curve**.

(b) **Barriers to entry** (eg distribution networks) are harder to overcome: For example, a brand image may be built up from scratch.

(c) The firm will have to **acquire the resources independently**.

(d) Organic growth may be **too slow for the dynamics of the market**.

Organic growth is probably ideal for market penetration, and suitable for product or market development, but it might be a problem with extensive diversification projects.

2.7 Acquisitions and mergers

2.7.1 The purpose of acquisitions

(a) **Marketing advantages**

(i) Buy in a new product range
(ii) Buy a market presence (especially true if acquiring a company overseas)
(iii) Unify sales departments or rationalise distribution and advertising
(iv) Eliminate competition or protect an existing market

(b) **Production advantages**

(i) Gain a higher utilisation of production facilities
(ii) Buy in technology and skills
(iii) Obtain greater production capacity
(iv) Safeguard future supplies of raw materials
(v) Improve purchasing by buying in bulk

(c) **Finance and management**

(i) Buy a high quality management team, which exists in the acquired company
(ii) Obtain cash resources where the acquired company is very liquid
(iii) Gain undervalued assets or surplus assets that can be sold off
(iv) Obtain tax advantages (eg purchase of a tax loss company)

(d) **Risk-spreading**

(e) **Independence**. A company threatened by a take-over might take over another company, just to make itself bigger and so a more expensive target for the predator company.

Many acquisitions **do** have a logic, and the **acquired company can be improved** with the extra resources and better management. Furthermore, much of the criticisms of **takeovers** has been directed more against the notion of **conglomerate diversification** as a strategy rather than takeover as a **method of growth**.

2.7.2 Problems with acquisitions and mergers

(a) **Cost**. They might be too expensive, especially if resisted by the directors of the target company. Proposed acquisitions might be referred to the government under the terms of anti-monopoly legislation.

(b) **Customers** of the target company might resent a sudden takeover and consider going to other suppliers for their goods.

(c) **Incompatibility**. In general, the problems of assimilating new products, customers, suppliers, markets, employees and different systems of operating might create 'indigestion' and management overload in the acquiring company. A proposed merger between two UK financial institutions was called off because of incompatible information systems.

(d) **Poor success record of acquisitions.** Takeovers benefit the shareholders of the acquired company often more than the acquirer. According to the Economist Intelligence Unit, there is a consensus that fewer than half of all acquisitions are successful.

(e) **Driven by the personal goals** of the acquiring company's managers, as a form of sport, perhaps.

2.8 Joint ventures

There are a number of other ways by which companies can co-operate, but which stop short of being mergers or takeovers.

(a) **Consortia:** Organisations co-operate on specific business areas such as purchasing or research.

(b) **Joint ventures:** Two firms (or more) join forces for manufacturing, financial and marketing purposes and each has a share in both the equity and the management of the business.

   (i) **Share costs**. As the capital outlay is shared, joint ventures are especially attractive to smaller or risk-averse firms, or where very expensive new technologies are being researched and developed (such as in the civil aerospace or petrochemical industries).

   Finding the right joint venture partner could be very important to companies with **funding constraints** but high development costs, especially if the venture partner brings credibility as well as providing the necessary finance.

   (ii) **Reduce risk**. As well as sharing costs, sharing risk is also a common reason to form a joint venture. Again, this could be particularly relevant to capital-intensive industries, or industries where high costs of product development increase the risk of product failure.

   A joint venture can reduce the **risk of government intervention** if a local firm is involved. In a number of countries, joint ventures with host governments or state-owned enterprises have also become increasingly important.

   (iii) Participating enterprises **benefit from all sources of profit**.

   (iv) **Close control** over marketing and other operations.

   (v) Overseas joint ventures provide **local knowledge, quickly**.

   (vi) **Synergies**. One firm's production expertise can be supplemented by the other's marketing and distribution facility.

   Note that joint ventures are one of two kinds of **joint arrangement** as defined in IFRS 11 *Joint Arrangements* (see Section 2.8.2); the other being the looser arrangements known as joint operations.

(c) A **licensing agreement** is a commercial contract whereby the licenser gives something of value to the licensee in exchange for certain performances and payments.

   (i) The licenser may provide rights to produce a patented product or to use a patented process or trademark as well as advice and assistance on marketing and technical issues.

   (ii) The licenser receives a **royalty**.

(d) **Subcontracting** is also a type of alliance. Co-operative arrangements also feature in supply chain management, JIT and quality programmes.

2.8.1 Disadvantages of joint ventures

(a) **Conflicts of interest** between the different parties.

(b) **Disagreements** may arise over profit shares, amounts invested, the management of the joint venture, and the marketing strategy.

(c) One partner may wish to **withdraw** from the arrangement.

(d) There may be a temptation to neglect **core competences**. Acquisition of competences from partners may be possible, but alliances are unlikely to create new ones.

Case example: Owens-Illinois

In May 2010, the US glass packaging manufacturer Owens-Illinois Inc. announced that it was teaming up with a Thai company to buy four plants in China and Southeast Asia that make beverage and food containers.

The joint venture of Owens-Illinois and Thailand's Berli Jucker Public Co. signed a deal to buy Faser & Neave Holdings' Malaya Glass plants in Sichuan Province, China; Saraburi Province, Thailand; Johor Bahru, Malaysia and Ho Chi Minh City, Vietnam.

The plants make containers for the beer, non-alcoholic beverage and food markets, and employ about 1,900 people.

The joint venture involved buying the plants for $221.7 million, according to a news release. Owens-Illinois were liable for $132.4 million of the total.

The plants in Malaysia and Vietnam would be operated by a joint venture owned 50 per cent by Owens-Illinois and 50 percent by Berli Jucker. The acquired interest in the Chinese plant would be managed as part of Owens-Illinois' existing China operations. Berli Jucker would assume majority ownership of the Thai operation.

Owens-Illinois Chairman and CEO Al Strucken said the deal fitted his company's objective of seeking 'a leadership position in China and Southeast Asia.'

He said the plant in Sichuan would expand the presence of the company in China, while the joint venture would give it a competitive position in the growing markets of Vietnam and Malaysia.

2.8.2 Accounting for joint arrangements

The terms of the contractual arrangement between parties to a joint arrangement are key to deciding whether the arrangement is a joint venture or a joint operation.

IFRS 11, *Joint arrangements*, details the issues that should be considered when determining the appropriate treatment.

Definitions

Joint operation: A joint arrangement whereby the parties that have joint control of the arrangement have rights to the assets and obligations for the liabilities relating to the arrangement.

Joint venture: A joint arrangement whereby the parties that have joint control of the arrangement have rights to the net assets of the arrangement.

Joint control: The contractually agreed sharing of control of an arrangement, which exists only when decisions about the relevant activities require the unanimous consent of the parties sharing control.

(*IFRS 11*)

IFRS 11 requires that a joint operator recognises line-by-line in its own financial statements the following in relation to its interest in a **joint operation**:

- Its assets, including its share of any jointly held assets
- Its liabilities, including its share of any jointly incurred liabilities

- Its revenue from the sale of its share of the output arising from the joint operation
- Its share of the revenue from the sale of the output by the joint operation, and
- Its expenses, including its share of any expenses incurred jointly.

However, for a **joint venture**, IFRS 11 requires that a joint venturer recognises its interest in a joint venture as an investment in its consolidated financial statements, and accounts for that investment using the equity method in accordance with IAS 28, *Investments in Associates and Joint Ventures*.

2.9 Franchising

Franchising is a method of expanding the business on less capital than would otherwise be possible, because **franchisees** not only pay a capital lump sum to the franchiser to enter the franchise, but they also bear some of the running costs of the new outlets. For suitable businesses, it is an **alternative business strategy to raising extra capital** for growth. Probably the most well-known franchisers are McDonalds, but other franchisers include Dyno-Rod, Express Dairy, Holiday Inn, Kall-Kwik Printing, Kentucky Fried Chicken, Sketchley Cleaners and Body Shop.

The franchiser and franchisee each provide different inputs to the business.

(a) The **franchiser**

  (i) Name, and any goodwill associated with it

  (ii) Systems and business methods, business strategy and managerial know-how

  (iii) Support services, such as advertising, training, research and development, and help with site decoration

(b) The **franchisee**

  (i) Capital, personal involvement and local market knowledge
  (ii) Payment to the franchiser for rights and for support services
  (iii) Responsibility for the day-to-day running, and the ultimate profitability of the franchise

Case example: McDonalds

In its Annual Report for 2012, McDonald's states: 'We view ourselves primarily as a franchisor and believe that franchising is important to delivering great, locally-relevant customer experiences and driving profitability.'

However, although the majority of McDonald's restaurants are franchised, around 20% are operated by the company. (At the 2012 year-end, there were 34,480 restaurants in total; 27,882 were franchised or licensed, and 6,598 were operated by the company itself.)

In the Annual Report, McDonald's management note that:

> *Directly operating restaurants is paramount to being a credible franchisor and is essential to providing Company personnel with restaurant experience. In our Company-operated restaurants, and in collaboration with franchisees, we further develop and refine operating standards, marketing concepts and product and pricing strategies, so that only those that we believe are most beneficial are introduced in the restaurants.*

McDonald's business model also enables it to deliver locally-relevant restaurant experiences to its customers, within the context of being a global business.

In this regard, the Annual Report also stresses the importance of the alignment between McDonald's, its franchisees and its suppliers in achieving success, which highlights the importance of supply chain management in the health of the business. (We will look at supply chain management in more detail in Chapter 3 of this Study Manual.)

More generally, the business 'Outlook for 2013' section in the Annual Report also provides an illustration of the way the Ansoff matrix can be applied in practice. (Think about how McDonald's strategy described below could be classified in relation to the matrix):

> *We anticipate a continued flat to declining informal eating out (IEO) segment in many of the markets where we operated. Growing market share will remain our focus to attain sustainable and profitable long-term growth.*

McDonald's aims to highlight promotions of its core menu favourites, while strategically expanding its menu with relevant new offerings across all parts of the day, including premium products that can deliver higher average revenue per product sold. For example, it will look to introduce existing products like wraps and blended ice beverages into new markets, and offer more of the unique flavour-based promotional food events which have been successful so far.

McDonald's also aims to emphasise the day parts – like breakfast and extended evening opening hours – which are still growing globally in both established and emerging markets.

Alongside this, the company aims to make its products more accessible to customers through new restaurant openings, extended opening hours, and faster, more accurate service through innovative order taking.

2.9.1 Advantages of franchising

(a) **Reduces capital requirements**. Firms often franchise because they cannot readily raise the capital required to set up company-owned stores. John Y. Brown, the former president of Kentucky Fried Chicken, maintained that it would have cost KFC $450 million to establish its first 2,700 stores if it had run them as company-owned stores, and this was a sum that was not available to the corporation in the early stages of its life.

(b) **Reduces managerial resources required**. A firm may be able to raise the capital required for growth, but it may lack the managerial resources required to set up a network of company-owned stores. Recruiting and training managers and staff accounts for a significant percentage of the cost of growth of a firm. Under a franchise agreement, the franchisees supply the staff required for the day-to-day running of the operation.

(c) **Improves return on promotional expenditure through speed of growth**. A retail firm's brand and brand image are crucial to the success of its stores. Companies often develop their brand through extensive advertising and promotion, but this only translates into sales if they have a number of stores that customers can visit after seeing their advertisements.

As franchising provides quicker access to capital and managerial resources, a firm can expand more quickly through franchising than through opening new company-owned stores. Faster expansion through franchising, in turn, should allow companies to achieve a favourable return on their promotional campaigns.

(d) **Benefits of specialisation**. As the franchisee and the franchiser both contribute different resources to the franchise, franchising provides an effective way of reducing costs: each party concentrates on their core areas, and increases their efficiency in those areas. For example, in the fast-food business, product development and national promotion are more efficiently handled on a large scale (by the franchiser), whereas the production of food itself is handled better on a relatively smaller scale (by the franchisee).

(e) **Low head office costs**. The franchiser only needs a small number of head office staff because there is a considerable delegation of operational responsibility to the franchisees. For example, in the fast-food business, the franchisees provide the staff who work in the restaurants, and so the franchisees incur the HR and payroll costs associated with that.

2.9.2 Disadvantages of franchising

(a) **Profits are shared**. The franchisee receives the revenue from the customer at the point of sale and then pays the franchiser a share of the profits.

(b) The **search for competent candidates** is both costly and time consuming where the franchiser requires many outlets (eg McDonald's in the UK).

(c) **Control** over franchisees. (McDonald's franchisees in New York recently refused to co-operate in a marketing campaign.)

(d) **Risk to reputation**. A franchisee can damage the public perception of a brand by providing inferior goods or services.

(e) **Potential for conflict**. There may be disagreement over the respective rights and obligations of the franchiser and franchisee, for example over the level of support to be provided or the fees payable.

2.10 Alliances

An alliance is a slightly looser form of collaboration. It will involve a detailed legal agreement setting out how firms will work together. Typically, alliances can be formed between industry rivals in order to reduce the competitive forces that they face, such as the Star Alliance of 27 airlines. In terms of airline alliances, the major benefit is 'code sharing' whereby two or more members are able to book customers onto the same flight, leading to cost sharing and a rationalisation of fleet sizes. A major problem with forming alliances is overcoming regulatory resistance, as such agreements are often viewed as anti-competitive because they typically reduce customer choice.

2.11 Potential use of assurance reports

In either a joint venture or a franchise arrangement, profits have to be shared between the various parties. In this respect, it could be valuable for the parties to have assurance that profits have been calculated correctly.

The *Assurance Sourcebook* (produced by ICAEW) suggests the following mini-scenario where assurance would be valuable:

> *The criteria which define the split of profits in a joint venture are defined in the joint venture agreement but the profit allocation needs clarification with the two parties. Both parties want assurance that the profit allocation has been calculated properly and in accordance with the agreement.*

A second illustration from the sourcebook highlights a scenario which could apply to a franchise or a licensed operation:

> *The management agreement made between hotel owners and operators includes a requirement for specific assurance over the reporting of management fee calculations. The hotel owners could benefit from an assurance report which verifies the way figures are extracted for use in the management fee calculation, and then also confirms that the calculation of the management fee is in accordance with the terms of the management contract.*

3 Strategic decision-making

Section overview

- In a sense, generating strategies is relatively easy, as a combination of applying models including Porter and Ansoff, allied with mimicking the successful strategies of your rivals will typically yield numerous potential ploys. At this point the available options will need to be narrowed down in a systematic and objective way as an organisation will not have the resources to pursue all possible actions simultaneously.

Once an organisation has identified its current strategic position, and the different potential strategic options available to it, it then it has to choose which of these options it wants to pursue.

The rational model of strategic planning suggests that individual strategies have to be evaluated against a number of criteria before a strategy or a mix of strategies is chosen. Johnson *et al* in *Exploring Strategy*, narrow these criteria down to three: **suitability**, **acceptability** and **feasibility**.

Suitability differs from acceptability and feasibility in that little can be done with an unsuitable strategy. However, it may be possible to adjust the factors that suggest a strategy is not acceptable or not feasible. Therefore, **suitability should be assessed first**.

3.1 Suitability

Suitability relates to the **strategic logic** of the strategy. The strategy must fit the company's operational circumstances. Will the strategy:

- **Exploit** company strengths and distinctive **competences**?
- Rectify company **weaknesses**?
- **Neutralise** or deflect environmental **threats**?

- Help the firm to seize **opportunities**?
- **Satisfy the goals** of the organisation? (And, at a more general level, does it fit with the company's mission and objectives?)
- **Fill the gap** identified by gap analysis?
- Generate/maintain **competitive advantage**?
- Involve an acceptable level of **risk**?
- Suit the **politics** and corporate **culture**?

An organisation should also consider two overall important strategic issues when assessing the suitability of an option:

- Does it **fit with any existing strategies** that the company is already employing, and which it wants to continue to employ?
- How well will the option actually address the company's strategic issues and **priorities**?

A number of the models which we have looked at in Chapters 1 and 2 of this Study Manual could be useful for assessing the suitability of a strategy:

Porter's generic strategies – For example, if an organisation is currently employing a cost leadership strategy and the basis of a proposed strategy is differentiation, this might not be suitable.

Value chain – Similar issues could be identified in relation to the activities in the organisation's value chain: will the activities required for the proposed strategy 'fit' with the nature of the activities in the organisation's current value chain?

BCG matrix – How will any new products or business units fit with the existing ones in an organisation's portfolio? Will they improve the balance of the portfolio?

Ansoff's matrix – Is the choice of product-market strategy suitable? For example, in order for a market development strategy to be suitable, there have to be unsaturated markets available which the organisation could move into. At the same time, the organisation's product or service has to be more attractive to customers than any existing competitor offerings so that the customers in the new market will want to switch to the organisation's product.

3.2 Acceptability (to stakeholders)

The acceptability of a strategy relates to people's expectations of it. It is here that stakeholder analysis can be brought in.

(a) **Financial considerations**. Strategies will be evaluated by considering how far they contribute to meeting the dominant objective of increasing **shareholder wealth**.

  (i) Return on investment
  (ii) Profits
  (iii) Growth
  (iv) EPS
  (v) Cash flow
  (vi) Price/Earnings
  (vii) Market capitalisation

(b) **Customers**. Will the strategy give customers something they want? How will customers react to the strategy? Customers may object to a strategy if it means reducing service or raising price, but on the other hand, they may have no choice but to accept the changes.

(c) **Management** have to implement the strategy via their staff.

(d) **Staff** have to be committed to the strategy for it to be successful. If staff are unhappy with the strategy, they could leave.

(e) **Suppliers** have to be willing and able to meet the input requirements of the strategy.

(f) **Banks** are interested in the implications for cash resources, debt levels etc.

(g) **Government**. A strategy involving a takeover may be prohibited under monopolies and mergers legislation. Similarly, the environmental impact may cause key stakeholders to withhold consent.

(h) **The public**. The environmental impact may cause key local stakeholders to protest. Will there be any pressure groups who oppose the strategy?

(i) **Risk**. Different shareholders have different attitudes to risk. A strategy that changed the risk/return profile, for whatever reason, may not be acceptable.

3.3 Feasibility

Feasibility asks whether the strategy can, in fact, be implemented.

- Is there enough **money**?
- Is there the **ability** to deliver the goods/services specified in the strategy?
- Can we deal with the likely **responses that competitors** will make?
- Do we have access to **technology, materials and resources**?
- Do we have enough **time** to implement the strategy?

An evaluation of an organisation's resources or competences (akin to a resource audit) could also be useful for assessing feasibility. Does the organisation have the resources it needs to implement the strategy successfully?

Strategies that do not make use of the existing competences, and which therefore call for new competences to be acquired, might not be feasible.

- Gaining competences via organic growth takes time
- Acquiring new competences can be costly

Aspects of feasibility are very important in relation to strategic choice because they may restrict the choices that are available to an organisation. For example, if an organisation does not have the finance available to support an expansion plan, it will not be able to implement that expansion plan.

3.4 Sustainability

Some organisations may feel it is appropriate to consider the longer term prospects for a strategy under a separate heading of sustainability. This indicates that a firm should aim to adopt strategies that will deliver a long-term competitive advantage.

Importantly, when thinking about 'sustainability', organisations need to consider not only environmental sustainability, but also whether their business model is economically and socially sustainable.

We will look at these ideas of 'the triple bottom line' (of economic prosperity, environmental quality, and social equity) in more detail in Chapter 11 later in this Study Manual.

Interactive question 3: Evaluating strategic options [Difficulty level: Intermediate]

BBB is a biotechnology company which develops pharmaceutical drugs. It was founded seven years ago by three scientists when they left the university medical school, where they had been senior researchers. The Company employs 10 other scientists who joined from different universities. All of these employees are receiving relatively low salaries but participate in a share option scheme, such that when BBB is successfully floated on the stock exchange, they will receive shares in the company.

BBB currently has a number of new, innovative drugs in development, but the earliest any of these drugs might come to market is two years from now. It is expected that there would be one successful drug launched in most years after that for at least six years. However, successful drug launches are never guaranteed, due to the speculative nature of biotechnology and the long period of clinical trials through which any new drug must pass. BBB has to invest a significant amount of resources into the development of each potential drug, whether they are successfully launched or not. Currently, it has 12 drugs in development, a number of which may not make it to market. Due to the speculative nature of the industry, companies such as BBB are unable to obtain bank loans on commercial terms.

BBB is funded by an exclusive arrangement with a venture capital company. However, there is only sufficient cash in place to maintain the present level of activity for a further nine months. The venture capital company owns 15% of the equity of the company. The rest is owned by the three founders. It has always been the intention of the venture capital company and the founders that, once the company has a sufficient number of drugs in production and on the market, the company would be floated on the stock exchange. This is expected to happen in five years' time.

Recently, there have been a number of approaches to BB which might solve its cash flow problems. The three founders have identified the following options:

1 The venture capital company has suggested that it will guarantee the cash flow until the first drug is successfully launched in commercial quantities. However, it would expect its equity holding to rise to 60% once this offer is accepted.

2 A large pharmaceutical company has offered to buy BBB outright and retain the services of the three founders (in research roles) and a few of the staff.

3 Another biotechnology company has offered to enter into a merger with BBB. This company has also been established for seven years and has one drug which will be launched in six months. However, of the four other potential drugs it has in development, none are likely to be commercially viable for another five years. This company would expect the three founders to stay with the newly merged company but feels a rationalisation of the combined staff would be needed.

Requirement

Using the 'Suitability, Acceptability, Feasibility' framework, evaluate the strategic options identified by the founders.

See **Answer** at the end of this chapter.

4 Evaluating strategic options

Section overview

- Whilst the Suitability, Acceptability, Feasibility framework will provide guidance on what steps are involved in strategic choice, it does not necessarily guide on *how* to carry out the evaluation of the choices available. In particular, detailed analysis on the returns on investment opportunities, alongside an analysis of the risks will be of value.

4.1 Investment decisions

Under the heading of 'Acceptable', particular consideration will be paid to the returns available to shareholders. In the context of a profit seeking organisation such as a listed company the financial returns will be of paramount importance. The techniques used to assess the likely returns on investment will include:

(a) Net Present Value
(b) Internal Rate of Return
(c) Payback Period
(d) Return on Capital Employed
(e) Return on Investment
(f) Residual Income

If the organisation in question is a Non-profit making concern, such as a charity or government – owned institution, then Value for Money will be more relevant than the actual returns. Value for money is commonly assessed via the following criteria.

(a) **Economy** – Does the organisation operate within its financial budget? For governmental institutions access to external finance is often limited or prohibited, so the ability to operate within a fixed budget is vital.

(b) **Efficiency** – The limited inputs, such as working capital, plant and machinery and employees must be managed in a way that allows them to be processed into outputs in an efficient manner. To control processes measures of throughput must be developed, often through composite key performance indicators (KPIs). For instance, a hospital's efficiency can be measured through metrics such as 'operations per surgeon' or 'patients treated per bed'.

(c) **Effectiveness** – All operational strategies must support the overall organisational strategy, and this can be monitored through 'SMART' objectives. As an example, a hospital's effectiveness can be measured against centrally set government targets such as mortality rates or cancer survivorship rates.

4.2 Risk analysis

Definition

Risk: Risk refers to the quantifiable spread of possible outcomes.

All business opportunities will be exposed to risks of differing types and to differing degrees. When faced with competing investment opportunities, the degree of risk faced can be the deciding factor. This is because investors will want to be rewarded with a level of return that is commensurate with the degree of risk faced.

As such, when assessing financial acceptability, riskier opportunities must deliver proportionally higher returns. Some of the investment appraisal methods highlighted earlier can be adjusted to factor in some of the risks by using an appropriate discount factor as an investment hurdle. You will explore this in more detail in Chapter 17 in this Study Manual.

Worked example: Risk analysis

Consider the following investment opportunites:

Investment A guarantees to return CU100,000 in one year, on an initial investment of CU50,000.

Investment B will deliver either CU200,000 or CU0 on the same intial investment over the same period of time with equal probabilities.

Solution

Investment A delivers a net return of CU50,000 with a 100% certainty.

Investment B will deliver an actual net outcome or either CU150,000 or (CU50,000). Using probabilities of 50:50 the expected value outcome is CU50,000 [(CU150,000 × 0.5) + (CU50,000 × 0.5)].

We would conclude that although the expected value of Investment B is the same as the outcome for Investment A, it clearly presents a higher risk as there is a wide spread of possible outcomes with this option.

4.3 The importance of assurance and due diligence

The nature of strategic evaluation means that businesses have to make choices and take decisions about what course of action, or what strategy, to pursue. In order to take these decisions, businesses need adequate, relevant and reliable information.

However, in relation to key strategic choices (such as, whether or not a company should acquire another company) problems may arise when one party to a transaction has more, or better, information than the other party. In other words, there is information asymmetry.

This problem is exacerbated by the fact that frequently there is an incentive for the party with greater information to use their superior position to gain an unfair advantage in a transaction. For example, if an acquisition target presents an optimistic forecast of its level of future earnings, this could lead to the purchase price for the company (and therefore the sale proceeds earned by its shareholders) being greater than if a less optimistic forecast had been presented.

Although the company hoping to make the acquisition will be able to review the statutory audited financial statements of the target company, these may not be sufficient to narrow the information gap between the purchasers and vendors, because the financial statements are prepared for a different purpose.

A greater, and more specific, level of assurance may therefore be required for acquisitions, mergers, or joint ventures. The most common type of assurance in this context is a **report of due diligence**.

There are several different forms of due diligence, some of which are carried out by accountants and financial consultants, while other aspects require the expertise of other specialist skills.

Due diligence will attempt to achieve the following:

- Confirm the accuracy of the information and assumptions on which a bid is based.
- Provide the bidder with an independent assessment and review of the target business.
- Identify and quantify areas of commercial and financial risk.
- Give assurance to providers of finance.
- Place the bidder in a better position for determining the value of the target company.

The precise aims will, however, depend upon the types of due diligence being carried out. Due diligence could be financial, commercial or operational.

4.3.1 Financial due diligence

Financial due diligence is a review of the target company's **financial position, financial risk and projections**. However, it is not the same as a statutory audit: its purposes are more specific to an individual transaction and to particular user groups, and there is normally a specific focus on **risk and valuation**.

4.3.2 Commercial due diligence

Commercial due diligence complements financial due diligence by considering the target company's **markets and external economic environment**. The information used in commercial due diligence work may come from the target company and its business contacts, but it may also come from external information sources.

It is important that the people carrying out commercial due diligence have a **good understanding of the industry in which the target company operates**. In this respect, it may be appropriate for people other than accountants to carry out commercial due diligence work.

The information that is relevant to commercial due diligence is likely to include the following:

- Analysis of main competitors
- Marketing history/tactics
- Competitive advantages
- Analysis of resources
- Strengths and weaknesses
- Integration issues
- Supplier analysis
- Market growth expectations
- Ability to achieve forecasts
- Critical success factors
- Key performance indicators
- Exit potential
- Management appraisal
- Strategic evaluation

4.3.3 Operational due diligence

Operational due diligence considers the operational risks and possible improvements which can be made in a target company. In particular, it will:

- Validate vendor assumed operational improvements in projections
- Identify operational upsides that may increase the value of the deal

4.3.4 Technical due diligence

In many industries the potential for future profitability, and thus the value of the company, may be largely dependent upon developing **successful new technologies**.

A judgement therefore needs to be made as to whether any technological benefits that have been promised by the vendor are likely to be delivered. This is very common in a whole range of different industries, including electronics, IT, pharmaceuticals, engineering, biotechnology, and product development.

Such technological judgements are beyond the scope of accounting expertise, but nevertheless the credibility of technological assumptions may be vital to the valuation process. Reliance will thus need to be placed upon the **work of relevant experts**.

4.3.5 Information technology due diligence

IT due diligence assesses the suitability and risks arising from **IT factors** in the target company (for example, any issues surrounding IT security, or integrating IT systems post-acquisition). These risks are likely to be relevant to most companies, but have **particular significance** where the target company operates in the IT sector.

4.3.6 Legal due diligence

Legal issues arising on an acquisition are likely to be relevant to the following:

- **Valuation** of the target company – eg hidden liabilities, uncertain rights, onerous contractual obligations.
- The **acquisition process** – eg establishing the terms of the takeover (the investment agreement); contingent arrangements; financial restructuring; rights; duties and obligations of the various parties.
- The **new group** – eg new articles of association, rights of finance providers, restructuring.

Reliance will need to be placed on lawyers for this process.

Human resources due diligence

Protecting and developing the **rights and interests of human resources** may be key to a successful acquisition. There may also be associated **legal obligations** (for example, obligations under a pension scheme, or regulations which protect employees' terms and conditions of employment when a business is transferred from one owner to another).

4.3.7 Tax due diligence

Information will need to be provided to allow the potential purchaser to form an assessment of the **tax risks and benefits** associated with the company to be acquired. Purchasers will wish to assess the robustness of tax assets, and gain comfort about the position regarding potential liabilities (including a possible latent gain on disposal due to the low base cost).

Information relating to any **tax warranties** that the vendor might offer should also be made available with the due diligence report as part of the 'marketing' information. This should generally not form a part of the due diligence itself though.

5 International strategies

Section overview

- International expansion is a major undertaking and firms must critically assess their reasons for it, and be sure that they have the resources to manage it, before doing so. The decision about which overseas markets to enter should be based on an assessment of market attractiveness, competitive advantage, and risk.

5.1 Internationalisation

In the last half of the 20th century, and now into the 21st century, the volume of world trade has been increasing significantly. There have been several factors at work.

(a) **Reduced protectionism**. Historically, some countries tried to protect local producers by imposing tariffs or quotas on imported products. However, many countries are now members of trade associations (such as SAARC, EU, ASEAN, MERCOSUR[1]) that encourage international trade and restrict protection.

[1] EU: European Union; ASEAN: Association of South-East Asian nations (Brunei, Cambodia, Indonesia, Laos, Malaysia, Myanmar, Philippines, Singapore; Thailand & Vietnam); MERCOSUR: an economic and political agreement to promote free trade among Argentina, Bolivia, Brazil, Paraguay, Uruguay & Venezuela, with Chile, Colombia, Ecuador, Guyana, Peru & Surinam as associate members.

(b) **Export-led growth**. The success of this particular strategy has depended on the existence of open markets elsewhere. Japan, South Korea and the other Asian 'tiger' economies (eg Taiwan) have chosen this route.

(c) **Market convergence**. Transnational market segments have developed whose characteristics are more homogeneous than the different segments within a given geographic market. **Youth culture** is an important influence here.

(d) **Internet**. Customers and markets are no longer restricted by time or geographical limitations. As such, the internet makes it much easier for consumers to make purchases from suppliers in other countries.

Internationalisation has meant a proliferation of suppliers exporting to, or trading in, a wider variety of places. In many domestic markets, it is now likely that the same international companies will be competing with one another. However, the existence of global markets should not be taken for granted in terms of **all** products and services, or indeed in **all** territories.

(a) Some **services** are still subject to managed trade (for example, some countries prohibit firms from other countries from selling insurance). Trade in services has been liberalised under the auspices of the World Trade Organisation.

(b) **Immigration.** There is unlikely ever to be a global market for labour, given the disparity in skills between different countries and restrictions on immigration.

(c) The market for some goods is much more globalised than for others.

  (i) Upmarket luxury goods may not be required or afforded by people in developing nations.

  (ii) Some goods can be sold almost anywhere, but to limited degrees. Television sets are consumer durables in some countries, but still luxury or relatively expensive items in other ones.

  (iii) Other goods are needed almost everywhere. With oil a truly global industry exists in both production (eg North Sea, Venezuela, Russia, Azerbaijan, Gulf states) and consumption (any country using cars and buses, not to mention those with chemical industries based on oil).

5.2 Key decisions in international expansion

There are two fundamental approaches to internationalising production: cost or competence-led, and market-led.

Cost or competence-led location

In this approach, production decisions are taken on the basis of the technology to be adopted, the scale of production (how many units per year) and the inherent characteristics of the location.

Company choices are then determined by a desire to obtain the cheapest – or, rather, best value or most cost effective – place to obtain supplies. The **cost reduction opportunities** must be sufficient to overcome any cost and inconvenience incurred in subsequently transporting goods to market.

With regard to location, **labour** is a major factor in terms of its cost, quality, productivity and its flexibility. This helps to explain why many clothing companies now use (cheap) labour in South East Asian countries to manufacture garments which are subsequently exported for sale to Western Europe and America.

Market-led location

Alternatively, a company may choose to locate some of its production activities inside a particularly attractive market, in order to benefit from customer demand in that market.

Case example: Starwood Hotels and Resorts

Starwood Hotels and Resorts Worldwide (Starwood) is one the world's largest hotel chains, with brands in its portfolio including Sheraton, Le Meridien, and Westin Hotels & Resorts.

Starwood considers its hotels and resorts to be premier establishments with respect to desirability of location, size, facilities, physical condition, quality and variety of service offered in the markets in which they are located.

In its Annual Report for 2012, Starwood (a North American company) noted that it had significant international operations, which included 164 owned, managed or franchised hotels in Europe, 71 in Latin America, and 243 in the Asia Pacific region.

Importantly, the Report also noted that,

> Our growth strategy is heavily dependent upon growth in international markets. As of December 31, 2012, 85% of our pipeline represented growth outside North America. Further, 60% of our pipeline represents new properties in Asia Pacific, and 44% represents new growth in China alone. If our international expansion plans are unsuccessful, our financial results could be materially adversely affected.

This theme of growth, highlighted in the 2012 Annual Report, was reinforced in March 2013 when Starwood announced that the company intended to increase the number of hotels under operation and development in Latin America to 100 by the end of 2013.

The Co-President of Starwood Hotels and Resorts for the Americas Region, said,

> In the last five years, our footprint in Latin America has expanded considerably to fulfil the increasing demand in business and leisure travel that has resulted from rising wealth, global business and a digitally connected world. We believe that demand for travel will continue to increase in Latin America and to meet that demand, we aim to have 100 hotels…[in the region]…by the end of 2013.

Starwood's Vice-president of acquisitions and development for Latin America highlighted the scope for growth in the market:

> There is still a great deal of opportunity, in world-class travel destinations like Mexico and Costa Rica, under-hoteled markets such as Brazil, top performers like Chile and Peru, and foreign investment favourites such as Colombia and Panama. We believe that we are best positioned to capitalise on the many opportunities in the market, given the affinity to our brands and our know-how of the region where we've been present for more than 40 years.

International expansion is a major undertaking and firms must know their reasons for it, and be sure that they have the resources to manage it, both strategically and operationally. The decision about which overseas market to enter should be based upon assessment of **market attractiveness**, **competitive advantage**, and **risk**.

Firms must deal with three major issues:

- Whether to market abroad at all
- Which markets to enter
- The mode(s) of entry

If a firm is considering investing in new production facilities in a foreign country, the choice of which country to invest in is a key strategic decision. Porter's 'Diamond' (which was covered in the *Business Strategy* syllabus) is a useful model for analysing the factors which could make a country attractive (or not) as a place to invest for different industries.

The four factors in the 'Diamond' are:

- Factor conditions
- Related and supporting industries
- Firm strategy, structure, and rivalry
- Demand conditions

Remember, however, that the four factors of the 'Diamond' are inter-related. Competitive advantage in an industry rarely comes from a single factor.

5.2.1 Deciding whether to market abroad

Firms may be **pushed** into international expansion by domestic adversity, or **pulled** into it by attractive opportunities abroad. More specifically, some of the reasons firms expand overseas are the following, which can be classified as either **internal** or **external** factors.

(a) **Chance**. Firms may enter a particular country or countries by chance. A company executive may recognise an opportunity while on a foreign trip or the firm may receive chance orders or requests for information from potential foreign customers.

(b) **Life cycle**. Home sales may be in the mature or decline stages of the product life cycle. International expansion may allow sales growth, since products are often in different stages of the product life cycle in different countries. For example, if a product is at the mature stage of its life cycle in a firm's home market, it could be beneficial to expand into an emerging market where the product may be at the introductory or growth stages of the life cycle.

(c) **Competition**. Intense competition in an overcrowded domestic market sometimes induces firms to seek markets overseas where rivalry is less keen.

(d) **Reduce dependence**. Many companies wish to diversify away from an over-dependence on a single domestic market. Increased geographic diversification can help to **spread risk**.

(e) **Economies of scale**. Technological factors may be such that a large volume is needed either to cover the high costs of plant, equipment, R&D and personnel or to exploit a large potential for economies of scale and experience. For these reasons firms in the aviation, ethical drugs, computer and automobile industries are often obliged to enter multiple countries.

(f) **Cheaper sources of raw materials**. Access to cheaper raw materials, or cheaper labour, could be a source of competitive advantage for an organisation, particularly if it is pursuing a cost leadership strategy.

(g) **Financial opportunities**. Many firms are attracted by favourable opportunities such as:

- The development of lucrative emerging markets (such as India and China)
- Depreciation in their domestic currency values (increasing the value of exports)
- Corporate tax benefits offered by particular countries
- Lowering of import barriers or other restrictions (such as tariffs and quotas)

International expansion

Before getting involved in international expansion, the company must consider both strategic and tactical issues.

(a) **Strategic issues**

(i) Does the strategic decision fit with the company's overall mission and objectives? Or will 'going international' cause a mis-match between objectives on the one hand, and strategic and tactical decisions, on the other?

(ii) Will the operation make a positive contribution to shareholders' wealth?

(iii) Does the organisation have (or can it raise) the resources necessary to exploit effectively the opportunities overseas?

(b) **Tactical issues**

(i) How can the company get to understand customers' needs and preferences in foreign markets? Are the company's products appropriate to the target market?

(ii) The company's performance will reflect the local economic environment, as well as management's control of the business. So the company needs to understand the economic stability and prospects of the target country before investing in it.

(iii) Cultural issues. Does the company know how to conduct business abroad, and deal effectively with foreign nationals? For example, will there be language problems? Are there any local customs to be aware of?

(iv) Are there foreign regulations and associated hidden costs?

(v) Does the company have the necessary management skills and experience?

(vi) Have the foreign workers got the skills to do the work required? Will they be familiar with any technology used in production processes?

If you remember in Chapter 1 we distinguished between resources and competences, and such a distinction could also be useful here. A number of the 'issues' listed above relate to resources and skills, but perhaps a more important overall consideration for a firm is whether it has the **core competences** required in order to expand internationally.

Social responsibility

Before moving to a foreign country, an organisation should also consider whether there are any **corporate social responsibility** (CSR) implications of such an expansion. For example, if local labour laws allow workers to be employed for low wages and in poor working conditions, does the organisation take advantage of this, or does it treat its workers better than it has to? Similarly, if pollution laws are not very strict, does the organisation comply with the minimum requirements or does it build more environmentally friendly facilities than it has to?

In both cases, the socially responsible course of action may not be the one that maximises short-term profits. But the organisation needs to consider its reputation as a whole, and its CSR position as a whole. If it is seen to be exploiting workers in one country, this could damage its brand more widely.

For example, over 1,100 workers were killed when three clothing factories in Savar, Bangladesh collapsed following a fire in April 2013. The factories supplied clothes to a range of international brands, including Primark, Mango and C&A, and labour groups and trade unions internationally began calling for immediate action to improve the working conditions in factories to reduce the risk of further, similar accidents occurring.

The importance of considering the CSR implications of foreign expansion is reiterated by the increasing importance of social and environmental reporting in companies' annual reports. For example, in the UK, the Companies Act requires all listed companies to report on environmental and social issues, including issues down their supply chains.

As a result, the potential social or environmental issues associated with the foreign expansion could become, in their own right, a significant factor in a company's decision about whether to expand internationally, and about how or where to expand.

5.2.2 Deciding which markets to enter

In making a decision as to which market(s) to enter, the firm must start by establishing its objectives. Here are some examples.

(a) What proportion of total sales will be overseas?

(b) What are the longer term objectives?

(c) Will it enter one, a few, or many markets? In most cases, it is better to start by selling in countries with which there is some familiarity and then expand into other countries gradually as experience is gained. Reasons to enter fewer countries at first include the following:

- (i) Market entry and market control costs are high
- (ii) Product and market modification costs are high
- (iii) There is a large market and potential growth in the initial countries chosen
- (iv) Dominant competitors can establish high barriers to entry

(d) What types of country should it enter (in terms of environmental factors, economic development, language used, cultural similarities and so on)? Three major criteria should be as follows:

- (i) **Market attractiveness** – This concerns such indicators as GNP per head, forecast demand, and market accessibility.
- (ii) **Competitive advantage** – This could be dependent on prior experience in similar markets, language, and cultural understanding.
- (iii) **Risk** – This involves an analysis of political stability, the possibility of government intervention, and similar external influences.

The matrix below (based on a model developed by Philip Kotler) can be used to bring together these three major criteria and assist managers in their decisions.

Evaluating which markets to enter

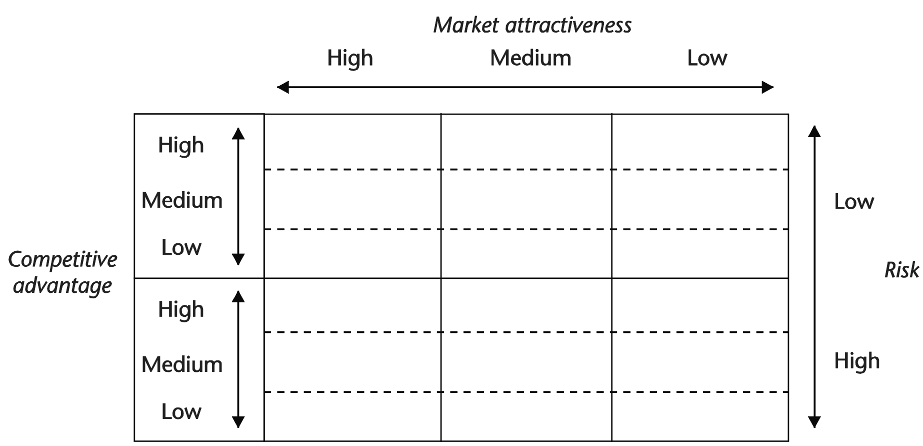


Figure 2.5: Kotler's market entry matrix

The best markets to enter are those located at the top left of the diagram. The worst are those in the bottom right corner. Obtaining the information needed to reach this decision requires detailed and often costly international marketing research and analysis. Making these decisions is not easy, and a fairly elaborate screening process will be instituted.

In international business there are several categories of risk.

(a) **Political risk** relates to factors as diverse as wars, nationalisation, arguments between governments etc.

(b) **Business risk.** This arises from the possibility that the business idea itself might be flawed. As with political risk, it is not unique to international marketing, but firms might be exposed to more sources of risk arising from failures to understand the market.

(c) **Currency risk.** This arises out of the volatility of foreign exchange rates. Given that there is a possibility for speculation and that capital flows are free, such risks are increasing.

(d) **Profit repatriation risk.** Government actions may make it hard to repatriate profits.

Market analysis

Firms need to analyse different markets before deciding which ones to enter. The following questions should be considered within such analysis:

- **Submarkets** – What submarkets are there within the market; defined by different price points, or niches for example?
- **Size and growth** – What are the size and growth characteristics of the market and submarkets within it? What are the driving forces behind trends in sales? What are the major trends in the market?
- **Profitability** – How profitable is the market and its submarkets now, and how profitable are they likely to be in the future? How intense is the competition between existing firms? How severe are the threats from potential new entrants of substitute products? What is the bargaining power of suppliers and customers?
- **Cost structure** – What are the major cost components for various types of competitor, and how do they add value for customers?
- **Distribution channels** – What distribution channels are currently available? How are they changing?
- **Key success factors** – What are the key success factors, assets and competences needed to compete successfully? How are these likely to change in the future? Can the organisation neutralise competitors' assets and competences?

5.2.3 Choosing modes of entry

The most suitable mode of entry varies:

(a) **Among firms in the same industry** (eg a new exporter as opposed to a long-established exporter)

(b) **According to the market** (eg some countries limit imports to protect domestic manufacturers, whereas others promote free trade)

(c) **Over time** (eg as some countries become more, or less, hostile to direct inward investment by foreign companies)

A large number of considerations apply.

Consideration	Comment
The firm's marketing objectives	These relate to volume, time scale and coverage of market segments. Thus, setting up an overseas production facility would be inappropriate if sales are expected to be low in volume.
The firm's size	A small firm is less likely than a large one to possess sufficient resources to set up and run a production facility overseas.
Mode availability	Some countries only allow a restricted level of imports, but will welcome a firm if it builds manufacturing facilities that provide jobs and limit the outflow of foreign exchange.

Consideration	Comment
Mode quality	All modes may be possible in theory, but some are of questionable quality or practicality. The lack of suitably qualified distributors or agents would preclude the export, direct or indirect, of high technology goods needing installation, maintenance and servicing by personnel with specialist technical skills.
Human resources requirements	When a firm is unable to recruit suitable staff, either at home or overseas, indirect exporting or the use of agents based overseas may be the only realistic option.
Market feedback information	In some cases, a firm can receive feedback information about the market and its marketing effort from its sales staff or distribution channels. In these circumstances, direct export or joint ventures may be preferred to indirect export.
Risks	Firms might prefer the indirect export mode as assets are safer from expropriation.

The specific modes of market entry are considered in the next section.

Case example: Tesco and the Indian grocery market

In August 2008, Tesco, the UK's largest food retail chain, announced its long-awaited entry into India's retail market, through a wholesale business and a tie-up with one of the country's largest conglomerates – the Tata group.

The UK supermarket group planned to invest £60m ($114m) in the first two years in the cash-and-carry outlets, which would initially be in Mumbai and offer fresh food, grocery and non-food products to small retailers.

Tesco also entered a franchise agreement to help Trent, a retail arm of the Tata group, develop its Star Bazaar hypermarket business, which it was planning to grow from the four outlets it currently had to 50 in five years.

Tesco's CEO at the time, Sir Terry Leahy said, 'The move complements our entries into China and the United States, giving us access to another of the most important economies in the world.'

Analysts believed that by linking with the Tata group, Tesco had secured one of the strongest partners available in India. Tata brought an existing retail capability and strong local knowledge of the Indian market (they are currently the most profitable retailer in India) while Tesco offered its expertise in developing infrastructure and supply chain capabilities (which historically constrained Indian retailing).

Tesco had been looking at entering the Indian market for a number of years, and it was not the only foreign retailer to want to do so. In 2007, the world's largest retailer (Walmart) had linked up with another Indian group, Bharti Enterprises, to offer similar services.

India is one of the world's fastest growing and largest retail markets. It is estimated to be growing at at least 8 per cent per year, and had sales of around $400bn per year (2008). However, it remains one of the most difficult for overseas operators because of a number of restrictions on foreign ownership in this politically sensitive sector. The vast majority of the retail market is controlled by the informal sector – comprising the country's estimated 12m–15m corner shop owners as well as hawkers and other small vendors, who form a powerful political lobby.

To protect these smaller operators, the government has historically only allowed 100 per cent ownership of retail stores for 'single brand' foreign retailers, those such as Gucci, which only sell products under their own name. 'Multi-brand' retailers, such as Tesco, Walmart and Carrefour, have not been allowed to sell directly to customers in retail stores. However, they can run wholesale operations and provide infrastructure support to local companies, as Tesco is doing with Tata.

Tesco said under the deal with Trent, it would receive a fee for offering its retail experience and technical capabilities to support the Tata unit's hypermarket roll-out plan.

'Tesco's wholesale business will supply merchandise to Star Bazaar, enabling the two companies to benefit from the rapid development of a modern supply chain,' the companies said.

The Indian authorities have been debating for a number of years whether or not to relax the foreign direct investment regulations to allow multi-brand retailers to open their own retail stores in India and sell directly to customers. An agreement was finally reached in September 2012 to permit such investment.

The fact that Tesco already has a wholesale business in India to build on, and the experience they have gained from their association with Tata, should put them in a good position to take advantage of the opportunities provided by the change in regulation.

Based on article, 'Tesco breaks into Indian grocery market', *Financial Times*, August 12, 2008. www.ft.com

5.3 Market entry modes

Exporting

Goods are made at home but sold abroad. It is the easiest, cheapest and most commonly used route into a new foreign market.

5.3.1 Advantages of exporting

(a) Exporters can **concentrate production** in a single location, giving **economies of scale** and **consistency of product quality**.

(b) Firms lacking experience can try international marketing on a **small scale**.

(c) Firms can **test** their international marketing plans and strategies before risking investment in overseas operations.

(d) Exporting **minimises operating costs**, administrative overheads and personnel requirements.

5.3.2 Indirect exports

Indirect exporting is where a firm's goods are sold abroad by other organisations who can offer greater market knowledge.

(a) **Export (buying) houses** are firms that facilitate exporting on behalf of the producer. Usually the producer has little control over the market and the marketing effort.

(b) **Specialist export management firms** perform the same functions as an in-house export department but are normally remunerated by way of commission.

(c) **Buying offices of foreign stores and governments**.

(d) **Complementary exporting** ('piggy back exporting') occurs when one producing organisation (the carrier) uses its own established international marketing channels to market (either as distributor, or agent or merchant) the products of another producer (the rider) as well as its own.

5.3.3 Direct exports

Direct exporting occurs where the producing organisation itself performs the export tasks rather than using an intermediary. Sales are made directly to customers overseas who may be the wholesalers, retailers or final users.

(a) **Sales to final user**. Typical customers include industrial users, governments or mail order customers.

(b) Strictly speaking an **overseas export agent** or distributor is an overseas firm hired to effect a sales contract between the principal (ie the exporter) and a customer. Agents do not take title to goods; they earn a commission (or profit).

(c) **Company branch offices abroad**. A firm can establish its own office in a foreign market for the purpose of marketing and distribution, as this gives greater control.

A firm can manufacture its products overseas, either by itself or by using an overseas manufacturer.

5.3.4 Overseas production

Benefits of overseas manufacture

- A **better understanding of customers** in the overseas market.
- **Economies of scale** in large markets.
- **Production costs are lower** in some countries than at home.

- **Lower storage and transportation costs**.
- **Overcomes the effects of tariff and non-tariff barriers**.
- Manufacture in the overseas market **may help win orders from the public sector**.

5.3.5 Contract manufacture

Licensing is a quite common arrangement as it avoids the cost and problems of setting up overseas.

In the case of **contract manufacture** a firm (the contractor) makes a contract with another firm (the contractee) abroad whereby the contractee manufactures or assembles a product on behalf of the contractor. Contract manufacture is suited to **countries** where the **small size of the market** discourages investment in plants; and to **firms** whose main **strengths are in marketing,** rather than production.

Advantages of contract manufacture

- No need to invest in plants overseas
- Lower risks associated with currency fluctuations
- Risk of asset expropriation is minimised
- Control of marketing is retained by the contractor
- Lower transport costs and, sometimes, lower production costs

Disadvantages of contract manufacture

- Suitable overseas producers cannot always be easily identified
- The need to train the contractee producer's personnel
- The contractee producer may eventually become a competitor
- Quality control problems in manufacturing may arise

5.3.6 Wholly owned overseas production

Production capacity can be built from scratch, or, alternatively, an existing firm can be acquired.

(a) **Acquisition** has all the benefits and drawbacks of acquiring a domestic company.

(b) **Creating new capacity** can be beneficial if there are no likely candidates for takeover, or if acquisition is prohibited by the government.

Advantages

(a) The firm does **not have to share its profits** with partners of any kind.
(b) The firm does **not have to share or delegate decision-making**.
(c) There are **none of the communication problems** that arise in joint ventures.
(d) The firm is able to operate completely **integrated** international systems.
(e) The firm gains a more **varied experience** from overseas production.

Disadvantages

(a) The **investment** needed prevents some firms from setting up operations overseas.

(b) Suitable **managers** may be **difficult to recruit** at home or abroad.

(c) Some overseas **governments discourage**, and sometimes prohibit, **100% ownership** of an enterprise by a foreign company.

(d) This mode of entry **forgoes the benefits of an overseas partner's market knowledge**, distribution system and other local expertise.

5.3.7 Outsourcing and Off-shoring

Although outsourcing or off-shoring are not primarily growth strategies, they are business strategies that could relate to an organisation relocating some of its activities. A number of companies in developed countries have outsourced some of their operations to foreign countries where they can be performed more cheaply.

Outsourcing is the contracting out of specified operations or services to an external provider.

By removing some of an organisation's work, outsourcing allows an organisation to devote more time to the activities which it continues to perform in-house. Generally speaking, outsourcing is appropriate for peripheral activities, meaning an organisation has more time to concentrate on its core activities and competences.

A further advantage of outsourcing is that external suppliers may capture economies of scale and experience effects. This allows them to provide the function being outsourced at a lower cost than if the organisation had retained it in house.

Getting the best out of outsourcing depends on **successful relationship management**, rather than through the use of formal control systems.

Outsourcing of non-core activities is widely acknowledged as having the potential to achieve important cost savings.

Advantages

(a) Can save on costs by making use of a specialist provider's **economies of scale**

(b) Can **increase effectiveness** where the supplier deploys higher levels of expertise (eg in software development)

(c) Allows the organisation to focus on its own **core activities**/competences

(d) Can deliver benefits and change more quickly than business process reorganisation in-house

(e) Service level agreements mean that the company knows the level of service they can expect

Disadvantages

(a) There may be problems finding a single supplier who can manage complex processes in full. If more than one supplier has to be used for a single process, then the economies of scale are likely to be reduced.

(b) Firms may be **unwilling to outsource whole processes** due to the significance of those processes or the confidentiality of certain aspects of them. (This could be a particular problem if the contractor company is also working for competitors.) Again, if processes are fragmented in this way, the economies of scale may be reduced.

(c) Outsourcing can lead to **loss of control**, particularly in relation to **quality issues**. This occurs when agreed service levels are not met. The firm that is outsourcing activities now has to develop competences in relationship management (with the outsourced suppliers) in place of its competences in the processes it has outsourced.

(d) Firms may be tied to **inflexible, long term contracts**.

(e) If there are specialist skills involved in the work, it may be difficult to switch to a new supplier if there are problems, or at the end of a contract period. This gives the external contractor significant bargaining power.

The outsourcing decision needs to be treated with care. The advantages it delivers will largely be seen in the short-term, but there could be longer-term disadvantages in relation to loss of control, quality or knowledge. Therefore, both the short-term and longer-term implications need to be considered before an organisation chooses to outsource.

5.3.8 Strategic alliances

Alliances were discussed in Section 2.10 of this chapter, and the nature of alliances lends itself to cross-border cooperation.

5.3.9 Joint ventures

Some governments discourage, or even prohibit, foreign firms setting up independent trading companies, and as such a joint venture with a domestic company may be the only route available.

We looked at joint ventures at Section 2.8 earlier in the chapter, but should note here that **international joint ventures** are a popular way for companies to enter new markets. Joint ventures allow companies to gain access to a partner's resources, including markets, capital, technologies and people.

International joint ventures can be a practical way for multinational companies to enter new markets, while the performance of local companies can also be enhanced by working with multinational partners (for example, as a result of knowledge transfer or technology transfer from the multinational partners).

Forming a joint venture (with the right partner) can be an effective way of achieving access to efficient and effective distribution channels and established customer bases.

While partnering with a local firm may be attractive to a foreign company if it doesn't have experience in such a market, in some cases establishing a joint venture may be necessary if there are barriers to foreign-owned or foreign-controlled companies in a country.

Case example: Joint ventures in China

In September 2012, the French resort operator Club Méditerranée announced in was negotiating with a Chinese developer to form a joint venture to build its third luxury resort on Hainan Island.

Club Med's chief executive said that the company hoped to open five new resorts in mainland China by 2015, by which time the company expected China to have become its second-biggest market.

In 2010, Club Med opened a ski resort in Yabuli, and it also has a second, beach resort at Guilin. The chief executive did not disclose the cost of Club Med's investment in China to date, but he said that developing a ski resort in Europe involved an investment of around €80 million, while a beach resort would typically cost around €60 million.

Club Med's business model involves seeking partnerships with local developers as a way to expand its portfolio worldwide. As the chief executive explained 'Leveraging on our brand as global resort, we take responsibility for sales and marketing, while our joint venture partner will finance the construction of the resort.' The resort at Guilin is a joint venture with a Taiwanese partner, while the Yabuli project involves a mainland Chinese partner.

In the six months to April 2012, there were 30,000 customers from China to Club Med resorts worldwide, an increase of 31% from the same period a year earlier. The increase in revenue from Chinese visitors increased a similar amount (up 33%) to just under €19 million for the same six month period.

Visitors from Brazil, Russia, India and China now account for around 20% of the Club Med group's customers, and the chief executive said the group would continue to target visitors from these countries in the light of depressed economic growth in the euro zone (Europe).

Based on: Li. S, (2012) 'Club Med in talks for third Hainan luxury resort.' *South China Morning Post*, 3 September 2012

However, not all joint ventures in China have been successful. Faced with a geographically vast but promising market, and obscured by a number of complex and contradictory rules, many foreign firms have entered China via joint ventures.

In theory, the case for joint ventures was compelling. The foreign partner provided capital, knowledge, access to international markets, and jobs. The Chinese partner provided access to cheap labour, local regulatory knowledge and access to what had previously been a relatively unimportant domestic market. The Chinese government protected swathes of the economy from acquisitions, but provided land, tax breaks and appeared to welcome investment.

However, in practice many of the arrangements have collapsed. There appear to have been three main reasons for this: (i) Chinese companies have been happy to receive money and technology, but did not want to be mere accessories to foreign firms; in many cases they had large-scale ambitions of their own; (ii) The allocation of profits and investments between the parties was unclear, leading to frequent disputes; and (iii) China itself has changed in recent years. Its hunger for foreign investors has been satisfied as domestic capital has become more abundant.

Danone & Wahaha

The French food giant, Danone, is one company whose investment in China turned irrevocably sour.

Danone acquired a 51% stake in the Chinese firm Wahaha Beverage in 1996, with its Chinese partner retaining the other 49%. Funding received from Danone also enabled Wahaha to invest in advanced production facilities, so that it was able to increase its output significantly after 1996.

Wahaha is one of China's best-known brands of bottled water and drinks, but the joint venture deal saw the Hangzhou Wahaha Group transfer the Wahaha brand to a Danone joint venture: Hangzhou Wahaha Food. Under the terms of the deal, Wahaha was prohibited from making (and selling) products which competed with Danone's range.

When the joint venture was formed, the Wahaha Group's only contribution to it was its ownership of the Wahaha trademark. It was given a 49% interest in the JV in exchange for the JV having exclusive use of the trademark.

When Danone made its investment, Wahaha – which claimed still to have relatively little experience of 'business' – welcomed the opportunity to have a partner.

Although Danone was the majority shareholder in the venture, and maintained a majority interest on the board of directors, the day-to-day management of the joint venture was delegated to the chairman of the Wahaha Group, Mr Zong.

Mr Zong ran the joint venture as if it was his own personal company (even appointing his wife and daughter to management positions), but under his management, the JV became very successful; gaining about 15% market share of the very large Chinese market for bottled water and beverages.

However, once Mr Zong and Wahaha became alive to the opportunities open to it, they took objection to the fact they had to agree any plans or growth strategies with a foreign majority owner. From around 2000, Wahaha began to create and operate separate subsidiaries selling Wahaha-branded drinks, competing directly with the joint venture, and therefore in violation of the joint venture agreement.

Danone and Wahaha subsequently became embroiled in a lengthy legal dispute which ended in September 2009 when Danone agreed to sell its interests in the joint venture.

Commentators now point to the failed relationship between Danone and Wahaha as an example of the tensions that arise as Chinese joint venture partners gain confidence and marketing prowess.

Based on and updated from: *The Economist* (2007) Wahaha-haha! The lessons from Danone and HSBC's troubled partnerships in China, 19 April.

5.4 International value chain

One of the key developments in the modern business world has been the internationalisation (or globalisation) of business markets and supply chains.

The global supply chain presents opportunities and threats for organisations.

Lower cost inputs – Gaining access to low-cost products made abroad represents an opportunity for companies based in developed countries to lower their input costs.

On the other hand, for organisations that fail to utilise low-cost foreign suppliers, the existence of these suppliers could represent a threat, which puts them at a competitive disadvantage.

The purchasing activities of large companies have become increasingly complicated as a result of different countries around the world developing different skills and competences. It is in the best interests of companies to search out the lowest-cost, highest-quality suppliers, wherever they may be. Moreover, the internet and global communications make it possible for companies to co-ordinate complicated multinational sales or purchases.

One commonly exploited opportunity for Western companies is **global outsourcing**.

Definition

Global outsourcing: The purchase of inputs from foreign suppliers or the production of inputs in foreign countries to lower production costs or to improve product design and quality.

Case example: Dyson moves production to Malaysia

In 2003, the entrepreneur James Dyson became embroiled in a row over exporting jobs after he announced plans to switch the production of washing machines from his base at Malmesbury, Wiltshire in the UK, to Malaysia, with the loss of 65 jobs.

The decision meant the end of manufacturing in Britain for Dyson, because the company had also switched production of vacuum cleaners to Malaysia a year earlier, with the loss of 800 jobs. At the time, production costs in Malaysia were 30% lower than in Malmesbury.

Unions reacted furiously to the announcement of the job cuts, but there was a more restrained response from the Trade Department (now the Department of Business, Innovation and Skills), where regret at the job losses was mixed with praise for Mr Dyson's contribution to innovation.

The joint general secretaries of Amicus, the engineering union, were scathing in their condemnation. One compared Mr Dyson to the pop star Britney Spears singing 'Oops I did it again' after the previous year's vacuum production decision. 'He has no commitment to his workforce and this is is a desperately bad example to the rest of the sector.'

The other general secretary commented: 'This latest export of jobs by Dyson is confirmation that his motive is making even greater profit at the expense of UK manufacturing and his loyal workforce. Dyson is no longer a UK product.'

The unions sought to increase pressure on ministers to intervene to slow the loss of manufacturing jobs in the UK and to prevent jobs being exported. The growth of India as a software and call centre economy has seen British companies transfer thousands of jobs overseas, while low-cost east European companies have benefited from the switch of manufacturing capacity.

In a brief statement following the announcement of the relocation plans, Dyson emphasised the way the business had been refocused; with production moving overseas, but research and development being retained and expanded at Malmesbury.

The company said switching vacuum cleaner production to Malaysia had secured 1,200 jobs at Malmesbury as well as achieving a substantial increase in output and a successful launch in America.

Following the switch in production to Malaysia, a third of the workforce at Dyson's Malmesbury headquarters workforce had an engineering or scientific background. James Dyson, the company's founder, said that the switch in the production of vacuum cleaners enabled the company to recruit an extra 70 engineers and scientists.

However, local politicians joined in the concern about the loss of manufacturing jobs, with the MP whose constituency includes Malmesbury arguing 'If excellent, high-tech British made products cannot make it, what hope is there for anyone else?'

[Based on: Gribben, R. (2003) Dyson production moves to Malaysia, *Daily Telegraph,* 21 August]

More recently, in February 2013, Dyson opened a new factory in Singapore, manufacturing motors for its products. The company said the new factory would give it greater control over production and its intellectual property. Four million digital motors are expected to be produced each year on the automated production line, which consists of 50 robots.

The company cited growing demand for its technology from markets including the US, Japan and China as the driving force behind the expansion.

However, Dyson said the expansion would also enable it to increase its headcount in the UK; and it announced plans to hire an extra 100 engineers in Wiltshire to design the 'next generation' of Dyson products.

5.5 Summary of entry strategies

The different entry strategies a firm could use for entering a foreign market can be summarised diagrammatically as below:

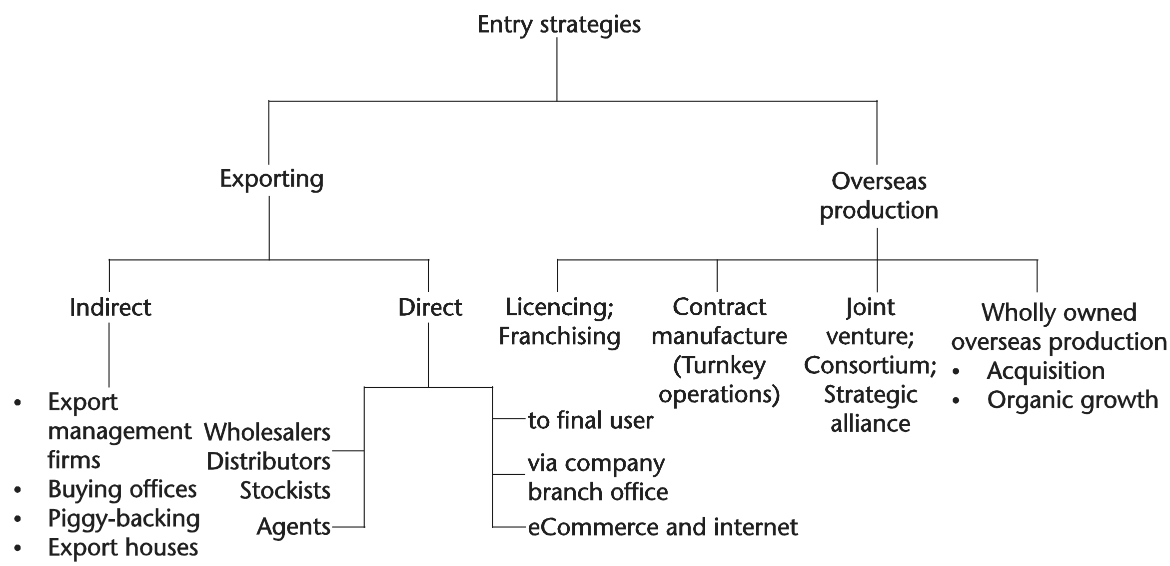


Figure 2.6: Market entry strategies

Interactive question 4: Growth strategies [Difficulty level: Intermediate]

DD Co (DD) is a manufacturer of specialised electronic tracking equipment used by police forces. The equipment allows the tagging, and tracing, of valuable equipment and also of prisoners. The company, which was only established five years ago, has a virtual monopoly in its own country. However, there are limited opportunities for growth in that country. As in most countries, the police forces in DD's home country are funded by the government. The Board of Directors, which owns the company, wishes to see the same level of growth in revenue and profits continue.

DD's equipment, which has been available for five years, is protected by a number of patents and involves some sophisticated technology, both in terms of the manufacturing process and the components that each device contains. Since the equipment is physically robust, there is only a limited replacement market.

The external cases, used for carrying the tracking equipment, are bought in from an outside supplier, but most of the other components are manufactured by DD in its own factories.

DD's Board of Directors has decided that in order to pursue a growth strategy, it will need to develop an export market. It wants to develop a presence in all major markets in the world within a further five years. The Managing Director has said that he expects the company to grow rapidly into a multinational company, operating in a number of countries.

The board has identified a number of countries as possible areas in which DD might operate. However, the board recognises that elements of the political, economic, cultural and legislative environments in those countries differ from those that exist in DD's own country.

Requirement

Evaluate FOUR market entry strategies that DD could use to develop a market in one of its identified countries.

See **Answer** at the end of this chapter.

5.6 Foreign exchange rates and financial statements (IAS 21)

For the accountant in business, an important consideration in relation to international expansion will be the potential impact that exchange differences could have on cash flows and profits, and on the financial statements.

International strategies may expose an organisation to risks relating to foreign exchange gains and losses. In your exam you may need to advise a company on the financial reporting aspects of overseas trading; that is, the '**translation gains and losses**'.

The relevant International Accounting Standard is IAS 21, *The Effects of Changes in Foreign Exchange Rates*. The objective of IAS 21 is to prescribe how to include **foreign currency** transactions and foreign operations in the financial statements of an entity, and how to translate financial statements into a **presentation currency**. The principal issues are which exchange rate(s) to use and how to report the effects of changes in exchange rates in the financial statements.

Definitions

Functional currency: The currency of the primary economic environment in which the entity operates.

Presentation currency: The currency in which financial statements are presented.

The basic steps in translating foreign currency transactions are:

1 The reporting entity determines its functional currency

2 The entity translates all foreign currency items into its functional currency

3 The entity reports the effects of translation and the associated tax impact in its financial statements

5.6.1 Foreign currency transactions: initial recognition

An entity is required to recognise foreign currency transactions in its functional currency. The entity should achieve this by translating the foreign currency amount at the **spot exchange rate** between the functional currency and the foreign currency at the date on which the transaction took place.

Average rate – Where an entity has a high volume of transactions in foreign currencies, translating each transaction may be an onerous task, so an average rate may be used. For example, a duty-free shop at Heathrow airport may receive a large amount of dollars and euros every day and may opt to translate each currency into sterling using an average weekly rate.

Similarly, a business whose sales occur relatively evenly throughout year (ie its business is not seasonal) could use an average rate for the year rather than using an actual rate for every transaction.

(IAS 21 provides no further guidance on how an average rate should be determined, so an entity should develop a method which is easily implemented with regard to any limitations in its accounting systems).

5.6.2 Subsequent measurement

A foreign currency transaction may give rise to assets or liabilities which are denominated in a foreign currency. These assets and liabilities will need to be translated into the entity's functional currency at each reporting date. The basis on which they are translated depends on whether the assets or liabilities are monetary or non-monetary items.

Definitions

Monetary items: Are units of currency held, and assets and liabilities to be received or paid in a fixed or determinable number of units of currency. (Examples of monetary items include: cash and bank balances; trade receivables and payables; loan receivables and payables.)

Non-monetary items: A non-monetary item does not give the right to receive, or create the obligation to deliver, a fixed or determinable number of units of currency. (Examples of non-monetary items include: amounts prepaid for goods and services; goodwill; intangible assets; inventories; property, plant and equipment.)

At each subsequent reporting date the following rules should be applied.

- **Monetary items**: Foreign currency monetary items should be translated and then reported using the **closing rate**.
- **Non-monetary items** carried at **historical cost** are translated using the exchange rate at the **date of the transaction** when the asset or liability arose.
- **Non-monetary items** carried at **fair value** are translated using the exchange rate at the date when the fair value was determined.

5.6.3 Recognition of exchange differences

Exchange differences arise:

- **On a re-translation of a monetary item at the year end** (eg if a foreign currency receivable remains outstanding at the year end).

  The exchange difference is the difference between initially recording the items at the rate ruling at the date of the transaction and the subsequent retranslation of the monetary item to the rate ruling at the reporting date. Such exchange differences should be reported as part of the **profit or loss** for the year.

- **When a monetary item is settled in cash** (eg a foreign currency payable is paid)

  These exchange differences should also be recognised as part of the **profit or loss** for the period in which they arise.

  There are two situations to consider here:

  (a) The transaction is settled in the same period as that in which it occurred: in this case, all the exchange difference is recognised in that period.

  (b) The transaction is settled in a settled in a subsequent accounting period: an exchange difference is recognised in each intervening period up to the period of settlement, determined by the change in exchange rates during that period. A further exchange difference is recognised in the period of settlement.

- **Where there is an impairment, revaluation or other fair value change in a non-monetary item**

  These are recognised as follows:

  (a) When a gain or loss on a non-monetary item is recognised as **other comprehensive income** (for example, where property denominated in a foreign currency is revalued) any related exchange differences should also be recognised as **other comprehensive income**.

  (b) When a gain or loss on a non-monetary item (eg fair value change) is recognised in **profit or loss**, any exchange component of that gain or loss is also recognised in **profit or loss**.

Case example: Beazley plc

In the first half of 2009, the insurance company Beazley plc announced a fall in pre-tax profits for the half year of 55%, from £45 million to £20.1 million.

However, these headline figures hid the reality that the first six months of 2009 were a near record-breaking half year for Beazley, with *operating* pre-tax profits rising by 52% to £69.9 million.

The difference between the two sets of figures arose from the different approach to translating monetary and non-monetary items, as required by IAS 21.

As with any insurance company, Beazley takes in premiums and then pays out any claims against the risks it has underwritten. The problems arise from policies that remain in force beyond the reporting date. A proportion of the premium is held on the statement of financial position (as unearned premium) to cover the proportion of the risk which falls in the following year.

Around 90% of Beazley's business is non-sterling business. For reporting purposes, this has to be translated into the company's reporting currency: sterling.

The unearned premiums are non-monetary items, so IAS 21 requires that they are translated at historic exchange rates. However, the corresponding monetary items are translated at closing rates. Consequently, if the historic and closing rates differ, there is a non-monetary profit or loss in the company's accounts. This profit or loss will unwind during the next accounting period as the premium revenue is earned and becomes revenue.

The net effect over the two accounting periods is zero, but the profit or loss reported in both periods can be significantly affected.

The currency volatility in 2008 and 2009 saw significant movements in the value of the pound and the dollar relative to each other. During 2008, sterling fell by 27.6% relative to the dollar. But it then rebounded by 14.6% by the end of the first half of 2009.

Insurers, like Beazley, which transacted a significant part of their business in dollars, but for which the dollar was not their functional currency, initially recorded significant gains under IAS 21 and then substantial losses.

For Beazley, this translated into a £46 million currency gain in 2008, but then a £49.8 currency loss in the first half of 2009 as the earlier gain was unwound.

As a result of seemingly artificial movements, the Finance Director of Beazley argued that the rules enshrined in IAS 21 prevented the company's accounts from doing what they are supposed to do. Instead of helping to provide an understanding of the company's performance, and an insight into it, they obscured the company's underlying performance.

Based on article: Bride, M. (2009), Deep water, *Accountancy Magazine*, December.

5.6.4 Foreign currency translation and financial statements

The previous section has looked at the requirements for the translation of foreign currency transactions.

However, foreign currency translation will also be required when foreign activities are undertaken through foreign operations (eg foreign subsidiaries) whose financial statements are based on a different functional currency than that of the parent company.

IAS 21 identifies the appropriate exchange rate which should be used for translating the financial statements of the foreign operation into the reporting entity's presentation currency.

The following procedures should be followed to translate an entity's financial statements from its functional currency into a presentation currency:

- Translate all assets and liabilities (both monetary and non-monetary) in the current statement of financial position using the **closing rate** at the reporting date

- Translate income and expenditure in the current statement of profit or loss and other comprehensive income using the exchange rates ruling at the **transaction dates**. (An approximation to actual rate is normally used; being the **average rate**.)
- Report the **exchange differences** which arise on translation as **other comprehensive income**. (Where a foreign subsidiary is not wholly-owned, allocate the relevant portion of the exchange difference to the non-controlling interest.)

Note that the comparative figures are the presentation currency amounts as presented the previous year.

The exchange differenced arising when translating the financial statements of foreign operations are reporting as other comprehensive income (rather than as part of the profit or loss for the year) because they have not resulted from any exchange risks to which the entity is exposed. The differences have arisen purely through changing the currency in which the financial statements are presented. To report these exchange differences in profit or loss would distort the results from the trading operations, as shown in the functional currency financial statements, since these differences are unrelated to the foreign operation's trading performance or financial operation.

5.6.5 Exchange rates and financial performance

It should be noted that, in your *Strategic Business Management* exam, your focus should be the consequences of business decisions, not simply the reporting mechanics. For instance you should be able to advise a company on the financial reporting impact of a decision to manufacture in a foreign country, versus manufacturing domestically and exporting abroad.

Such a decision has a fundamental impact on the way foreign exchange gains or losses are reported. As we have seen in Sections 5.6.3 and 5.6.4 above, any exchange difference arising from individual transactions in foreign currencies is recognised in profit or loss. However, exchange differences arising from the translation of the accounts of foreign operations prior to consolidation are reported as other comprehensive income.

Equally, you should be prepared to advise a company on how a decision to manufacture abroad could affect its performance. For example, if exchange rates in the foreign country appreciate against the rates in the countries where products are sold, what effect could this have on the sales price (or the margin which is earned on the products)?

Exchange rate movements can affect the price of both imported goods and services, and exported goods and services. Importantly, this could apply not only to transactions with third parties, but also to 'internal' transactions within a supply chain.

Companies can deal with currency fluctuations in a number of ways:

- **Currency matching** – Trying to ensure that assets/liabilities and revenues/costs are incurred in the same currency.
- **Foreign currency hedging** – Financial instruments (such as forward contracts, foreign currency futures, money market hedges or currency options) can be obtained from financial markets to reduce a company's exposure to unfavourable exchange rate movements. The detail of foreign currency hedging, and the appropriate accounting treatment for it (as prescribed by IAS 39) is covered in Chapter 15 of this Study Manual.
- **Market entry strategies** – A company could use a market entry strategy (eg licensing) which takes account of local currencies. So, for example, the local agent could operate in a local currency, but remit their license fee in the company's 'home' currency – so the risk relating to any exchange movements rests with the local agent.

5.6.6 Multinational companies and taxation

Although this issue does not relate to foreign exchange rates, one other important issue to consider in relation to multi-national businesses is transfer pricing. This could be particularly important in relation to tax planning, and there have been a number of high profile media stories in 2013 where it has been suggested that companies such as Starbucks have used transfer pricing to reduce the amount of tax they pay in the UK. For example, it has been suggested that Starbuck's corporation (based in the USA) charges its UK operation high prices for such things as the 'use of its logo' while the Swiss-based firm, Starbucks Coffee Trading Co. also earns a 'moderate profit' on the price it charges Starbucks UK for its coffee beans.

(We will look at international transfer pricing in more detail in Chapter 16 later in this Study Manual.)

Summary and Self-test

Summary

Once an organisation has assessed its current strategic position, it needs to choose what strategies to pursue in order to achieve its goals and objectives.

How to compete: An organisation has to decide the generic type of competitive strategy it wants to pursue as the basis for its competitive advantage – cost leadership or differentiation.

Although Porter's generic strategy model is a key theory in business strategy, alternative models (eg strategy clock) suggest that there are a wider range of strategies an organisation can pursue successfully than Porter's model suggests (eg hybrid strategies).

Product-market strategy (Ansoff's matrix): An organisation needs to decide what combination of existing or new products/services, in existing or new markets, it wants to offer in order to achieve strategic growth.

Method of growth: Once an organisation has decided what growth strategies to pursue it has to choose whether to develop its business itself (organic growth), to acquire an existing firm, or to co-operate in some way with another firm (eg joint venture, franchise).

When considering how appropriate a strategy is for it to pursue, an organisation needs to evaluate the suitability, acceptability and feasibility of the strategy. It should also consider the sustainability of the strategy.

In order to make informed decision about what course of action to pursue, businesses need reliable information. This can be a particular issue in relation to acquisitions or mergers, hence the importance of due diligence.

The level of sales offered by new market opportunities could be a key driver for international expansion, but international expansion could also be driven by cost or competence-led factors (eg cheap labour).

Before expanding internationally, an organisation should consider: the attractiveness of the market, whether it will be able to establish a competitive position in the market; and the risks attached to entering the market.

An organisation also needs to consider its strategy for entering a foreign market – eg exporting, or setting up local production facilities.

International expansion could have a significant impact on an organisation's financial statements, as a result of translation gains and losses.

Self-test

Self-test question 1

SJB is a publicly listed Bangladeshi company consisting of three divisions: leisure, engineering and financial services. The three divisions have similar sized revenues and employ, in total, 900 people. The only division that is currently profitable is engineering, which has not been affected by the severe downturn in consumer spending that started three years ago (in 20X1) and is still continuing. The Bangladesh government has forecast that consumer spending will not recover to its 20X0 levels for at least another four years. This reduced level of consumer spending has impacted very detrimentally on SJB's leisure and financial services divisions.

SJB's corporate strategy has been to 'buy any business where SJB's exceptional management skills give an opportunity to earn exceptional profits'. However, this strategy has recently been called into question, as since the start of the recession in 20X1, SJB's cash reserves have been exhausted. It no longer makes a profit and its share price has declined by 80% from its historic high in 20X0. SJB's Board is finding it difficult to manage its business because of the very different nature of the three divisions' activities, which means that they are subject to different external environmental influences.

Recently, the Board of SJB has been considering the future direction of its business. It has an opportunity to acquire a large engineering company, HAL, which is in financial difficulties. HAL currently employs 500 people. If SJB made this acquisition it would become the largest engineering business, in terms of revenue, in the Bangladesh. It would also have a substantial export business, which it does not currently have.

The Board of SJB has been reviewing its current organisational structure and has decided to divest itself of the leisure and financial services divisions. The purpose of this corporate reorganisation is to achieve a more concentrated business focus and a return to profitability.

Requirements

(a) Advise the board of SJB of the future strategic directions available to it, as indicated by Ansoff's product-market scope matrix. For each of the cells in the matrix, give an example of a strategy SJB could use to carry out each of the future strategic directions.

(b) Discuss the potential benefits and disadvantages of the possible acquisition of HAL.

Self-test question 2

Ambion is the third largest industrial country in the world. It is densely populated with a high standard of living. Joe Swift Transport (known as Swift) is the largest logistics company in Ambion, owning 1,500 trucks. It is a private limited company with all shares held by the Swift family. It has significant haulage and storage contracts with retail and supermarket chains in Ambion. The logistics market-place is mature and extremely competitive, and Swift has become market leader through a combination of economies of scale, cost efficiencies, innovative IT solutions and clever branding. However, the profitability of the sector is under increased pressure from a recently elected government that is committed to heavily taxing fuel and reducing expenditure on roads in favour of alternative forms of transport.

It has also announced a number of taxes on vehicles that have high carbon emission levels, as well as reducing the maximum working hours and increasing the national minimum wage for employees. The company is perceived as a good performer in its sector. The 20X9 financial results reported a Return on Capital Employed of 18%, a gross profit margin of 17% and a net profit margin of 9.15%. The accounts also showed a current liquidity ratio of 1.55 and an acid test ratio of 1.15. The gearing ratio is currently 60% with an interest cover ratio of eight.

Ten years ago the northern political bloc split up and nine new independent states were formed. One of these states was Ecuria. The people of Ecuria (known as Ecurians) traditionally have a strong work ethic and a passion for precision and promptness. Since the formation of the state, their hard work has been rewarded by strong economic growth, a higher standard of living and an increased demand for goods that were once perceived as unobtainable luxuries. Since the formation of the state, the government of Ecuria has pursued a policy of privatisation. It has also invested heavily in infrastructure, particularly the road transport system, required to support the increased economic activity in the country.

The state haulage operator (EVM) was sold off to two Ecurian investors who raised the finance to buy it from a foreign bank. The capital markets in Ecuria are still immature and the government has not wished to interfere with or bolster them. EVM now has 700 modern trucks and holds all the major logistics contracts in the country. It is praised for its prompt delivery of goods. Problems in raising finance have made it difficult for significant competitors to emerge. Most are family firms, each of which operates about 20 trucks making local deliveries within one of Ecuria's 20 regions.

These two investors now wish to realise their investment in EVM and have announced that it is for sale. In principle, Swift are keen to buy the company and are currently evaluating its possible acquisition. Swift's management perceive that their capabilities in logistics will greatly enhance the profitability of EVM. The financial results for EVM are shown in Figure 1. Swift has acquired a number of smaller Ambion companies in the last decade, but has no experience of acquiring foreign companies, or indeed, working in Ecuria. Joe Swift is also contemplating a more radical change. He is becoming progressively disillusioned with Ambion. In a recent interview, he said that, 'Trading here is becoming impossible. The government is more interested in over regulating enterprise than stimulating growth'. He is considering moving large parts of his logistics operation to another country and Ecuria is one of the possibilities he is considering.

20X9

Figure 1 – Extract from financial results: EMV

Extract from the statement of financial position

	$million
Assets	
Non-current assets	
Intangible assets	2,000
Property, plant and equipment	6,100
	8,100
Current assets	
Inventories	100
Trade receivables	900
Cash and cash equivalents	200
	1,200
Total assets	9,300

	$million
Equity and liabilities	
Equity	
Share capital	5,700
Retained earnings	50
Total equity	5,750
Non-current liabilities	
Long-term borrowings	2,500
Current liabilities	
Trade payables	1,000
Current tax payable	50
	1,050
Total liabilities	3,550
Total equity and liabilities	9,300

Extract from the statement of comprehensive income

	$million
Revenue	20,000
Cost of sales	(16,000)
Gross profit	4,000
Administrative expenses	(2,500)
Finance cost	(300)

Profit before tax	1,200
Income tax expense	(50)
Profit for the year	1,150

Requirement

Assess, using both financial and non-financial measures, the attractiveness, from Swift's perspective, of EVM as an acquisition target.

Self-test question 3

Two Wheels is a private Bangladeshi company founded in 1982 that produces bicycles for the general market. It is managed by Darius Young, the grandson of its founder. The shares are totally owned by the family, with Darius and his wife controlling just under half of the shares, the rest being held by other members of the family. When the company was founded, the bicycles were targeted mainly at people who could not afford to buy motor vehicles – then a relative luxury – but who needed transportation to get them to work or for local travel. Initially, the company was a regional producer focusing on markets in Dhaka but over the next 75 years, Two Wheels transformed itself into a national company. Two Wheels took advantage of changes in fashion and periodically introduced new models focusing on different market segments. Its first diversification was into making racing bicycles, which still account for 16% of its volume output. Most of these bicycles are very expensive to produce. They are made of specialist light-weight metals and are often custom-built for specific riders, most of the sales being made on a direct basis. Members of amateur cycling clubs contact the company directly with their orders and this minimises distribution costs, so making these machines more affordable to the customers. Two Wheels' reputation has been enhanced by this highly profitable product. The company has seen no reason to change its branding policy and these products are still sold under the 'Two Wheels' brand name.

During the 1990s, the company responded to the demand for more sporty leisure machines. Mountain bikes had become the fashion and Two Wheels designed and produced some models which appealed to the cheaper end of the market. These products, although robust and stylish, were relatively cheap and were aimed at families with teenage children and those who could not afford to spend large sums of money on the more sophisticated models. The company is currently selling nearly 30% of its output to this market segment. Most of the sales are through specialist bicycle shops, although about 25% of these mountain bikes sales are made through a national retail chain of bicycle and motor vehicle accessories stores. Apart from those sold via this retail network, under the retail brand name, the mountain bikes were also sold under the Two Wheels brand. With the advent of fitness clubs, the company saw an opening for the provision of cycling machines for the health club and gymnasium market. These machines were sold at a premium price but they still accounted for only 4% of total volume sales of the company. The main product group for the company was still its basic bicycle – it is the entry model for most families who are buying bicycles for teenagers and for those people who still use bicycles as a means of transportation as distinct from seeing them as entertainment or fun machines. The product is standardised, with few differentiating features, and as such, can be produced relatively cheaply. About 80% of this segment is sold through the same national retail chain mentioned above with reference to mountain bike sales. These bicycles, in fact, are built for the retail chain and marketed under their brand name. This appears to be advantageous to Two Wheels because it guarantees them a given level of business without their being responsible for either distribution or promotion. This segment, however, is now seeing increasing competition from cheaper overseas imports.

The company had historically made reasonable profits and most of these were re-invested in the company's production facilities, increasing capacity substantially. However, throughout the late 1990s, Two Wheels has seen its market being eroded. Sales have fallen gradually, mainly because the total Bangladesh market for bicycles has been in decline, but also because of increased competition from foreign suppliers. The high value of Taka has encouraged imports. Surprisingly, during this period Two Wheels actually increased its share of domestic output. This is due to the fact that it has been prepared to accept lower margins so as to maintain sales and, in addition, a few Bangladeshi producers had decided to exit the market and move into other, more attractive product lines.
By early in the year 20X8, the company has seen its profits continue to fall. It now has a debt to the bank of CU7 million, having been unable to pay for all recent, new capital expenditure out of retained earnings. (Table One gives some financial information about the recent performance of Two Wheels.)

There are now very few Bangladeshi manufacturers of bicycles that concentrate solely on producing bicycles. Most have a diversified portfolio and can count on other product groups to support the bicycle sector when demand is poor. However, Two Wheels has continued to focus entirely on this specialised product range. It is surviving basically because it has built up a strong reputation for reliable products and because the Young family has, until recently, been content with a level of profits which would be unacceptable to a public company that had external shareholders to consider. However, it is now becoming apparent that unless some radical action is taken, the company cannot hope to survive. The bank will now only make loans if Two Wheels can find a suitable strategy to provide it with a higher and more acceptable level of profit. If the company is to retain its independence (and it is questionable whether any company will really want to acquire it in its current position) it has to consider radical change. Its only experience is within the bicycle industry and therefore it appears to be logical that it should stay in this field in some form or other.

Darius Young has examined ways to improve the profitability of the company. He is of the opinion that if Two Wheels becomes more successful, it could become a desirable acquisition for other companies. However, currently the company will not attract bidders unless it is at a low price. Darius has looked at the profile of his products and wonders whether any rationalisation could help to improve performance. He has also decided to look at the potential for overseas marketing. Having examined statistics on current world production and sales figures he has identified that the real growth areas for bicycles are in the Far East. China alone supports a bigger market for bicycles than the whole of Europe and North America. Bangladesh, India and Pakistan have also developed a significant demand for bicycles. Darius decided to visit some of these markets and he has returned full of enthusiasm for committing Two Wheels to operate in these Far Eastern markets or in Bangladesh, India and Pakistan. Whilst Darius considers that exporting from the Bangladeshi might be a viable option, he has become increasingly attracted to manufacturing in the Far East, particularly in India. He believes that transportation costs could prove to be a disadvantage to exporting for Two Wheels. He estimates that costs for shipping and insurance could add about 20% to the final selling price. Furthermore, he is concerned about the discrepancy between labour costs in Bangladesh and in India. Wage rates, including social costs in India, appear to be about 25% of those in the Bangladesh and these costs account for approximately 30% of the total production costs.

Darius has summoned a meeting of all the shareholders to persuade them to agree to plan to manufacture, or at least assemble, bicycles in India . The other shareholders are not quite so enthusiastic. They feel that this strategy is too risky. The company has never been involved in overseas business and now they are being asked to sanction a strategy which by-passes the exporting stage and commits them to significant expenditure overseas. Darius is convinced that the bank will lend them the necessary capital, given the attractiveness of these overseas markets. The other shareholders are more in favour of a gradual process. They want to improve the position within Bangladesh market first rather than leap into the unknown. They also believe that diversification into other non-bicycle products might be less risky than venturing overseas. They know the Bangladeshi market but overseas is an unknown area. Darius has decided that it is time he sought some professional advice for the company. A management consultant, Molly Dunn, has been retained. She is a qualified accountant who also has an MBA from a prestigious business school.

Table One: Information concerning Two Wheels' current sales and financial performance

Financial years to 31 March	*20X6/20X7*	*20X7/20X8*	*20X8/20X9 (estimated)*
Mountain bikes			
Volume	27,000	24,000	22,000
Direct costs CU'000	3,780	3,600	3,410
Revenue CU'000	4,590	4,200	3,850
Standard bicycles			
Volume	45,000	40,000	36,000
Direct costs CU'000	4,050	3,600	3,312
Revenue	4,500	3,800	3,412
Racing bicycles			
Volume	14,400	12,800	13,200
Direct costs CU'000	7,560	7,360	7,986
Revenue	10,080	9,280	9,900
Exercise bicycles			
Volume	3,600	3,500	3,450
Direct costs CU'000	1,062	1,137.5	1,155.75
Revenue CU'000	1,224	1,277.5	1,259.25
Indirect costs CU'000:			

Distribution	282	290	362
Promotion	484	407	346
Administration and other	1,209	1,234	1,456
Interest on loan		560	560
Profit before tax CU'000	1,967	369	(166.5)

Requirements

Acting in the role of Molly Dunn:

(a) Write a report, evaluating the current strategies being pursued by Two Wheels for its different market segments, using appropriate theoretical models to support your analysis.

(b) Identify and explain the key factors which should be taken into consideration before Two Wheels decides on developing manufacturing/assembly facilities in India.

(c) Write briefing notes to the shareholders, explaining the advantages to the company of concentrating solely on the production of bicycles and also the opportunities that may be available by pursuing a strategy of diversification.

IFRS 11, *Joint arrangements*

- Details the issues which should be considered when determining the appropriate financial reporting treatment for joint ventures and joint operations, and specifies the accounting treatment for both kinds of joint arrangements. **Overview**

IAS 28, *Investment in associates and joint ventures*

- Outlines the accounting for investments in associates and joint ventures, where an associate is an entity over which an investor has significant influence but not control or joint control, and a joint venture is as determined in IFRS 11. **Overview**

IAS 21, *The effects of changes in foreign exchange rates*

- IAS 21 prescribes how to include foreign currency transactions and foreign operations in the financial statements of an entity, and how to translate financial statements into a presentation currency. The principal issues are which exchange rate(s) to use, and how to report the effects of changes in exchange rates. **Overview**

IAS 39, *Financial instruments: Recognition and Measurement*

- Outlines the requirements for the recognition and measurement of financial assets, financial liabilities, and some contracts to buy or sell non-financial items. **Overview**

Answers to Interactive questions

Answer to Interactive question 1

Choosing a competitive strategy

Porter's logic behind his generic strategies model is that a firm should follow only one of the generic strategies in order to achieve **competitive advantage**. According to Porter, if a firm tries to combine more than one of the strategies, it risks becoming '**stuck in the middle**' and losing its competitive advantage.

Applying these ideas could help the owners of BMK assess whether their restaurants are following a coherent competitive strategy – either individually or as group – or whether they are becoming 'stuck in the middle.' If they are becoming 'stuck' in this way, the lack of a clear strategy might be contributing to the **decline in BMK's profits**.

Generic strategies

Porter suggests firms should choose a potential strategy based on one of three generic strategies: cost leadership, differentiation or focus.

Cost leadership – If BMK chooses to become a cost leader, it must ensure it has the lowest costs in the industry as a whole. By having a lower cost base than its competitors, BMK could achieve a greater profit than them, even if its sales prices were the same as theirs.

Although this aspect of Porter's strategy focuses primarily on cost rather than price, it appears that BMK's **restaurant near the railway** is pursuing this kind of strategy, since it claims to be 'the cheapest in town.' However, to maintain its profitability, the restaurant must ensure it can continue to keep its cost base lower than any of its competitors' cost bases.

Differentiation – If BMK chooses a strategy of differentiation, it must deliver a product or service that the industry as a whole believes to be unique. As a result of this uniqueness, BMK will be able charge its customers a **premium price**.

It appears that the extremely expensive '**fine dining' restaurant** in the historic country house is charging a premium price in this way. However, to maintain its profitability, the restaurant must ensure it maintains its distinguishing features – be they the quality of the menu; the service, or the ambience. These features are what differentiates the restaurant from others in the industry and make it attractive to customers, even though it is charging a premium price.

Focus – A focus strategy will involve segmenting the industry, such that BMK would then pursue a strategy of cost leadership or differentiation within a single segment of the restaurant industry.

Three of BMK's restaurants seem to be following this type of strategy and tailoring their offering to a specific **market niche**: the barge restaurant specialising in **fish dishes**; the **steak house**; and the restaurant catering for **children's birthday parties**.

Stuck in the middle – BMK has eight restaurants in total. We have identified five of them as following one or other of Porter's generic strategies, but this means the other three - with conventional menus and average prices – are likely to be stuck in the middle.

In this respect, BMK needs to look urgently at finding a way of establishing a competitive advantage for these three restaurants. This should allow them to improve their profitability.

Strategy and marketing

We do not know whether all the restaurants in the chain are branded unilaterally as BMK restaurants, or whether they have retained their own names as well as their own styles and prices. If BMK is trying to run the restaurants as a single group, under a single brand name, then the analysis of the restaurants' current position, indicates that the **group as a whole is at risk of being 'stuck in the middle'** due to the diversity of its strategies.

In this respect, Porter's generic strategies model suggests that BMK would be best advised to run the restaurants as separate business units, and to develop marketing strategies which support each restaurant's individual characteristics.

However, even if BMK chooses to do this, it still needs to consider whether the restaurants' current strategies can deliver a **sustainable competitive advantage**. For example, the prices of foodstuffs and drinks are rising in BMK's country, which will increase its cost base. So, how sustainable is a cost leadership strategy, particularly as there is little evidence of specific technologies or processes that will allow BMK to sustain a lower cost base than any of its competitors?

Given the overall economic context in which BMK is operating, BMK's owners might decide that Porter's **focus strategies** (either cost-focus, or differentiation-focus) offer them the most practical way of maintaining or improving the profitability of their restaurants.

Answer to Interactive question 2

Strategy 1 is a strategy of **market development**, involving the establishment of more luxury hotels in new geographical locations. The cost of investment is likely to be high, and at the moment profit margins in the luxury hotels business are low. The potential return may not justify the risk in the strategy.

Strategy 2 is a strategy of either **product development** – opening a range of three-star hotels, but targeting the same group of customers as for the five-star hotels – or **diversification** – opening a range of three-star hotels for a new set of target customers. It is probably more likely that the company would need to target a different group of customers from those that use five-star hotels, even though some individuals and businesses may be switching to cheaper hotel accommodation in order to economise. Management has no experience of running three-star hotels, and a diversification strategy could involve excessive risks.

Strategy 3 is a **diversification** strategy. There may be good business opportunities in recreational centres in East Asia, but the management of Sleepway does not appear to have any experience of running any businesses other than hotels. The golf and country clubs may follow a different business model to hotels.

Recommendation

All three strategies involve risk, and although Strategy 1 is the lowest risk, returns from this strategy may be unsatisfactory. The CEO is expecting economic recovery in the next few years, but opening three new hotels could be a gamble. Without more information it is difficult to make a recommendation, but all three strategies would involve a big expansion of the business for a company that currently has only nine hotels.

All three options may well be beyond the resource capabilities of the company, and any strategy for growth should be less ambitious. A more conservative approach of seeking to open one more luxury hotel may be the most appropriate option for this company, but this recommendation should be subject to further analysis.

Answer to Interactive question 3

1 **Cash flow guarantee from venture capital company**

Suitability

BBB's main weakness is a shortage of cash, and the guarantee from the venture capitalists will ensure there are sufficient funds to allow BBB to continue until the first drug is successfully launched in commercial quantities.

The injection of cash will not, in itself, add to BBB's strengths, but assuming the new drug proves commercially successful the funding could allow BBB a competitive advantage, which it would have otherwise been denied.

The venture capitalists have only agreed to guarantee BBB's funding until the first drug is successfully launched, and so there may still be question marks about the **longer term funding requirements** between that launch and BBB's flotation, unless cash inflows from the launch of that drug are sufficient to support the business' cash needs.

However, to the extent that the venture capitalist **funding will meet cash needs** in the short to medium term and bring at least one new drug to market, this option is suitable.

Acceptability

Venture capitalists – This plan will see a significant rise in the venture capitalist's shareholder in the company – from 15% to 60%. As the venture capitalists have proposed the plan, we can assume it is acceptable to them.

Founders – However, the increase in the venture capitalist's shareholding will mean that the **founders' stakes in the company are significantly reduced**. This may not be acceptable to the founders, particularly in the context of any profits they might make when the company is floated in five years' time.

Employees – Similarly, the plan will not be acceptable to the employees because it will reduce the numbers of shares available to them through their share option scheme. Currently, the employees are prepared to accept relatively low salaries because they will receive shares in the company when it floats. However, if this option is removed, they are likely to either **want higher salaries**, or will **leave the company** altogether. If too many employees leave, BBB's ability to develop its new drug may be jeopardised.

Feasibility

This option does not, in itself, affect the internal resources of the company, so there are no problems about its feasibility.

2 **Purchase by pharmaceutical company**

Suitability

This option will allow at least some of the drugs that BBB is working on to be brought to market, but not by BBB as a company in its own right.

Given the founders' intention to float the company on the stock exchange, it seems likely that one of the strategic goals was to **run BBB as an independent company**. From that perspective, the outright purchase by another company is not a suitable option.

Acceptability

Venture capitalists

This option is **unlikely to be acceptable to the venture capitalists**, not least because they have proposed an alternative option. However, possibly more importantly, they are unlikely to be happy that whereas they invested in BBB expecting to see significant returns when it successfully launches its first new drug, they will no longer get the benefit of these returns. We do not know the terms of the deal under which the pharmaceutical company has offered to buy BBB (for cash, or for shares) but either way, it is unlikely that the venture capitalists will receive the same returns as they would if BBB had successfully launched the new drug as an independent company.

Founders

This option **may not be acceptable to the founders** either, because while they currently have the independence and status of being their own bosses, under the new structure they will simply be employees (researchers) in a much larger company. If the large company offers the founders a favourable price to acquire BBB now, (rather than them having to wait five years to benefit from the flotation) the relative acceptability of this option may be increased. However, this will probably be unlikely – especially if the larger company is aware of BBB's cash flow problems.

Employees

The employees will be concerned about the acquisition because the larger pharmaceutical company **only intends to retain 'a few of the staff'**. Therefore, there is a risk that some of the current employees will be made redundant, which will not make this an acceptable option for them.

The other issue for all the employees to consider is that they will lose the potential benefits accruing from BBB's share option scheme in the event of it floating. However, if the larger company offered them higher base salaries than BBB did, they may be prepared to accept the security of a higher salary instead of the potential benefits of the share option scheme.

Feasibility

There are no problems with the feasibility of this option.

3 **Merger with another biotechnology company**

Suitability

Because the other biotechnology company's new drug will be launched in six months' time, this will provide **a short term cash injection** to support BBB until its first new drug is launched.

However, whereas BBB is then expecting to launch one new drug in most subsequent years, the other company is not expecting to have any other new drugs commercially available for another five years. Therefore, it is **debatable whether the other company has the same strength in developing new drugs** as BBB. If the merger effectively means that the other company provides a short-term cash injection in return for piggy-backing on BBB's competences in the longer term, then that is unlikely to be a suitable option for BBB.

Acceptability

Venture capitalists

Again, this option is **unlikely to be acceptable** to the venture capitalists, because it would mean BBB rejects the option they have proposed. Also the merger would **dilute the venture capitalist's share** in the new company, which is unlikely to be acceptable.

Founders

As with the acquisition by a larger company, the merger would **reduce the founder's independence and autonomy**, because the directors of the other company would now be jointly responsible for business decisions and strategy. This change may not be acceptable to BBB's founders. Moreover, there is no indication of how long the founders would be expected to stay with the newly merged company. If they are expected to remain for a long time, they may find this restrictive.

Also, there is no indication as to whether the newly merged company would still **look to float in five years' time**. If it would not, this again may be undesirable for BBB's founders.

Employees

The merger is very unlikely to be acceptable to the employees, because the rationalisation of the workforce will mean that some **employees are made redundant**.

Also, if the newly merged company does not intend to float, the employees who remain will **lose the potential benefits from the share option scheme**. It is possible, that they may be offered higher base salaries to compensate for this, but this appears unlikely since the other company has fewer new drugs in the pipeline than BBB and so **on-going cash flow could still be a problem** for the business.

Feasibility

The feasibility of this option will depend on how similar the research and development practices of the two companies are. The merger is the only option that will involve the integration **of the systems from two different companies**. This could mean that there are some significant changes to BBB's operating systems, and the **time taken** to complete the merger could also be an issue.

In addition, BBB's founders have **no experience of managing a merger** process, which could increase the risk of the merger being unsuccessful.

Answer to Interactive question 4

Note:

You were asked to evaluate four strategies, and the following suggested solution evaluates four strategies involving external partners.

However, a fifth alternative you could have suggested would be organic growth in which DD sets up operations of its own in the target countries.

1 **Agency agreements**

DD could continue to manufacture its products in its own factories in its home country, and then **export** the products to its targets countries. In such a scenario, DD could also use local **sales and marketing agents** in the target countries to promote demand for its product.

Suitability – It is likely that the police forces in DD's target countries will be funded by their governments. Therefore, if DD selects agencies that already have established relationships with the relevant government departments in a country, it could increase its chances of making sales in that country.

Acceptability – A potential risk with this approach comes from the level of control DD will have over the agency, and accordingly how much effort the agency puts into selling DD's product.

DD will be totally reliant on the agency to generate sales for it, but if the agency doesn't devote much time and effort or resources to promoting DD's product, then this approach will not be able to generate the '**rapid growth**' the Managing Director wants. On this basis, an agency agreement may not be an acceptable strategy.

Feasibility – This is a relatively simple strategy, and also one that allows DD to maintain control over the manufacturing standards and quality of its product.

Low capital requirement – There will be no need for DD to acquire premises or employ staff in the target countries, which could be a particular benefit in the early stages of expansion, before DD establishes how lucrative the market in each country might be. If a market turns out not to be as lucrative as DD had hoped, it can withdraw from that market relatively cheaply because it will not have invested any capital there.

Equally, DD will not need to develop any in-depth knowledge of the business practices and customs in its target countries because agents will already have this local knowledge.

2 **Licence agreement**

> **Note:** A Licence agreement would seem to be more appropriate than a franchise agreement in this context, because DD is dealing with a tangible product rather than a business concept.
>
> Under a franchising agreement, the franchisor allows the franchisees to use a *process* or *business concept*, as well as the franchisor's name, in return for the payment of a franchise fee. However, in DD's case, the agreement is to *manufacture specific products* rather than to use a *business concept*, meaning that a licence agreement is more appropriate than a franchise agreement.

Under a licensing agreement, a company in the target country could manufacture DD's product using components supplied by DD, and using DD's manufacturing process.

Suitability – In order for licensing to be a successful strategy, DD will need to find a suitable company in the target country that could manufacture the product to the appropriate standard, and then market and sell the product effectively. The scenario doesn't give any indication of how easily DD would be able to find such a licence partner, but without one, this strategy would not be viable.

However, if DD can select a licensee that already has established relationships with the relevant government departments in a target country, DD's sales opportunities should benefit from this.

Feasibility – Assuming that DD can find a suitable company to act as its 'licensee' in a country, then the strategy should be feasible. DD would not need to build its own factory in the target country, nor employ any staff there, so the strategy doesn't impose any resource constraints on DD, and could therefore be implemented relatively quickly.

Acceptability – The Board of Directors are keen to see both revenue and profits grow rapidly. A potential drawback of this strategy is that the licensee is likely to require a larger proportion of the profit than an agent would, because the licensee is adding value to the products by manufacturing them.

Another concern relates to preserving DD's **intellectual property**. Not only is DD's equipment protected by patents, but its manufacturing process also contains some sophisticated technology. Although DD is likely to require any licensee to sign a confidentiality agreement before a license is granted, there is still a risk that the licensee may be able to use the knowledge it gains about DD's product and processes to develop its own competitor products in time. The emergence of a potential competitor in this way could adversely affect DD's ability to sustain revenue and profit growth.

On this basis, even if a suitable licensee company could be found, licensing doesn't appear to be an acceptable strategy.

3 **Joint venture**

DD could establish a joint venture with an existing company in its target markets, and the joint venture would manufacture and market DD's product in those markets.

Suitability – A joint venture (JV) arrangement will allow DD to have a much **stronger influence** over the manufacturing and marketing process than a licensing arrangement because some of DD's own employees will be involved with the JV.

DD's greater involvement in the operation will also help it **develop its own knowledge** of the market in the target country, and in doing so may help DD identify additional new product or market opportunities which may allow further revenue growth.

Similarly, DD's active involvement in the JV will help DD to **identify problems more quickly** than would be the case under an agency or licensing agreement.

Acceptability – Profit sharing – DD will have to share the profits from the JV with its venture partner. The percentage split is likely to reflect the division of responsibilities between the venture partners, so if DD's partner takes on the bulk of the responsibility for manufacturing and marketing, that partner might also expect the majority share of the proceeds. This may prove contrary to the aim of maintaining DD's profit growth.

Knowledge transfer – The directors may also be concerned about the degree of knowledge transfer about DD's products and processes to the venture partner. As with a licencee, there is a risk that the venture partner could use the JV as a means of finding out about DD's intellectual property and then set itself up as a competitor in future.

Feasibility – Capital costs – It is likely that any capital costs (for example, for new plant and equipment) will have to be jointly funded by DD and its venture partner. Therefore, a joint venture is likely to require greater capital investment by DD than either an agency agreement or a licence. Also, if the venture proves unsuccessful, DD would have greater financial exposure to losses than it would have under either of these two methods of expansion.

4 **Acquisition**

DD may decide that, rather than working in partnership with another company, it would prefer to acquire an existing company in its target country outright and introduce its own manufacturing capability into that company to deal with local demand for its product.

Suitability – DD is not working with a JV partner or a licensee so it would **retain full control** of its technology, thereby reducing the risk of knowledge being transferred out of the company to any potential future competitor.

Moreover, DD would retail full control of the manufacturing, quality, marketing and sales processes in the organisation.

In this respect, establishing a wholly owned subsidiary in a country could be strategically important. If DD subsequently wants to export in other surrounding countries, this operation would provide a useful base for doing so.

Acceptability – Moreover, DD would not have to share any of the proceeds of the business with any other partners.

Feasibility – However, there are a number of issues with the feasibility of this strategy:

- **Target company** – DD would have to identify a suitable target company that was willing to be acquired, and it would then have to manage the acquisition and integration of that company into the 'DD Group'. There is no evidence to suggest that DD has made any acquisitions before, and the company's inexperience will add to the risk involved in this strategy.
- **Cost of acquisition** – DD needs to consider the costs involved. If it buys a relatively successful company, then the purchase price is likely to be high. If it buys a less successful firm, the purchase price may be lower but DD is likely then to have to invest further in improving the firm's facilities and premises to bring them up to the standard required to host DD's sophisticated technology.
- **Political issues** – Some countries, and governments, look unfavourably on foreign owned companies and assets. Given that DD's main customers are governments, it cannot afford to pursue an entry strategy which is not politically acceptable to the governments in its target countries.
- **Investment levels** – Making an acquisition is likely to involve a far greater investment by DD than any of the other strategies we have considered so far. However, the size of the potential market (for a specialist product with only a limited replacement market) may not justify the level of investment required.
- **Barriers to exit** – Moreover, if DD does enter a market via an acquisition but the acquisition does not prove successful, there will be significant barriers to exit which could make leaving the market expensive. (For example, if DD closes down the company it had acquired, it could incur significant redundancy costs.)

Alternative suggestion:

Build its own plant in target country

Rather than entering some kind of partnership with, or acquiring, an existing company in its target countries, DD could set up foreign divisions of its own in those countries.

This is likely to involve DD acquiring the necessary land and then building its own manufacturing facility. It is also likely to require DD to develop its own sales and marketing networks in the relevant countries.

Suitability – This approach would allow DD to retain control over all aspects of manufacturing and marketing, and to retain all of the profits from the venture. Moreover, DD would have modern, purpose-built factories for its manufacturing operations to use.

Acceptability/Feasibility – Building a factory is likely to involve **considerable capital investment,** yet DD will have no guarantee that the level of future sales it will generate will justify that investment.

If the operation provides unsuccessful and DD wants to leave the market, it will then have the additional costs associated with closing the factory, selling the building and laying off the staff who work there.

DD's **lack of previous experience or contacts** in its target countries will make it harder for DD to enter the markets there. For example, DD may be unfamiliar with local customs and business practices; it is unlikely to have any contacts among (buying) decision makers in the government; and it won't have any access to sales and distribution channels.

Slow growth – DD's lack of existing contacts and networks, coupled with the time taken to build new premises, will mean that establishing its own operations in its target markets is likely to be a much slower means of growth than partnering with, or acquiring, an existing company.

This could be a particular issue here, given the need to build a completely new factory, and therefore the risk of potential delays and problems associated with the construction project (in an unfamiliar country).

Answers to Self-test

Answer to Self-test question 1

Part (a)

Ansoff's product-market matrix looks at the mix of products and markets a firm can use to try to achieve growth, and identifies four options:

(i) **Market penetration** – Increasing sales within **current markets** (increasing the firm's market share in those markets) using **existing products**

(ii) **Market development** – Selling **existing products** to **new markets**

(iii) **Product development** – Selling **new products** but to **existing markets**

(iv) **Diversification** – Introducing **new products** and selling them to **new markets.**

SJB is currently considering two proposals – the acquisition of HAL, and the disposal of the leisure and financial services divisions – and it could look at these proposals to see how they could help it carry out the future strategic directions indicated in Ansoff's matrix.

Market penetration – SJB and HAL both operate in the engineering market in Bangladesh. Therefore, acquiring HAL could be seen as a market penetration strategy, because it would allow SJB to increase its market share to the point that it becomes the largest engineering business in the Bangladesh.

Market development – SJB does not currently have any export business, but HAL does. Therefore, the acquisition could provide SJB with the opportunity to sell its existing products into the export markets in which HAL already operates.

Product development – We do not know how similar the engineering products or services that HAL sells are to SJB's, however it seems likely that there will be at least some similarity. Consequently, the acquisition could lead to some synergistic benefits in respect of product development. For example, SJB and HAL's engineers working together to develop new products. These new products could then be offered to both SJB and HAL's customers.

Diversification – The decision to divest itself of the leisure and financial services divisions demonstrates SJB's desire to achieve a more concentrated business focus. This may suggest that the board are not currently interested in diversification, particularly unrelated diversification. However, it is possible they could be interested in **related diversification by**, for example, acquiring a supplier who produces some of the parts used in the engineering business.

Part (b)

Benefits

Market leader – After the acquisition, SJB would have the largest engineering business, by revenue, in the Bangladesh. This size should also allow it to benefit from greater economies of scale than it currently enjoys.

Export markets – SJB does not currently have any export business, but the acquisition will give it a substantial export business. This could be particularly important, given the prolonged recession in the Bangladesh and the risk that it could adversely affect SJB's engineering business in the future. Having export markets, that are at different stages in their business cycles to Bangladesh markets, should help provide SJB with alternative sources of growth, even if the Bangladesh engineering market enters a downturn.

Application of management skills – SJB's corporate strategy is based on applying its 'exceptional management skills' to help it make significant profits from any companies it has acquired. The fact that HAL is currently in financial difficulties could make it an ideal target for SJB to acquire and turn around, using its exceptional management skills, and the fact that SJB already has experience of managing an engineering business.

Disadvantages

Financial difficulties – Although the fact that HAL is in financial difficulties may allow SJB to acquire it for a relatively cheap price, acquiring a business in financial difficulties could still be a risk, particularly as SJB's 'exceptional management skills' have recently been called into question, and its cash reserves have been exhausted.

Impact on resources – Depending on how HAL performs post-acquisition, it may prove to be a further drain on SJB's resources. Moreover, because SJB's cash reserves have already been exhausted, it will not be able to make any substantial investments into HAL, even if it becomes clear these are required after the acquisition.

Source of HAL's current difficulties – It is not clear why HAL is in financial difficulties, whether for example the problems are due to a short-term slow-down in demand, or a more structural decline in demand for its products. If the financial difficulties are due to longer term problems, then there may be little SJB can do to restore HAL's financial performance.

Employee integration – HAL seems to be quite a large company in relation to SJB. HAL currently employs 500 people, while SJB employs 900 across its three divisions. Acquiring 500 new employees will be a substantial management task for SJB, but if the integration of HAL and SJB's engineering businesses isn't successful, this will reduce TKC's chances of gaining any synergies from the acquisition.

Answer to Self-test question 2

The suitability, feasibility, acceptability technique can be used to assess the attractiveness of EVM as an acquisition target.

Suitability

Suitability relates to the strategic logic of the strategy – it should fit the organisation's current strategic position and should satisfy a range of requirements.

Acquiring EVM would appear to be a suitable strategy for Swift. This is based on a number of considerations:

- The Ambion market is mature and highly competitive. This pushes down profit margins.
- The Ambion government is hostile to road transport. This has led to high taxes and restricted working practices which again push down margins.
- Acquiring EVM would provide Swift with access to a new market in which demand is growing, competition is immature and the government are investing in road transportation.
- Acquiring EVM will increase the overall size of the group, allowing increased economies of scale to be exploited that purchasing trucks and other equipment.

However, suitability of the acquisition may also be reduced in light of any potential culture clash that may arise between the two companies involved. These may arise for a number of reasons:

- Swift has no experience of operating or acquiring foreign companies
- Swift has no experience of trading in Ecuria
- Although EVM is now a private company, the mindset may still be that of the government organisation it once was. Changing these practices, although potentially leading to higher profits, may be complex and could lead to reputation-damaging labour disputes. This may be unavoidable if Swift attempt to force the Ambion style working practices upon them, and may lead to conflicts that could be impossible to resolve.

Acceptability

The acceptability of a strategy depends on expected performance outcomes and the extent to which these are acceptable to stakeholders. Acceptability can be evaluated by considering return, risk and shareholder reactions.

Return

- EVM delivers a Return on Capital Employed (ROCE) of 18.4%. This is very similar to the ROCE of Swift Transport and appears to be a strong performance for the sector. This should be acceptable to Swift shareholders.

– The gross profit margin at 20% is higher than that of Swift. However, its net profit margin of 7.5% is lower. This may raise concerns over suitability. The low net profit margin may be due to EVM still carrying high costs from its state-owned days. However, it is possible that Swift will be able to improve the profit margin through economies of scale and by implementing competences gained at Albion. This would make the prospect more acceptable.

Risk

– Liquidity (as demonstrated by the current ratio of 1.14% and the acid test ratio of 1.05%) is much lower than that of Swift. Swift will have to determine why this is the case.

– Gearing (30.9%) is much lower for EVM than for Swift. This may indicate a more conservative approach to long-term lending.

– The interest cover ratio (5) is only 60% of that of Swift's. This could indicate lower profitability, but it could also mean that EVM's interest charges are relatively high, due to the problems the Ecurian investors had in raising finance.

Stakeholders

– Swift is still a private run company and the family are major shareholders, making opposition to the acquisition from the shareholders unlikely.

– Drivers may not be in full support of the acquisition.

– Joe has openly criticised the government who may now respond, for example, by imposing taxes on foreign investment.

Feasibility

Feasibility is concerned with whether the strategy can be implemented and if the organisation has sufficient strategic capability (resources and competences) to deliver it. Swift has the funds in place and its competences are one of the main factors driving the acquisition. This would suggest that the acquisition is a feasible strategy for Swift to pursue.

Answer to Self-test question 3

Two Wheels

Part (a)

Report

To: Darius Young, Managing Director
From: Molly Dunn, Management Consultant
Date: x-x-xxxx
Subject: Evaluation of Two Wheels Company strategies

Introduction

This report is designed to consider the different **strategies** that Two Wheels is following in its various markets and to **evaluate each of these individual strategies** given the information provided for the last two years and the current year's estimated figures.

In overall terms, Two Wheels has seen a **decline in demand** for its products, with demand expected to fall by 17% from the period 20X6/X7 to 20X8/X9. Revenue is expected to fall by 9.6% by 20X8/X9. Direct costs are an increasingly large proportion of sales revenue and are expected to reach 86% of revenue in the current year, a rise of over five percentage points over the period. Together with a dramatic expected increase in indirect costs of 38% over the period, this has resulted in Two Wheels' profit of CU1,967,000 in 20X6/X7 being turned into an expected loss of CU166,500 by 20X8/X9. This performance is unacceptable.

Two Wheels has **four distinct market sectors** – racing bicycles, mountain bikes, health clubs and basic bicycles – with distinctly different strategies being followed for each market; therefore I will consider each market in turn.

Background

Two Wheels is a private, family-owned company which is now a national producer of bicycles. Some of its products are sold under its own brand name whereas others are sold through a national retail chain under its retail brand name. Over the last few years, Two Wheels has seen its **market being eroded** with **increasing competition** from cheaper overseas imports. The overall Bangladeshi market for bicycles is in decline and this has been made worse by the high value of Taka, encouraging imports from foreign suppliers. However, during this period Two Wheels has been able to increase its share of domestic output by accepting lower profit margins in order to maintain sales. Two Wheels concentrates its efforts solely on the bicycle market and has a **strong reputation** for reliable products.

Each individual market that Two Wheels operates in will now be considered in turn in the light of this background information.

Racing bicycles

Two Wheels has been making racing bicycles for many years and this area currently accounts for approximately 16% of its volume output and almost 50% of its sales revenue. This is the only sector of Two Wheels' business where the volume of sales is expected to **increase** this year. This sector is by far the **most profitable** of Two Wheels' market areas, although anticipated revenue has fallen by 2% over the period considered and **direct costs** of production have increased by an expected 5.6%. However, this area still remains profitable and although the bicycles are expensive to produce, some being custom-made, the **distribution costs** in this sector are minimised by the policy of taking direct orders from amateur cycling clubs. These racing bicycles are marketed under the Two Wheels brand name and have enhanced its reputation.

Two Wheels appears to have followed a successful strategy of **premium pricing** in this market and has **differentiated** the product by the policy of producing custom-made bicycles. Despite the cost increases, the margins in this sector are still healthy with clear potential for volume and revenue growth. Any potential for increasing Bangladeshi market share in this area or diversifying into sales of racing bicycles overseas should seriously be considered as this is clearly the most successful part of the current business.

This area of the business could be described as a **cash cow**, according to the BCG growth-share matrix as Two Wheels' market share is relatively high and the market is growing slowly.

Mountain bikes

Two Wheels moved into this fashion area in the 1980s, producing relatively cheap models and currently this sector accounts for 30% of Two Wheels' output but only 23% of revenue. The volume of **sales is expected to decline by 19%** over the period considered; and **revenue to decline by 16%**. However, direct costs of production have increased each year and are anticipated to be 89% of revenue for mountain bikes in the current year. Despite increases in costs and decreases in revenue, this sector remains **relatively profitable** in relation to other market sectors of the business.

About 75% of these mountain bike sales are made under the Two Wheels brand name through **specialist bicycle shops**. The remaining sales are made through a **national retail chain** of bicycle and motor vehicle accessories stores under the retailer's own brand name.

Two Wheels' pricing policy of charging relatively low prices for the mountain bikes is a strategy of **penetration pricing**; however, in order for this to be successful, Two Wheels needs to be able to **compete on costs**. The increases in direct costs will tend to invalidate this policy as Two Wheels does not appear to have the production capacity to achieve the **economies of scale** necessary to maintain profit margins, as sales volumes decline and cheaper foreign imports pose a threat.

As Two Wheels has been so successful in its premium pricing policy in the racing bike market, and the majority of the mountain bikes are also marketed under the Two Wheels brand name, the company should consider **moving away from the low price market** for mountain bikes. If the mountain bikes produced are promoted as being of high quality based upon the well-respected **brand name** of Two Wheels in the racing bike market, the company may be able to attract customers prepared to pay a higher price due to the quality of the product.

This area of Two Wheels' business certainly appears to have potential but if changes in both the stabilisation of costs and marketing and pricing policy are not made, it would appear that profits from this sector will continue to decline.

Exercise bicycles

The health club market for **exercise bicycles** plays only a small part in Two Wheels' business currently with only 4% of total volume sales. As this is a **niche market**, it is possible to have a **premium pricing policy**; this sector has been consistently profitable over the period, although margins have reduced to an expected 8% for the current year. Part of the reason for the fall in profitability is, as with other areas of the business, the **escalation of costs** which, in the current year, represent 92% of the sales value of the exercise bicycles.

This market sector is different from Two Wheels' other areas as it is a **diversification** into a different line of business. The exercise bicycles will have some similarities to the other bicycles manufactured but the market characteristics are very different. Health clubs are a completely different type of customer from those for the other sectors. Sales volume is expected to show a slight fall in the current year since Two Wheels do not produce a full range of exercise equipment, which the market seems to prefer in its suppliers. Therefore, Two Wheels might consider **diversifying** into production of **other fitness equipment** such as running machines and cross trainers. This market appears to be potentially profitable but currently Two Wheels is too small a player to take advantage of it in full.

Standard bicycles

The main product of the group, the standard bicycle, accounts for about 50% of the output volume and is therefore still the **core of the business**. However, the **margins** in this area are the main cause of Two Wheels' overall fall in profitability. Sales volume has decreased by 20% over the past two years but sales revenue has fallen by even more, at 24%, as a result of reducing price in an attempt to maintain sales levels in the face of **increasing competition** from cheaper overseas imports. In the current year, the margin has fallen to 2.9%, from 10% two years ago. In 20X6/X7, the production cost per bicycle was CU90 but this has increased to CU92 per bicycle in the current year. In addition to this, the selling price has reduced from CU100 two years ago to just under CU95 currently.

About 80% of these bicycles are supplied to a national retail chain supplying bicycles and motor accessories and marketed under the chain's own brand name. As Two Wheels is heavily dependent upon the retail chain, it may be that the retailer is forcing prices down using its **buying power**.

Two Wheels' strategy in this market appears to have been one of competing on **both cost and price**. Unfortunately, it appears not to have worked. Prices are coming down and costs are rising. This area of the business is now being **subsidised** by the other more profitable but smaller markets.

There is no real brand association with the basic bicycles as the majority is sold under the retailer's brand name. Therefore, it might be difficult for Two Wheels to disassociate itself from the retailer and sell directly, although it may be possible to build on the brand association from the racing bicycle market. According to the BCG growth-share matrix,the basic bicycle market could be categorised as a '**dog',** as the Bangladeshi market in this area does not appear to be growing and Two Wheels appear to have a relatively low market share.

If Two Wheels is to improve profitability in this market it must decrease costs, probably move away from dependence on the retailer and attempt to **differentiate its product** in some way. Withdrawal from this market could be considered although as it is such a significant element of the business, this may be a **dangerous strategy** and should only be considered when all other options have been examined.

Indirect costs

A further worrying area of the business is in the **escalating indirect costs**. Over the two years there has been a staggering increase of 38% in total indirect costs. **Distribution costs** are up by 28% although this may be understandable, given the nature of the direct sales of the racing bicycles and exercise bicycles.

Administration costs have also increased by 20% over the last two years which, given the decrease in sales volumes, appears unusual.

Promotion costs have, however, fallen and this must be **rectified** if Two Wheels is to capitalise on its brand name and increase sales volumes.

Loan interest is unavoidable but worryingly high as in the current year, **interest cover is only 0.70 times**, an unsustainable level in the long run.

Conclusion

Two Wheels currently has a wide range of strategies, a premium pricing policy for racing bicycles and exercise bicycles, and an attempt to be a cost leader at the lower end of the market with its basic and mountain bikes. **Production costs** must be brought under control before any rationalisation of strategies can be considered.

It would appear that Two Wheels' strengths lie in its **strong reputation and brand** association in the racing bicycle market. If this can be extended to the **mountain bike market**, and a premium pricing policy introduced here with **market differentiation based upon the quality of the product**, then this could produce significant improvements in the mountain bike market.

A further potentially successful market is that of the **health club equipment** if the production range can be extended. The basic bicycle market could be improved with more control of direct costs but as the Bangladeshi market is not expanding, and the strategy has been one of cost leader, which has not succeeded, then it may be necessary to consider withdrawal from this market.

It would appear that the future of ABC lies with the **quality products** as Two Wheels does not appear to have the production capacity to achieve the cost economies necessary for a successful cost leader strategy at the lower end of the market.

Part (b)

When considering any potential investment, many factors must be taken into account but when contemplating such a major change in strategy as the managing director is proposing, there must be a **wide ranging review** of the key factors.

Operations

Let us first consider the **operational aspects** of the development of a manufacturing or assembly facility in India. The proposal is based upon the **large demand** for bicycles perceived in the Far East, the **cheaper labour** which would reduce **production costs** and the reduction in **transportation costs**.

As far as the demand for bicycles is concerned, the view of the market appears to be that of the managing director and there is no evidence that any **market research activities** have been carried out. What type of bicycles are in demand in India and can Two Wheels produce bicycles that satisfy this demand? If the bicycles required are not the same as those currently manufactured by Two Wheels, there may be significant costs involved in re-design and changes to the manufacturing processes.

The **labour cost** aspect must be put into perspective. Labour costs only account for 30% of the total production cost, therefore the cheaper labour would only lead to a maximum decrease in production costs of 22.5%. The labour issue should be considered further – how does the **productivity** of bicycle manufacturing employees in India compare to that in the Bangladeshi? If productivity is significantly lower in India, then this could **wipe out any cost benefit**.

The **transportation costs** of bicycles from the Bangladeshi to India are obviously significant. However, if the proposed facility is set up in India instead, there are still likely to be significant transportation costs, since India covers a vast area and demand is likely to be spread widely. This internal transportation cost should not be ignored.

Two Wheels must consider other operational aspects of setting up a manufacturing facility in India. Can the correct **components** be purchased at a competitive price and be delivered on time? What type and amount of **marketing expenses** will there be? Two Wheels must also question its **ability to run** such an operation as it has no experience in even trading with other countries, let alone setting up a full scale operation in one, particularly one as distant and unknown as India.

Finance

Two Wheels must also consider **financial aspects**. The company has very low profit levels currently and a large debt outstanding. How does it propose to **raise the finance** necessary for such a major investment? Would the finance be raised in this country or in India? Are there opportunities for a Bangladeshi company to raise major finance in India? Would a joint venture with a Chinese company be a viable option?

Further financial problems will concern the **remittance of funds back to the Bangladeshi** and any **foreign exchange risks** that Two Wheels may face. Many countries restrict the amount of their currency that can be taken out of the country and as Two Wheels is so short of funds it will clearly require any profits to be remitted back to the Bangladeshi. Two Wheels should also consider the foreign exchange risks that are associated with any form of trade with foreign countries. If the Indian currency moves against Taka, then Two Wheels could be subjected to large foreign exchange losses.

Risk

Political risk is a further important area that should be considered. How stable is the Chinese government? What is their attitude to foreign investors – are they encouraged or are there sanctions which will make operations more difficult and expensive?

Analysis

Many of the key factors involved in this proposal can be addressed through a **PESTEL analysis** (social, legal, economic, political and technological aspects). Analysis of social factors will help to define the market, determine the type of bicycle required and clarify the potential customer and method of marketing and sale. Legal factors will include dealing with suppliers, contracts for setting up a factory and employment issues. Economic factors will help to define the demand structure, inflation rates, interest rates and availability of finance. Political issues will be of great importance in a country such as India which has large state control. From the technological viewpoint, particularly if there is a demand for Two Wheels' more high-tech products, such as the racing bicycle, does the technology exist in India or must it be exported?

Part (c)

Briefing notes on advantages of concentration on bicycle production or diversification

Advantages of concentrating on bicycle production

- Two Wheels has been in the bicycle manufacturing business for many decades and therefore has the **skills and competences** necessary to operate in this area. These skills might not necessarily be easily transferred to other markets such as production of other fitness equipment.
- The fact that Two Wheels specialises in the production of bicycles, albeit of different types, would argue that the company obtains some **economies of scale** from just this type of production. As direct costs are increasing, there is some doubt about these economies of scale but diversification into another field may reduce margins even more.
- It could be argued that Two Wheels should stick to its **core activities** and not be side-tracked into other areas in which it has limited experience. This will also be of benefit in developing value chain relationships.
- By remaining within the bicycle industry, the Two Wheels **brand name** can be cultivated. Its value in other sectors must be doubted.

Advantages of diversification

- If the bicycle market is in decline or faced with significant competition from cheaper foreign imports, then there may be **gains to be made in other markets**.
- Other markets, such as the health and fitness club market, may offer higher gains than the bicycle market, although the **risks** may also be greater because of factors such as changes in technology.
- If Two Wheels were to **diversify**, this would reduce the **risk** of becoming involved in an individual market area that may decline and would give the company **greater flexibility** to deal with changes in fashion and technology.
- It is possible that Two Wheels could use its current **distribution networks** in order to market a different range of products.
- **New products** may have greater potential to provide technological or commercial advantages to the company.

Conclusion

The theory behind diversification for large companies is that there is no need for a company to do this simply to reduce the risk of just being in one industry as the shareholders are quite capable of doing this on their own behalf by owning a portfolio of shares. However, for a private family-owned company that is experiencing problems with profitability, a move into a new area is enticing. For Two Wheels, given its core expertise, diversification should only be considered if it is believed that there are no future gains to be made from its current markets and that moves into non-core areas are likely to be successful.

CHAPTER 3

Strategic implementation

Introduction

Topic List

1 Acquisitions and strategic alliances
2 Aligning organisational structure and strategy
3 Managing change
4 Cost reduction
5 Evaluating functional strategies
6 Business plans

Summary and Self-test

Technical reference

Answers to Interactive questions

Answers to Self-test

Introduction

Learning objectives

	Tick off
• Demonstrate and explain the impact of acquisitions and strategic alliances in implementing corporate strategy and evaluate the nature and role of assurance procedures in selecting and monitoring such strategies	☐
• Evaluate and explain the relationship between business strategy and organisational structure	☐
• Explain and evaluate the nature and methods of change management, and advise on the implementation of change in complex scenarios	☐
• Demonstrate and explain the techniques that may be used in implementing a strategy to reduce costs, for example supply chain management, business process re-engineering and outsourcing	☐
• Evaluate, in a given scenario, the functional strategies necessary to achieve a business's overall strategy	☐
• Develop business plans and proposals and advise on technical issues relating to business and organisational plans, assess the impact on historic and projected corporate reporting information	☐

Syllabus links

In Chapter 2, we looked at the issues organisations should consider when choosing the strategies they wish to pursue. In this chapter, we now look at some of the issues they need to consider when implementing those strategies. Ultimately, a strategy will only be successful if it can be (and is) implemented successfully.

Knowledge brought forward

The motives for acquiring companies were covered in your *Business Strategy* paper, as were the different types of organisational structure that organisations can adopt.

Networks and supply chain management were also covered in your *Business Strategy* paper, although we will consider them in more detail here.

Change management and strategies for change in Business Strategy are discussed in some detail in the *Business Strategy* paper.

However, as we have noted in previous chapters, at Advanced level you will need to select relevant ideas from appropriate models and theories, and apply them to complex scenarios in order to advise an organisation on how it can implement strategies to help achieve its overall strategy and objectives.

1 Acquisitions and strategic alliances

Section overview

- In Chapter 2, the option of organic growth was presented as a strategic option for growth. However, a firm can also grow by combining with other firms, through merger or acquisition. A **merger** is the integration of two or more businesses. An **acquisition** is where one business purchases another.
- Mergers and acquisitions are fraught with risks relating to integration and overpaying for a target company. An alternative approach is to therefore agree to work with partners, either within, or across industries in order to reduce the competitive forces faced.

1.1 Acquisitions

Many companies consider growth through acquisitions or mergers.

Definition

A **merger**: The joining of two separate companies to form a single company.

An **acquisition**: The purchase of a controlling interest in another company.

It is important for a company to understand its reasons for acquisition and that these reasons are valid in terms of its strategic plan. The classic reasons for acquisition as a part of strategy are as follows:

Reason	Effect on operations
Marketing advantages	New (or extended) product range Market presence Rationalise distribution and advertising Eliminate competition Combine adjoining markets
Production advantages	Economies of scale: synergies Acquire technology and skills Greater production capacity Safeguard future supplies Bulk purchase opportunities
Finance and management	Management team improve running of the business Cash resources Gain assets, including intellectual property Tax advantages (eg losses bought) Asset stripping Turnaround opportunities
Risk-spreading	Diversification

Acquisitions provide a means of entering a market, or building up a market share, more quickly and/or at a lower cost than would be incurred if the company tried to develop its own resources. Corporate planners must, however, consider the level of **risk** involved. Acquiring companies in overseas markets is more risky for a number of reasons such as differences in culture and/or language, and differences in the way the foreign company is used to being managed.

The acquirer should attempt an evaluation of the following:

- The prospects of technological change in the industry
- The size and strength of competitors
- The reaction of competitors to an acquisition

- The likelihood of government intervention and legislation
- The state of the industry and its long-term prospects
- The amount of synergy obtainable from the merger or acquisition
- The cultural fit between predator and target

Case example: Compaq and Hewlett-Packard's merger

Historically, the perceived wisdom on Wall Street has been that mergers are exciting; and they create value. Moreover, the bigger the merger, the better.

However, more recently, mergers, particularly among large-cap companies, have not been looked upon so favourably, and the results of some high profile mergers support this scepticism. Consider the merger of Citibank with Travelers. The price of a Citi share at the time of the merger (October 1998) was $32.50. By 2008, shares sold for less than $25. So, there had been about a 25% reduction in lower shareholder value in 10 years.

The merger between Time Warner and AOL was even more famously unsuccessful. At the time of the merger (January 2000), Time Warner stock sold for $71.88. By 2008, shares in Time Warner could be bought for less than $15.

The problem with many of the ill-fated mergers is that they were the results of misguided intentions. Often, they were driven by management's desire for aggrandizement; the desire simply to be bigger than competitors. At other times, mergers were fuelled by a desire for diversification. And, egged on by aggressive investment bankers and a receptive stock market, the deals got done.

However, not all mergers are doomed to failure. Of the deals announced in the early years of the 21st century, few attracted as many negative views as the combination of Hewlett-Packard and Compaq Computer. When it was announced in September 2001, the HP-Compaq merger was met with almost universal scepticism and cynicism. And doubts about the merits and benefits of the merger continued long after it was implemented in mid-2002.

Yet, the merger turned out to be a success – whether measured by market share, market leadership or increased shareholder value.

Ben Rosen, who had been non-executive chairman of Compaq Computer until 2000, was not surprised by this success though. He said he thought the merger sounded like a terrific deal when it was announced, because there was a good fit between the two companies. Most of Hewlett-Packard's weaknesses were complemented by Compaq's strengths, and vice versa. In other words, both companies should benefit from the merger, and therefore it was a merger of two big companies which ought to work.

However, Rosen's view was not widely shared, and there was vociferous opposition to the merger. Writing in the New York Times in February 2002, Walter Hewlett, son of the HP co-founder, Bill Hewlett, said 'The Compaq merger is a dangerously risky, a very costly, step... The risk is great that trying to meld two disparate companies and cultures together in the computer business will come to grief.'

Other observers were equally caustic. Quoted in *Time* magazine shortly after the merger announcement, Todd Kort, principal analyst for Gartner Research, said, 'This is not a case of 1+1 = 2. It's more like 1+1 = 1.5.'

IDC analyst Roger Kay said, 'Dell must be totally gleeful, because these guys are going to spend all their time untangling themselves.' Apparently, Michael Dell, CEO of Dell Computer was even reported to have called the merger the dumbest deal of the decade.

For a while after the merger was implemented, the doubts expressed by its critics seemed justified. The integration of the two companies and the execution of the merger went poorly. Many of the best and brightest staff from Compaq left; some voluntarily, others not.

Hewlett-Packard CEO Carly Fiorina was the architect of the merger, and its champion. She made it happen despite fierce opposition from the Hewlett and Packard family members, their foundations, and from other large shareholders. But while she did the deal, she simply did not have the skills to manage one of the world's largest technology companies. For almost three years (while Fiorina was CEO of the merged entity) it failed to realise the potential of the combined companies. Criticism of the merger continued, and showed little sign of abating.

In Febraury 2005, Carol Loomis wrote an article in *Fortune* magazine, arguing that:

This was a big bet that didn't pay off, that didn't even come close to attaining what Fiorina and HP's board said was in store. At bottom they made a huge error in asserting that the merger of two losing computer operations, HP's and Compaq's, would produce a financially fit computer business.... It must deal with both the relentless competition in computers and its own particular need to battle on two fronts, against both IBM and Dell.

However, six weeks after the publication of this article that pilloried Hewlett-Packard, the board hired Mark Hurd to replace Fiorina. Only then did the company acquire the management skills needed to take the raw material that was there and transform it into a world leader in technology. In the three years since Hurd became CEO, the results have been truly remarkable. He took the pieces assembled by Fiorina, applied his management skills to them, and created a growing, profitable and increasingly valuable company.

The eventual success of the merger of the merger can be seen by comparing the movement in share prices of Dell, IBM and Hewlett Packard between May, 2002 and April 2008. Over this period, which had once been the darling of the business press and industry analysts, had seen its share price fall by 20%. IBM's share price rose by 42%, and HP's by 163%. The S&P 500 rose by 28% over the same time.

This begs the question of where the pundits who criticised the merger went wrong. At one level, they applied a generic logic (that big mergers are bad) rather than looking analytically at whether there is a real fit between the two merging companies. Perhaps more importantly, though, for the initial three years that the merged company was struggling, the struggles were attributed to the merger. However, the merger wasn't the problem; it was the management. All Hewlett-Packard needed was strong management (as from Mark Hurd) in order to realise the latent potential of the merged company.

Based on: Rosen, B. (2008), The merger that worked: Compaq and Hewlett-Packard, *Huffington Post*, April, www.huffingtonpost.com 9

1.2 Better off tests

Michael Porter suggests that one of the key issues behind acquisitions should be in realising synergies between the existing company and the new acquisition.

To this end, he suggests that potential acquisitions should be assessed against three tests:

(a) **Better off test** – Will the company being acquired be better off after the acquisition? Will it gain competitive advantage from being in the group?

(b) **Attractiveness test** – Is the target industry structurally attractive? (Porter originally developed his tests in relation to diversification, and so was looking at companies making acquisitions in unrelated industries. However, the point about 'attractiveness' could be applied more generally to look at target companies, or countries.)

(c) **Cost of entry** – The cost of the acquisition (or the cost of entering a new market) must not capitalise all future profits from that acquisition (or market). In other words, will the future cash flows from the acquisition be greater than the amounts paid to acquire it?

Porter also identified another key point in relation to successful acquisitions, which could be called the **parenting test**. Has the company making the acquisition got the necessary skills as a corporate parent to get the best value out of the company being acquired? For example, have they got any **experience of previous acquisitions**?

It is also important to remember that many acquisitions turn out not to be successful. Ashridge Management College suggests that as many as 70% of mergers and acquisitions fail to meet their objectives, and some even bankrupt the acquiring company. In many cases, managers have too little experience with the acquisition process, and also they make acquisitions for the wrong reasons.

Equally, acquisitions can fail because there isn't a good strategic fit between the company making the acquisition and the company being acquired.

Case example: Daimler/Chrysler

In 1998, Daimler Benz, the German car manufacturer best known for its Mercedes premium brand, merged with the US company, Chrysler, a volume car manufacturer. The merged company, Daimler Chrysler, became the world's largest car manufacturer.

However, although the deal was originally billed as a merger of equals, in practice it was a takeover by Daimler. Interestingly, by March 2001 the share price for the new group had fallen to just over 60 percent of what it had been in November 1998.

A number of reasons were identified for the poor performance of the Daimler/Chrysler group:

- US and German **business cultures were different**. Possibly because of cultural problems in the new group, many key Chrysler managers left after the merger.
- Mercedes was a premium brand which had been extended to making smaller cars. Chrysler depended on high volumes, not a premium product. Therefore, the distinction between 'premium' and 'volume' businesses got blurred.
- The new group did not properly exploit economies of scale, such as sharing components. There was a degree of technology-sharing among the engineers, and this did result in some success stories, such as the Chrysler 300 model. However, many critics argued that the merger **could not deliver the synergies** that had been expected because the businesses were never successfully integrated. In effect, they seemed to be running two independent product lines: Daimler and Chrysler.
- **Productivity and efficiency** at Chrysler was far lower than industry norms. (In 2000, each vehicle took Chrysler around 40 hours to make, compared to approximately 20 for the American factories of competitors such as Honda and Toyota.) In addition, its purchasing was inefficient, and fixed costs were too high for the size of the company. Overall, Chrysler's performance was much weaker than Daimler had realised going into the deal.

Ultimately, the Daimler Chrysler merger failed to produce the trans-Atlantic automotive powerhouse that had been hoped for, and in 2007 Chrysler was sold to a private equity firm that specialises in restructuring troubled companies. In December 2008, Chrysler received a $4bn loan from the US Government to stave off bankruptcy. Nonetheless, Chrysler eventually filed for bankruptcy in April 2009.

While it was by no means the only reason why it failed, the failure to implement change effectively and to integrate the companies after the merger, was a major contributing factor to the failure of the merger.

1.3 The mechanics of acquiring companies

As an accountant in business, you may be required to assess the value of an acquisition. We look in more detail at the different valuation methods in Chapter 12 of this Study Manual where we will also address the corporate reporting issues arising from acquisitions and mergers.

However, at this point in the manual, we will simply note that there are a number of methods that could be used to value a company being acquired.

(a) **Price/earnings ratio:** The market's expectations of future earnings. If it is high, it indicates expectations of high growth in earnings per share and/or low risk.

(b) **Accounting rate of return**, whereby the company will be valued by estimated future profits over return on capital.

(c) **Value of net assets** (including brands).

(d) **Dividend yield**.

(e) **Discounted cash flows**, if cash flows are generated by the acquisition. A suitable discount rate (eg the acquirer's cost of capital) should be applied.

(f) **Market prices.** Shareholders may prefer to hang on for a better bid.

1.3.1 Takeovers or mergers financed by a share exchange arrangement

Many acquisitions are paid for by **issuing new shares** in the acquiring company, which are then used to buy the shares of the company to be taken over in a 'share exchange' arrangement. An enlarged company might then have the financial 'muscle' and borrowing power to invest further so as to gain access to markets closed to either company previously because they could not individually afford the investment.

1.3.2 Acquisitions and earnings per share

Growth in EPS will only occur after an acquisition in certain circumstances.

(a) When the company that is acquired is bought on a lower P/E ratio; or

(b) When the company that is acquired is bought on a higher P/E ratio, but there is profit growth to offset this.

1.3.3 Debt finance

Another feature of takeover activities in the USA especially, but also in Bangladesh, has been the **debt-financed takeover**. This is a takeover bid where most or all of the purchase finance is provided by a syndicate of banks for the acquisition. The acquiring company will become very highly geared and will normally sell off parts of the target company.

A **leveraged buyout** (LBO) is a form of debt-financed takeover where the target company is bought up by a team of managers in the company.

1.3.4 Assurance procedures and company valuations

Accounting policies can have a significant impact on the valuation of acquisitions. They could be used to inflate the share price or to depress it. Optimistic accounting policies, valuing assets generously, bringing forward revenue recognition, and delaying provisions may inflate the company position and share price.

On the other hand accelerating expenses or making very conservative estimates of future earnings may depress share prices.

There may be agency issues with both approaches. Directors who wish to retain their own jobs may attempt to boost earnings, and hence share prices, to deter takeovers. On the other hand, directors who feel they can benefit if a takeover occurs may be tempted to depress a company's market valuation, even though shareholders may lose out as a result.

These scenarios in which the interests of company directors (agents) may be different from those of the shareholders (principals), are indicative of the **principal-agent problem**.

The way companies are structured and operate means that managers and directors (agents) are placed in control of resources that are not their own, but have a contractual obligation to use those resources in the interests of their owners (the shareholders). The principal-agent problem arises when agents start using a company and its resources as a means to serve their own interests, rather than to maximise the total financial returns to the company's owners. Where actions taken by an agent deviate from the principal's best interest, this deviation is called an agency cost.

With any acquisition or merger, shareholder value must be protected as far as possible, and thus it is essential to perform some level of due diligence. For example, it will be very important that management forecasts are evaluated critically to ensure they do not appear to be over- or under-stated.

Assurance procedures in relation to acquisitions and mergers are considered in Chapter 12 of this Study Manual, although we have also already discussed due diligence in Chapter 2.

Definition

Due diligence: Due diligence is a term that describes a number of concepts involving the investigation of a company prior to signing a contractual agreement. This assurance procedure is typically carried out by an external firm appointed by the purchasers. The provider of the due diligence will assume a duty of care towards the party that appoints them.

The term due diligence is fairly wide in its application and extends far beyond a review of the target company's financial statements. For instance, specialist firms could be appointed to review the following areas:

- Information systems
- Legal status
- Marketing/brand issues
- Macro-environmental factors
- Management capabilities
- Sustainability issues
- Production capabilities
- Plant and equipment

Interactive question 1: Due diligence [Difficulty level: Easy]

Alpha Oil plc has agreed provisional terms with a small industry rival, Beta Extraction plc, for a full takeover. Beta has now agreed to open up its books to Alpha for due diligence purposes.

Requirement

Advise Alpha as to the types of due diligence its shareholders would expect to see performed before a takeover could proceed.

See **Answer** at the end of this chapter.

1.4 Acquisitions and organic growth compared

Advantages of acquisition

Acquisitions are probably only desirable if organic growth alone cannot achieve the targets for growth that a company has set for itself.

(a) Acquisitions can be made to enter new product or geographical areas, or to expand in existing markets, much more **quickly**.

(b) Acquisitions **can avoid barriers to entry**. If there are significant barriers to entry into a market (or if there is already intense competitive rivalry), then it might not be possible for a new entrant to join the market in its own right. However, acquiring an existing player in the market would enable a group to join that market.

(c) Acquisitions can be made **without cash**, if share exchange transactions are acceptable to the company.

(d) When an acquisition is made to diversify into new product areas, the company will be **buying technical expertise, goodwill and customer contracts**.

Disadvantages (or risks) of acquisitions

(a) **Cost***.* They might be too expensive, and will involve high initial capital costs to acquire shareholdings in the target company. If the acquisition is resisted by the directors and shareholders of the target company, this may force the offer price to be increased further.

(b) There could also be **valuation issues** here. The management of the target company are likely to know more about its true value than the acquiring company, and so it could be difficult to arrive at a fair price for the sale.

(c) **Customers** of the target company might consider going to other suppliers for their goods.

(d) **Incompatibility***.* In general, the problems of assimilating new products, customers, suppliers, markets, employees and different systems of operating might create 'indigestion' and management overload in the acquiring company. One of the main reasons why acquisitions and mergers fail is because of the **lack of 'fit'** between the two companies.

(e) **Post-acquisition costs**. Even if the acquisition goes ahead, there will be significant costs involved in integrating the acquired company's systems (production systems, IT systems etc) with those of the parent company.

(f) **Lack of information***.* Commentators have suggested that the 'acquisitions' market for companies is rarely efficient. This means that companies making an acquisition do not have perfect information about the company they are acquiring. This could mean that the price they pay for the acquisition is too high, and/or the future value the company brings to the group is lower than they had anticipated.

(g) **Cultural differences**. There may be clashes if the culture and management style of the acquired company is different to the acquiring one. There is potential for human relations problems to arise *after* the acquisition.

(h) **Rationalisation costs**. As the parent organisation looks to benefit from synergies after an acquisition, they often streamline the workforce, leading to redundancy costs, but possibly also damaging morale amongst the workforce.

It is worth considering the **stakeholders** in the acquisition process:

(a) Some acquisitions are driven by the personal goals of the acquiring company's **managers**. For example, some managers may want to make the acquisition and increase the size of the firm as a means of increasing their own status and power. Alternatively, other managers may view an acquisition as a means of preventing their own company being taken over, thereby making their job safer.

(b) **Corporate financiers and banks** also have a stake in the acquisitions process as they can charge fees for advice.

Takeovers often benefit the shareholders of the acquired company more than the acquirer. According to the Economist Intelligence Unit, there is a consensus that fewer than half of all acquisitions are successful. One of the reasons for failure is that firms rarely **take into account non-financial factors**.

(a) All acquirers conduct financial audits of target companies but many do not conduct anything approaching a **management audit**.

(b) Some major problems of implementation relate to **human resources and personnel issues** such as morale, performance assessment and **culture**. If key managers or personnel leave, the business will suffer.

Another common problem following a merger or acquisition is that the **post-acquisition phase is not properly managed**, so the two component companies are never properly integrated. In this way, the potential benefits of the deal cannot be fully realised.

It may also be the case that an acquisition cannot be pursued due to a likely refusal by government on competition grounds.

Case example: Competition Commissions

The activity of the Competition Commission in the UK is a good example of the way governments may approach the problem of monopoly. The Office of Fair Trading may ask the Competition Commission (CC) to investigate if it appears that competition is being prevented, distorted or restricted in a particular market. The Secretary of State may do the same if any proposed takeover or merger would create a firm that controlled 25% or more of the market and where a merger appears to lead to a substantial lessening of competition in one or more markets. The Commission will then investigate the proposed merger or takeover and recommend whether or not it should be allowed to proceed.

Although the Competition Commission is specifically a UK authority, other countries have similar authorities, which aim to curtail anti-competitive behaviour.

For example, in Australia, the mandate of the Australian Competition and Consumer Commission (ACCC) is to protect consumer rights, business rights and obligations, perform industry regulation and price monitoring, and prevent illegal anti-competitive behaviour.

In the USA, the United States Department of Justice Antitrust Division is responsible for enforcing US antitrust laws. It shares jurisdiction over civil antitrust cases with the Federal Trade Commission (FTC) and often works jointly with the FTC to provide regulatory guidance to businesses.

In addition to regulatory bodies in individual countries, there are also supranational bodies that regulate restrictive practices. The European Commission and the national competition authorities in all EU member states co-operate with each other through the European Competition Network (ECN).

This creates a mechanism to counter companies that engage in cross-border practices designed to restrict competition. As European competition rules are applied by all members of the ECN, the ECN provides a means to ensure they are effectively and consistently applied. Through the ECN, the competition authorities from different EU member states are able to inform each other of proposed decisions and to pool their knowledge.

Interactive question 2: Growth strategies [Difficulty level: Intermediate]

JKL is a small European company. It currently employs 40 people and has an annual revenue of about 11 million euros. One aspect of its recently formulated strategy is an aspiration to expand into a neighbouring country, France, by means of organic growth.

The reason that JKL's strategy for expansion is based on organic growth is due to JKL's past experience. Two years ago, the directors of JKL negotiated the purchase of a business, LMN, located in a different region of its home country. At the time of this acquisition, LMN was regarded by JKL as having complementary capabilities and competences. However, within a short time after the acquisition, JKL judged it to have been a failure and LMN was sold back to its original owner at a loss for JKL.

JKL employed consultants to analyse the reasons for the failure of the acquisition. The consultants concluded that the failure had happened because:

1 JKL and LMN had very different corporate cultures and this had posed many difficulties, which were not resolved;

2 JKL and LMN had very different accounting and control systems and these had not been satisfactorily combined;

3 JKL had used an autocratic management style to manage the acquisition and this had been resented by the employees of both companies.

JKL has learnt that a French competitor company, XYZ, may shortly be up for sale at a price which would be very attractive to JKL. XYZ has a very good reputation in its domestic market for all aspects of its operations and its acquisition would offer JKL the opportunity to widen its skill set.

None of JKL's staff speaks fluent French or is able to correspond in French.

Requirement

Discuss, in the context of JKL, the respective advantages and disadvantages of pursuing a strategy of expansion by:

(a) Organic growth

(b) Acquisition

See **Answer** at the end of this Chapter.

1.5 Strategic alliances

Some firms enter long-term **strategic alliances** with others for a variety of reasons.

(a) They **share development costs** of a particular technology.

(b) The **regulatory environment** prohibits take-overs (eg most major airlines are in strategic alliances because in most countries – including the US – there are limits to the level of control an 'outsider' can have over an airline).

(c) **Complementary markets or technology.**

(d) **Learning.** Alliances can also be a 'learning' exercise in which each partner tries to learn as much as possible from the other.

(e) **Technology**. New technology offers many uncertainties and many opportunities. Such alliances provide funds for expensive research projects, spreading risk.

Strategic alliances only go so far, as there may be disputes over control of strategic assets.

Case example: General Motors and Peugeot Citroen

In February 2012, General Motors (GM) and PSA Peugeot Citroen (PSA) announced a global alliance which the two companies said would save them $2bn annually within about five years (by combining purchasing) and would see them develop cars together. The two firms said they hoped to launch their first common design by 2016.

The US and French carmakers said they would share vehicle platforms, components and modules, and create a global purchasing joint venture to buy commodities and parts that would have combined purchasing power of $125bn a year. Additionally, the alliance is exploring areas for further co-operation, such as integrated logistics and transportation. GM's chief executive described the deal as 'a broad-scale global strategic alliance that will improve each company's competitiveness and will contribute to the long-term profitability in Europe particularly, but around the world as well.'

The alliance will give GM and PSA, which have joint sales of about 12m units, global industry leadership in production of 'B' compact and 'D' upper-middle segment cars.

However, both companies stressed the alliance was not a merger, and said that it would not change either company's existing plans to rationalise their operations in Europe and to return them to sustainable profitability. At the time the alliance was announced, both PSA and GM's Opel unit were losing money and had more plants than they needed. GM and PSA said the cost synergies from the alliance would be split evenly between the two carmakers, which will continue to compete and sell cars under their own brands and on a competitive basis.

PSA's chief executive said that the alliance grew out of 'a growing realisation of very concrete synergies that exist between our companies.'

GM and PSA's alliance will initially focus on small and midsize cars, multipurpose vehicles and small sport utility vehicles (or crossovers). The two companies said they would also consider developing a new common platform for low-carbon vehicles.

However, while GM and PSA highlighted the potential benefits of the alliance, history shows that alliances between rival carmakers have a patchy track record. Daimler demerged from Chrysler in 2007 after an acrimonious partnership that lasted nine years, and Volkswagen and Suzuki went to arbitration after an alliance they concluded in 2009 ran into difficulties in 2011.

Commenting on GM and PSA's alliance, the head of European automotive research at Credit Suisse said 'The European auto industry is running out of options. This [alliance] is obviously worth the effort, but whether it's going to be successful, who knows?'

Based on: Reed. J, (2012) GM and Peugeot confirm alliance, *Financial Times*, 29 February, www.ft.com

1.5.1 Choosing alliance partners

Hooley *et al* suggest the following factors should be considered in choosing alliance partners.

Drivers	What benefits are offered by collaboration?
Partners	Which partners should be chosen?
Facilitators	Does the external environment favour a partnership?
Components	Activities and processes in the network
Effectiveness	Does the previous history of alliances generate good results? Is the alliance just a temporary blip? For example, in the airline industry, there are many strategic alliances, but these arise in part because there are legal barriers to cross-border ownership.
Market-orientation	Alliance partners are harder to control and may not have the same commitment to the end-user.

Alliances have some limitations

(a) **Core competence**. Each organisation should be able to focus on its core competence. Alliances do not enable it to create new competences.

(b) **Strategic priorities.** If a key aspect of strategic delivery is handed over to a partner, the firm loses flexibility. A core competence may not be enough to provide a comprehensive customer benefit.

2 Aligning organisational structure and strategy

Section overview

- Historically, business strategies tended to be based upon what could be achieved within the confines of an existing organisational structure. However, current thinking is that a successful strategy will be largely informed by external factors, such as PEST or five forces analysis, and as such, the organisational structure should be moulded around the corporate strategy.

Views about organisational structure have changed over time. Traditionally, management theorists have advocated formal structures, alongside a top-down, command-and-control approach to strategy, in which senior managers made the decisions and the rest of the organisation simply implemented them.

However, this view of structure and strategy is now being challenged. In contemporary organisations, where key knowledge is held by employees at all levels within the organisation, and where change is constant, relying on formal top-down structures may no longer be sufficient.

Johnson, Scholes and Whittington point out that a fast-moving, knowledge-intensive world raises two key issues for organisations:

(a) A static concept of formal structure is becoming less and less appropriate, because organisations have to frequently **reorganise themselves in response to changing conditions**.

(b) **Harnessing the valuable knowledge possessed by workers throughout the organisation** requires a more flexible process than top-down formal hierarchies generated. Informal relationships and processes are vital to generating and sharing the knowledge that can be fundamental to competitive advantage.

As a result, formal structures and processes need to be aligned with informal processes and relationships to create **coherent configurations** (see Section 2.2 below).

Contingency approach

In this context, it is important to note the contingency approach to organisational structure, which takes the view that there is no one best, universal structure. There are a large number of variables, or situational factors, which influence organisational design and performance. The contingency approach emphasises the need for **flexibility**.

The most appropriate structure for an organisation depends on its situation. It is an 'if then' approach; in other words, if certain situational factors are present, then certain aspects of structure are most appropriate.

Typical situational factors include:

- Type and size of organisation and purpose
- Culture
- Preferences of top management/power/control
- History
- Abilities, skills, needs, motivation of employees
- Technology (eg production systems)
- Environment

Burns and Stalker identified two (extreme) types of structure (and management style):

- **Mechanistic** – Rigid structure, bureaucratic management structure/style, applicable in stable environments

- **Organic** – More fluid structures, appropriate to changing circumstances (ie dynamic environments).

These distinctions link with the distinction between the prescriptive (rational model) and emergent approaches to strategy and structure. Both mechanistic and organic elements may exist side by side in any one organisation. For example, in a hotel, 'production' departments like the kitchens may be suited to a mechanistic structure but 'service' departments, like marketing, may work better with organic structures.

Burns and Stalkers' mechanistic style is also illustrated in organisations with formalised structures, with strict rules and regulations. The rules control employee behaviour, such that employees have little or no autonomy to make decisions on a case-by-case basis.

Formalisation makes employee behaviour more predictable, since whenever a problem or issue arises, employees know they have to refer to a handbook or a procedure guideline to find out how to deal with the issue. In this way, they respond to issues in a similar way across the organisation, which leads to consistency of behaviour.

For example, McDonald's has a strongly bureaucratic structure, in which employee jobs are highly formalised, with clear lines of communication and very specific job descriptions. This kind of structure is an advantage for McDonald's because it seeks to produce a uniform product around the world at low cost.

However, while formalisation reduces ambiguity and provides clear guidance to employees, it does have some disadvantages. A high degree of formalisation does not encourage innovation, because employees are not given any scope to innovate. Formalised structures are often also associated with reduced motivation and job satisfaction.

In relation to decision-making, formalised structures often leads to a slower pace of decision-making. Employees have to refer any potential decisions to senior managers to make a decision, rather than having any authority to take decisions at a lower level.

By contrast, Google adopts a structure and culture in which employees are encouraged to innovate and take decisions, as illustrated in the case study below.

Case example: Google

Google encourages employee risk-taking and innovation.

When a Vice President in charge of the company's advertising systems made a mistake, costing the company millions of dollars, she was actually commended by Larry Page (one of the co-founders of Google) who congratulated her for trying, noting that he would rather run a company in which people are moving quickly and trying to do too much, rather than being too cautious and doing too little.

This kind of attitude towards acting fast and accepting the cost of mistakes as a natural consequence of operating at the cutting edge, may help explain why the company has performed ahead of competitors such as Yahoo!

Google's culture is also reflected in their approach to decision-making. Decisions at Google are made in teams, rather than being made by a senior person and then implemented top-down. It is common for several team members to tackle a problem and for employees to try to influence each other using rational persuasion and data. Gut feeling has little impact on the way decisions are made, however. Rather than saying, 'I think…', employees are encouraged to say, 'The data suggests…'

A key issue for Google is how to maintain its values as it expands. It is a company which emphasises its desire to hire the smartest people, but this could mean that it will attract people with big egos who are difficult to work with. Google realised that its strength comes from its 'small company' values, which emphasise risk taking, agility and co-operation. Therefore, the recruitment process is very important at Google. The process is extremely rigorous, and each candidate may be interviewed by as many as eight people on several occasions. Through this scrutiny, the company is trying to ensure it selects 'Googley' employees who will share the company's values, perform at high levels, and be liked by their colleagues within the company.

2.1 Challenges that inform structure

Johnson, Scholes and Whittington identify three major groups of challenges for twenty first century organisational structures:

(a) **Flexibility of organisational design.** The rapid pace of **environmental change** and increased levels of **environmental uncertainty** demand flexibility of organisational design.

(b) **Effective systems.** The creation and exploitation of **knowledge** requires effective systems to link the people who have knowledge with the applications that need it.

(c) **Internationalisation.** Internationalisation creates new types and a new scale of **technological complexity** in communication and information systems; at the same time, **diversity of culture**, practices and approaches to personal relationships bring their own new problems of organisational form.

Of these three sets of issues, the need to capture, organise and exploit knowledge is probably the most pressing for most organisations. An important element of response to this need is therefore an emphasis on the importance of facilitating effective **processes** and **relationships** when designing **structures**. Johnson, Scholes and Whittington use the term **configuration** to encompass these three elements.

2.2 Organisational configuration

Definition

Organisational configuration: An organisation's configuration consists of the structures, processes and relationships through which it operates.

(a) **Structure** has its conventional meaning of organisation structure (that is, the formal roles, responsibilities and lines of reporting in an organisation).

(b) **Processes** drive and support people: they define how strategies are made and controlled; and how the organisation's people interact and implement strategy.

(c) **Relationships** are the connections between people within the organisation; and between those inside it and those on the outside. Relationships outside the organisation are becoming increasingly important in the context of outsourcing, supply chain management and strategic alliances.

Effective processes and relationships can have varying degrees of formality and informality and it is important that formal relationships and processes are aligned with the relevant informal ones.

It is very important to be aware that structures, processes and relationships are **highly interdependent**: they have to work together intimately and consistently if the organisation is to be successful.

2.3 Types of structure

An organisation's formal structure reveals much about it.

(a) It shows who is **responsible** for what.

(b) It shows who **communicates** with whom, both in procedural practice and, to a great extent, in less formal ways.

(c) The upper levels of the structure reveal the **skills, the organisation values** and, by extension, the **role of knowledge and skill** within it.

Johnson, Scholes and Whittington review seven basic structural types:

- Functional
- Multi-divisional
- Holding company
- Matrix
- Transnational
- Team
- Project

2.4 The functional structure

Definition

Functional structure: People are organised according to the type of work that they do.

In a functional organisation structure, departments are defined by their **functions,** that is, the work that they do. It is a traditional, common sense approach and many organisations are structured like this. Primary functions in a manufacturing company might be production, sales, finance, and general administration. Sub departments of marketing might be selling, advertising, distribution and warehousing.

2.4.1 Advantages of functional departmentation

- It is based on work specialism and is therefore logical.
- The firm can benefit from economies of scale.
- It offers a career structure.

2.4.2 Disadvantages

- It does not reflect the actual business processes by which **value is created**.
- It is hard to identify where profits and losses are made on individual products.
- People do not have an understanding of how the *whole* business works.
- There are problems of co-ordinating the work of different specialisms.

2.5 The multi-divisional and holding company structures

Definition

Multi-divisional structure: Divides the organisation into semi-autonomous divisions that may be differentiated by territory, product, or market. The holding company structure is an extreme form in which the divisions are separate legal entities.

(a) Divisionalisation is the division of a business into **autonomous regions** or product businesses, each with its own revenues, expenditures and profits.

(b) Communication between divisions and head office is restricted, formal and related to performance standards. Influence is maintained by headquarters' power to hire and fire the managers who are supposed to run each division.

(c) Divisionalisation is a function of organisation size, in numbers and in product-market activities.

Mintzberg believes there are inherent problems in divisionalisation.

(a) A division is partly **insulated** by the holding company from shareholders and capital markets, which ultimately reward performance.

(b) The economic advantages it offers over independent organisations 'reflect fundamental inefficiencies in capital markets'. (In other words, different product-market divisions might function better as independent companies.)

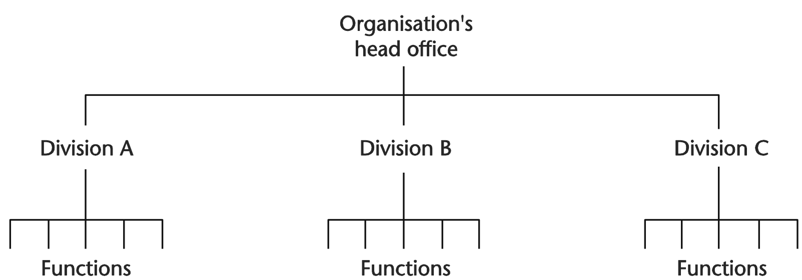
(c) The divisions are **more bureaucratic** than they would be as independent corporations, owing to the performance measures imposed by the strategic apex.

(d) Headquarters management have a tendency to **usurp divisional profits** by management charges, cross-subsidies, head office bureaucracies and unfair transfer pricing systems.

(e) In some businesses, it is impossible to identify completely independent products or markets for which divisions would be appropriate.

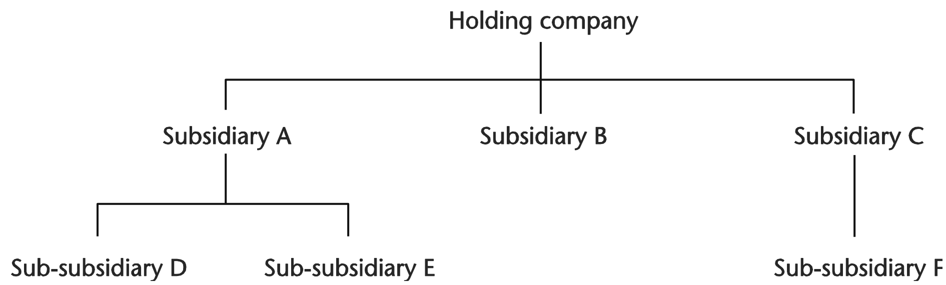
The multi-divisional structure might be implemented in one of **two forms**.

(a) **Simple divisionalisation**



This enables concentration on particular product-market areas, overcoming problems of functional specialisation at a large scale. Problems arise with the power of the head office, and control of the resources. Responsibility is devolved, and some central functions might be duplicated.

(b) The **holding company** (group) structure is a radical form of divisionalisation. **Subsidiaries are separate legal entities**. The holding company can be a firm with a permanent investment or one that buys and sells businesses or interests in businesses: the subsidiaries may have other shareholders.



Divisionalisation has some advantages, despite the problems identified above.

(a) It focuses the attention of subordinate management on business performance and results.

(b) **Management by objectives** is the natural control default.

(c) It gives more authority to junior managers, and therefore provides them with work that grooms them for more senior positions in the future.

(d) It provides an organisational structure which reduces the number of levels of management. The top executives in each division should be able to report direct to the chief executive of the holding company.

2.6 The matrix structure

Definition

Matrix structures: Attempt to ensure co-ordination across functional lines by the embodiment of dual authority in the organisation structure. Matrix structures provide for the formalisation of management control between different functions, whilst at the same time maintaining functional departmentation. It can be a mixture of a functional, product and territorial organisation.

A golden rule of classical management theory is **unity of command**: an individual should have one boss. (Thus, staff management can only act in an advisory capacity, leaving authority in the province of line management alone.) Matrix and project organisation may possibly be thought of as a reaction against the classical form of bureaucracy by establishing a structure of **dual command**, either temporary (in the form of projects) or permanent (in the case of matrix structure).

2.7 Matrix organisation

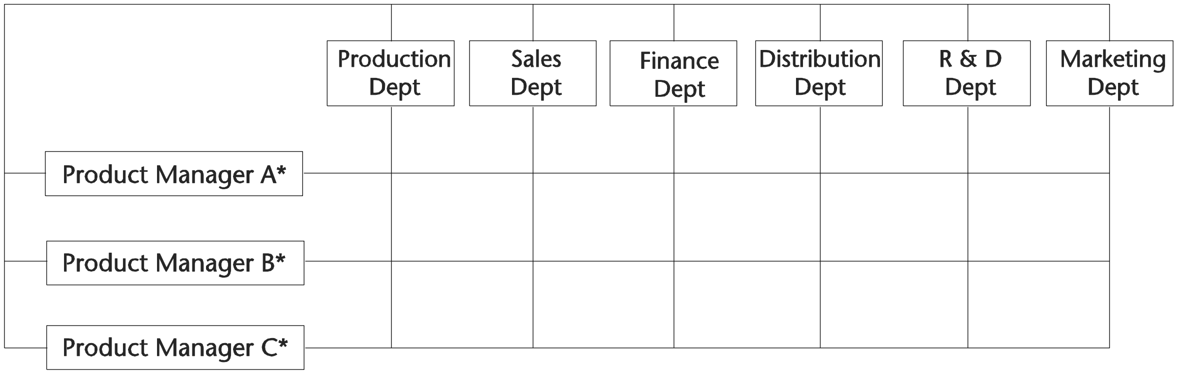
Case example: Lockheed Martin

Matrix management first developed in the 1950s in the USA within the aerospace industry. Lockheed, the aircraft manufacturers, were organised into a functional hierarchy. Customers were unable to find a manager in Lockheed to whom they could take their problems and queries about their particular orders, and Lockheed found it necessary to employ 'project expediters' as customer liaison officials. From this developed 'project co-ordinators', responsible for co-ordinating line managers into solving a customer's problems. Up to this point, these new officials had no functional responsibilities.

Owing to increasingly heavy customer demands, Lockheed eventually created 'programme managers', with authority for project budgets and programme design and scheduling. These managers therefore had functional authority and responsibilities, and thus a matrix management organisation was created.

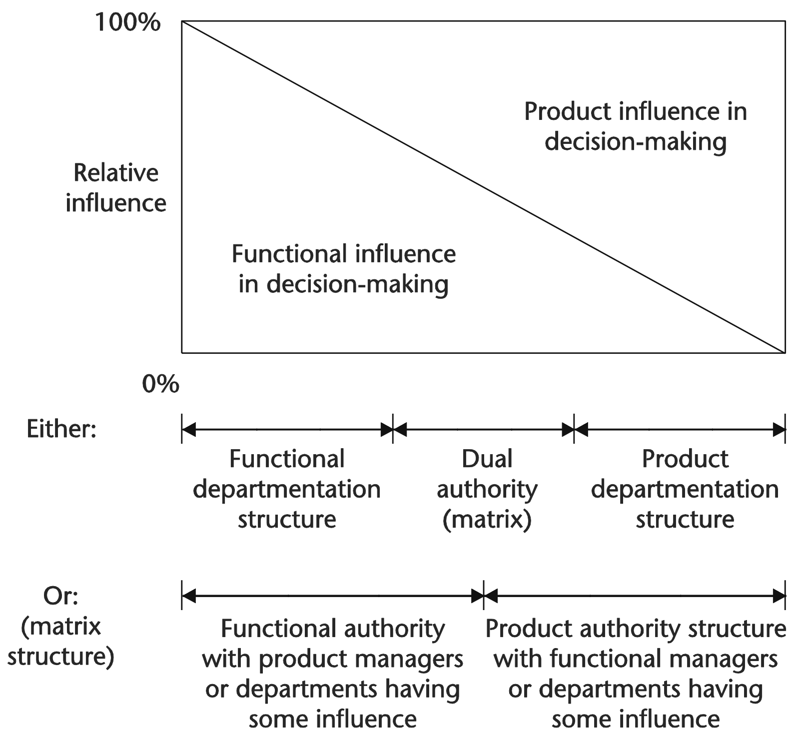
The matrix organisation imposes the multi-disciplinary approach on a permanent basis. For example, it is possible to have a product management structure superimposed on top of a functional departmental structure in a matrix; product or brand managers may be responsible for the sales budget, production budget, pricing, marketing, distribution, quality and costs of their product or product line, but may have to co-ordinate with the

R&D, production, finance, distribution, and sales departments in order to bring the product on to the market and achieve sales targets.



* The product managers may each have their own marketing team; in which case the marketing department itself would be small or non-existent.

The authority of product managers may vary from organisation to organisation.



Once again, the division of authority between product managers and functional managers must be carefully defined.

Matrix management thus **challenges classical ideas** about organisation by rejecting the idea of one person, one boss.

A subordinate cannot easily take orders from two or more bosses, and so an arrangement has to be established, perhaps on the following lines.

(a) A subordinate takes orders from one boss (the functional manager) and the second boss (the project manager) has to ask the first boss to give certain instructions to the subordinate.

(b) A subordinate takes orders from one boss about some specified matters and orders from the other boss about different specified matters. The authority of each boss would have to be carefully defined. Even so, good co-operation between the bosses would still be necessary.

2.7.1 Advantages of a matrix structure

(a) It offers greater **flexibility**. This applies both to **people,** as employees adapt more quickly to a new challenge or new task, and develop an attitude which is geared to accepting change; and to **task and structure**, as the matrix may be short-term (as with project teams) or readily amended (eg a new product manager can be introduced by superimposing his tasks on those of the existing functional managers). Flexibility should facilitate efficient operations in the face of change.

(b) It should improve **communication** within the organisation.

(c) Dual authority gives the organisation **multiple orientation** so that functional specialists do not get wrapped up in their own concerns.

(d) It provides a **structure for allocating responsibility to managers for end-results**. A product manager is responsible for product profitability, and a project leader is responsible for ensuring that the task is completed.

(e) It provides for **inter-disciplinary co-operation** and a mixing of skills and expertise.

A matrix organisation is most suitable in the following situations.

(a) There is a fairly large number of different functions, each of great importance.

(b) There could be communications problems between functional management in different functions (eg marketing, production, R&D, personnel, finance).

(c) Work is supposed to flow smoothly between these functions, but the communications problems might stop or hinder the work flow.

(d) There is a need to carry out uncertain, interdependent tasks. Work can be structured so as to be **task centred**, with task managers appointed to look after each task, and provide the communications (and co-operation) between different functions.

(e) There is a need to achieve common functional tasks so as to achieve savings in the use of resources – ie product divisions would be too wasteful, because they would duplicate costly functional tasks.

2.7.2 Disadvantages of matrix organisation

(a) Dual authority threatens a **conflict** between managers. Where matrix structure exists it is important that the authority of superiors should not overlap and areas of authority must be clearly defined. Subordinates must know to which superior they are responsible for each aspect of their duties.

(b) One individual with two or more bosses is more likely to suffer **role stress** at work.

(c) It is sometimes more **costly** – eg product managers are additional jobs which would not be required in a simple structure of functional departmentation.

(d) It may be **difficult for the management to accept** a matrix structure. It is possible that a manager may feel threatened that another manager will usurp his or her authority.

(e) It requires consensus and agreement which may slow down decision-making.

2.8 The transnational structure

Definition

The transnational structure: Attempts to reconcile global scope and scale with local responsiveness.

In international strategy it has been difficult to combine **responsiveness to local conditions** with the degree of co-ordination necessary to achieve major **economies of scale**. The essence of the extreme case of the problem is an enforced choice between a low-cost product originally specified for a single market (typically the USA), which is potentially uninteresting or even actively shunned in other markets, and a range of low volume, and therefore high-cost, products, each specified for and produced in a single national market. These two cases are known as the **global** and the **multi-domestic** approaches to organisation and they have their own characteristic organisational structures. The global approach leads to **global divisions**, each responsible for the worldwide production and marketing of a related group of standardised products. The multidomestic approach leads to the setting up or acquisition of local subsidiaries, each with a great deal of autonomy in design, production and marketing.

The **transnational structure** attempts to combine the best features of these contrasting approaches in order to create **competences of global relevance**, **responsiveness to local conditions** and **innovation and learning** on an organisation-wide scale. Bartlett and Ghoshal describe it as a **matrix** with two important general features.

(a) It responds specifically to the challenges of globalisation.

(b) It tends to have a high proportion of fixed responsibilities in the horizontal lines of management.

The transnational organisation has three specific operational characteristics:

(a) National units are **independent operating entities**, but also provide capabilities, such as R&D, that are utilised by the rest of the organisation.

(b) Such shared capabilities allow national units to achieve global, or at least regional, **economies of scale**.

(c) The global corporate parent adds value by establishing the **basic role of each national unit** and then supporting the **systems, relationships and culture** that enable them to work together as an effective network.

If it is to work, the transnational structure must have very clearly defined managerial roles, relationships and boundaries.

(a) **Managers of global products or businesses** have responsibilities for strategies, innovation, resources and transactions that transcend both national and functional boundaries.

(b) **Country managers** must feed back local requirements and build unique local competences.

(c) **Functional managers** nurture innovation and spread best practice.

(d) **Managers at the corporate parent** lead, facilitate and integrate all other managerial activity. They must also be talent spotters within the organisation.

2.8.1 Disadvantages of the transnational structure

The transnational structure makes great demands on its managers, both in their immediate responsibilities and in the complexity of their relationships within the organisation. The complexity of the organisation can lead to the difficulties of control and the complications introduced by internal political activity.

2.9 The team-based structure

Both transnational and project-based structures extend the matrix approach by using cross-functional teams. The difference is that projects naturally come to an end, and so project teams disperse at this point.

A team-based structure extends the matrix structure's use of both vertical functional links and horizontal, activity-based ones by utilising **cross-functional teams**. Business processes are often used as the basis of organisation, with each team being responsible for the processes relating to an aspect of the business. Thus, a purchasing team might contain procurement specialists, design and production engineers and marketing specialists in order to ensure that outsourced sub-assemblies were properly specified and contributed to brand values as well as being promptly delivered at the right price.

2.10 The project-based structure

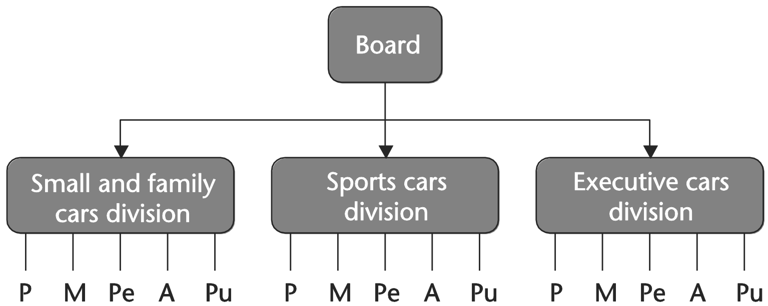
Definition

Project-based structure: Employees from different departments work together on a temporary basis to achieve a specific objective or to address a specific issue. Employees within the team perform specific job functions.

The project-based structure is similar to the team-based structure except that projects, by definition, have a **finite life** and so, therefore, do the project teams dealing with them. This approach is very flexible and is easy to use as an adjunct to more traditional organisational forms. Management of projects is a well-established discipline with its own techniques. It requires clear project definition, if control is to be effective, and comprehensive project review, if longer-term learning is to take place.

Interactive question 3: Car manufacturer [Difficulty level: Intermediate]

Danley Ltd is a car manufacturing company. It commenced business forty years ago and is currently organised along divisional lines. An outline organisation chart is shown below:



Key

P	=	Production	**Locations**	
M	=	Marketing	Small and family	Luton
Pe	=	Personnel	Sports	Bristol
A	=	Accounting	Executive	Newcastle
Pu	=	Purchasing		

The company is very keen to cut costs and improve profits before being floated on the Stock Exchange in 20X5. The current organisation structure owes much to history, reflecting the purchase of the sports car and executive car businesses in the past. Each division uses the same suppliers of components for cars and has the same accounting system.

Both the small and family cars division and the sports cars division use production line systems, whereas the executive cars division uses a small batch production system. Money is available for investment in new production systems.

The following comments have been made to you:

'Because of the slow production system we use where hold-ups between departments occur regularly, we only make two types of executive car, yet we sell all we can make. The marketing department feels that if we could make more types of car, including minor variations around a basic type, we could sell more. I must say that most of my workers seem to get rather bored making the same two cars.'

Richard Ingram (Managing director, Danley Ltd)

'My department has been arguing for some time that we're missing out on cost savings by having three purchasing functions. All purchasing can be done by one function. Unfortunately, some of the cost savings will come from redundancies. The best people in the three functions should be put together to form one function in Luton.'

Ray Pay (Purchasing manager, Small and family cars division)

Requirement

Recommend, with reasons, a revised organisation structure that would best suit the circumstances of the firm.

See **Answer** at the end of this chapter.

2.11 Choosing a structure

An organisational structure must provide a means of exercising appropriate **control**; it must also respond to the three challenges identified earlier: **rapid change**, **knowledge management** and **globalisation**.

Johnson, Scholes and Whittington summarise the seven basic types in a table with the number of stars indicating the capacity to deal with each challenge: three stars indicates high capacity; one star indicates low capacity.

	Control	Change	Knowledge	Globalisation
Functional	* * *	*	* *	*
Multidivisional	* *	* *	*	* *
Holding	*	* * *	*	* *
Matrix	*	* * *	* * *	* * *
Transnational	* *	* * *	* * *	* * *
Team	*	* *	* * *	*
Project	* *	* * *	* *	* *

However, Johnson, Scholes and Whittington still emphasise that no single model of organisational structure is suitable for all purposes: managers must make choices as to which challenges they regard as most pressing.

Goold and Campbell propose nine tests that may be used to assess proposed structures. The first four relate to the organisation's **objectives** and the **restraints** under which it operates.

(a) **Market advantage**: Where processes must be closely co-ordinated in order to achieve market advantage, they should be in the same structural element.

(b) **Parenting advantage**: The structure should support the parenting role played by the corporate centre. For example, a 'portfolio manager' would need only a small, low cost corporate centre.

(c) **People test**: The structure must be suited to the skills and experience of the people that have to function within it. For example, skilled professionals used to a team-working approach might be frustrated by a move to a functional hierarchy.

(d) **Feasibility test**: This test sweeps up all other constraints, such as those imposed by law, stakeholder opinion and resource availability.

The tests forming the second group are matters of **design principle**.

(a) **Specialised cultures**: Specialists should be able to collaborate closely.

(b) **Difficult links**: It is highly likely that some inter-departmental links will be subject to friction and strain. A good example would be the link between sales and production when there are frequent problems over quality and delivery. A sound structure will embody measures to strengthen communication and co-operation in such cases.

(c) **Redundant hierarchy**: The structure should be as flat as is reasonably attainable.

(d) **Accountability**: Effective control requires clear lines of accountability.

(e) **Flexibility**: The structure must allow for requirements to change in the future, so that unexpected opportunities can be seized, for example.

2.12 Network structure

A very modern idea is that of a **network structure**, applied both within and between organisations. Within the organisation, the term is used to mean something that resembles both the **organic** organisation and the structure of informal relationships that exists in most organisations alongside the formal structure. Such a loose, fluid approach is often used to achieve innovative response to changing circumstances.

The network approach is also visible in the growing field of outsourcing (see Section 4.12) as a strategic method. Complex relationships can be developed between firms, who may both buy from and sell to each other, as well as the simpler, more traditional practice of buying in services such as cleaning.

Writers such as Ghoshal and Bartlett point to the likelihood of network organisations becoming the corporations of the future, replacing formal organisation structures with innovations such as **virtual teams**. Virtual teams are interconnected groups of people who may not be in the same office (or even the same organisation) but who:

- Share information and tasks
- Make joint decisions
- Fulfil the collaborative function of a team

Organisations are now able to structure their activities very differently:

(a) **Staffing.** Certain areas of organisational activity can be undertaken by freelance or contract workers. Charles Handy's 'shamrock organisation' is gaining recognition as a workable model for a leaner and more flexible workforce, within a controlled framework. The question is: how can the necessary control be achieved though?

(b) **Leasing of facilities** such as machinery, IT and accommodation (not just capital assets) is becoming more common.

(c) **Production** itself might be outsourced, even to offshore countries where labour is cheaper. (This, and the preceding point, of course beg the question: which assets and activities do companies retain, and which ones do they 'buy-in'?)

Interdependence of organisations is emphasised by the sharing of functions and services. Databases and communication create genuine interactive sharing of, and access to, common data.

Johnson, Scholes and Whittington give four examples of network organisational structures:

(a) **Teleworking**, which combines independent work with connection to corporate resources.

(b) **Federations of experts** who combine voluntarily. This is common in the entertainment industry.

(c) **One-stop shops** for professional services in which a package of services is made available by a co-ordinating entity. The point of access to such a conglomerate might be a website.

(d) **Service networks** such as the various chains of franchised hotels that co-operate to provide centralised booking facilities.

Network structures are also discerned between competitors, where **co-operation on non-core competence matters** can lead to several benefits:

- Cost reduction
- Increased market penetration
- Experience curve effects

Typical areas for co-operation between **competitors** include R&D and distribution chains. The spread of the Toyota system of manufacturing, with its emphasis on just-in-time, quality and the elimination of waste has led to a high degree of integration between the operations of industrial **customers** and their **suppliers**.

3 Managing change

Section overview

- Introducing new strategic choices represents a form of change. As such, organisations must understand how change can be achieved and in particular, how resistance to change can be overcome.
- Equally, if it becomes clear that an organisation's current strategy has not worked as had been intended, then the organisation will need to make changes to its strategy or tactics in order to improve its performance.

It is very hard to ignore the impact of change on contemporary businesses. However, the visibility of change in this way also highlights the importance of understanding and managing the impact of change on businesses and the people who work for them.

Change is often an integral part of strategy. It is very important to be aware that strategic change and change management issues may be implicit in a scenario rather than being the explicit subject of a question requirement. You must be able to recognise the factors that drive change and constrain the ways in which it may be managed.

However, before we start to look at change management theories and models, we will look at some of the practical issues involved by using a case study.

Case example: McDonald's Fast Food Restaurants

Society's attitudes to fast food have been changing in the last few years, and if the fast food industry is to remain successful, it needs to recognise these shifting customer needs and respond to them. Concerns about rising obesity levels and advances in healthcare have highlighted the importance of a healthy diet. Increased access to mass communications (television, internet) have meant that consumers are becoming more informed about issues and are demanding better choices in convenience foods.

Meeting stakeholder needs

Changing **customer needs and requirements** illustrate the more general issue that the business environment is not static, but evolves over time, reflecting changes in the broader social environment.

However, customers are not the only important stakeholder whose interests McDonald's need to consider.

Other stakeholders include:

- **Business partners** – including franchisees and suppliers (Many of McDonald's restaurants are run by franchisees).
- **Employees** – When taken together, McDonald's corporation and its franchisees employ approximately 1.5 million people, with more than 30,000 restaurants spread across about 120 countries.
- **Opinion leaders** – including governments, the media, health professionals and environmental groups. McDonald's is very conscious of its corporate social responsibility, and constantly looks to adapt its operations to increase the positive impact it can have on society.

Responding to customers' needs

McDonald's conducts market research and listens to what its customers want to see on its menu, and also to understand customer opinions about brand image, quality, service, cleanliness and value.

One of the messages that emerged from this research in recent years was that customers wanted more choice, with healthier and lighter food options. Customers also wanted greater visibility in food labelling and more information about what they were eating: for example, how much fat and how much salt their meals contained.

Creating menu changes

McDonalds took a two-fold approach to converting these customer findings into menu changes. On the one hand, they improved existing products, and on the other, they created new ones.

Improving existing products – changes included introducing new cooking oil blends which were low in saturated fat, and reducing the amount of salt used when preparing the meals.

New products – these include new salad and deli choice ranges, which contain low levels of fat.

In addition, McDonalds now provides customers with extensive nutritional labelling, both in-store and on the company website. Packaging includes recommended daily intakes (for example of fats or carbohydrates) so that customers can see how their food choices relate to their overall daily requirements.

However, despite the changes, the new menu options are still consistent with the McDonald's brand. The packaging, presentation and service are still recognisably McDonald's.

Communicating the changes

Although making the changes was crucial, it was equally important to communicate the changes to the consumer. To this end, McDonald's developed advertising campaigns that were designed to highlight the new healthier food options, countering public perceptions of McDonald's as only selling unhealthy meals.

McDonald's has made use of a variety of advertising media – print, billboards, television and the internet – and it targets its audience for each media type carefully. For example, website advertising is designed to be appealing to teenagers, so is both interactive and informative, making use of the latest design and technology.

The McDonald's example illustrates how change occurs in a social context. This is an important point to recognise, because change management does not simply involve a choice between technological, organisational or people-oriented solutions. Rather, it involves finding solutions that combine these factors to provide integrated strategies, which help improve performance and results.

Change management is a crucial part of any project, which leads or enables people to accept new processes, technologies, systems, structures and values. Change management consists of the set of activities that help people move from their present way of working to a new, and hopefully improved, way of working.

3.1 The need for change

Definition

Change management: 'The continuous process of aligning an organisation with its marketplace and doing it more responsively and effectively than competitors'. (Berger)

Any organisation that ignores change does so at its own peril, because its inactivity is likely to weaken the organisation's ability to manage future scenarios.

The management guru, Peter Drucker, argues that a 'winning strategy' will require information about events and conditions outside the organisation, because only once an organisation has that information can it prepare for the new changes and challenges which arise from shifts in the world economy.

This does not, however, mean that implementing a strategic change will necessarily improve an organisation's performance.

Case example: Marks & Spencer

In 1993, Britain was experiencing a recession, and all the major retailers were suffering as consumers looked to cut back on their spending.

Marks and Spencer's (M&S) chief executive at the time, Richard Greenbury, decided to concentrate on the company's traditional core businesses of clothing and food to steer it through this difficult time. The strategy appeared to be successful, and M&S's profits rose steadily over the next few years and Greenbury planned to double the number of European stores by the year 2000.

However, the face of high street retail was changing, and a number of new companies such as Monsoon and Gap were emerging. They segmented the market, and offered customers cheaper, more socially aware designs than M&S. Additionally, Tesco, Sainsbury and Waitrose challenged M&S for some of its core business in the food sector. These companies eroded M&S's competitive advantage by offering products of similar quality at better value, thereby making M&S's product lines look expensive.

M&S's results in 1998 showed that falling sales had caused profits to halve from the previous year.

Luc Vandevelde became CEO in 2000, and he introduced new designers and new product ranges (eg Per Una) and switched to cheaper overseas suppliers to face the increased competition in the clothing market. (M&S had historically only used UK suppliers and had built up strong relationships with its suppliers, using the quality of its produce as a strong source of competitive advantage).

As profits continued to fall, M&S sold off its European operations, and decided to concentrate on its core UK businesses, opening a number of homeware and food only stores.

Celebrity endorsements, such as David Beckham's 'DB07' children's clothing range, were also introduced. Profits began to rise again in mid 2002 as a result of these activities, and then the top board posts were separated as Mr Vandevelde remained as chairman but handed over the CEO role to Roger Holmes.

By 2004, sales had slowed again, and M&S had to fight to stave off a takeover bid from the retail tycoon, Sir Philip Green. The policy of sourcing products directly from overseas continued, with the Far East and Eastern

Europe being the key locations. However, M&S continued to lose market share in its core business areas to competitors such as Asda and Next.

In 2005, M&S reacted to slowing sales by cutting prices to try to put pressure on its rivals. It also introduced a new promotional brand – Your M&S – which has become the main focus for its advertising and in-store merchandising. The 'Your M&S' brand was designed to portray a more modern and youthful image for M&S. To support this newer image, M&S has also been rolling out a new store format across all its stores – making them brighter and more spacious. The new look, combined with successful advertising campaigns in 2005–6 (for example the clothing campaign featuring Twiggy, and the food adverts with the slogan, 'This is not just food, this is M&S food') led to a resurgence in performance in 2006–7.

However, the economic downturn from 2008-9 meant that shoppers once again became more conservative in their spending. Price once more became a key issue, and M&S responded to this in their food stores with their '2 Dine for £10' offers – offering customers a 'restaurant experience' for less. Rather than competing on price with other food retailers, M&S effectively started competing with restaurants: offering customers a main meal, vegetables, and dessert for two, with a bottle of wine, for just £10. In other words, customers could get a restaurant-standard meal for £10, although they had to eat it in their own homes rather than a restaurant.

3.2 The process of change

In the same way that choosing a business strategy encourages an organisation to assess its current **position**, evaluate its strategic **choices**, and then decide upon a course of action to **implement**, we can also look at change management as a sequence of stages.

For an organisation to respond to the need for change, it needs a way of **planning for**, and **implementing changes**.

Although each situation should be considered individually, we can still identify some general steps which could be followed during a major change initiative.

Change processes usually begin with a change '**trigger**'. The trigger identifies the need or desire for change in a particular area.

Triggers include:

External events

- Changes in the economic cycle (for example, an economic downturn)
- New laws or regulations affecting the industry
- Stiffer competition from rivals or from new entrants
- Arrival of new technology (for example, the impact of faster communications and digital downloads on music and film entertainment)

Internal events

- Arrival of new senior management with different strategies, priorities and styles
- Implementation of new technologies or working practices
- Relocation of the business to different city or country

These triggers will force change. The issue for management is whether to seek to manage the change to get the best outcome, or just to let the change event run its course with uncertain outcomes.

In response to the trigger, some tentative plans about possible changes are prepared. Wherever possible, an organisation should consider a range of alternatives, and consider the advantages and disadvantages of each. **Stakeholders**' probable reactions to the changes should also be considered.

A preferred solution should then be chosen from the range of alternative options, and a **timetable** for implementing the changes should be established. The **speed** at which change is implemented is likely to depend on the nature of the change and people's anticipated reactions to it.

The plan for change then needs to be **communicated** to everyone who will be involved in implementing it, before the actual implementation stage gets underway.

Balogun and Hope Hailey summarise the process of change in a change flow chart.

Stage 1: Analyse competitive position

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Stage 2: Determine type of change needed

↓

Stage 3: Identify desired future state

↓

Stage 4: Analyse the change context

↓

Stage 5: Identify the critical change features

↓

Stage 6: Determine the design choices

↓

Stage 7: Design the transition process – levers and mechanisms

↓

Stage 8: Manage the transition

↓

Stage 9: Evaluate the change outcomes

Stages 1 and 2 of the flow chart can be summarised as the '**why and what**' of change, while Stages 3–9 can be summarised as the '**how**' of change.

Having identified the need for change in an organisation, then plotted an outline strategy, it is important that managers can implement the desired change(s) successfully.

We have identified a number of situations that might act as triggers for change in an organisation. However, it also important that organisations realise that change is an ongoing process and needs to be addressed all the time.

In the modern market economy, change is inherent in society. Not only do technologies change, so too do social norms, tastes and trends, demographic profiles and people's expectations of employment. In fact, almost every aspect of collective human life is subject to constant change.

In this respect, it is wrong to think a visionary 'future state' can always be reached through some highly programmed way.

Moreover, successful change management requires more than simply recognising a change trigger and acting on it. Successful exploitation of a change situation requires:

- Knowledge of the circumstances surrounding a situation
- Understanding of the interactions in that situation
- Awareness of the potential impact of the variables associated with the situation

Nevertheless, many organisations do view change as a highly programmed process which follows a 'formula' and it is useful for us to consider a framework for change:

Recognition – Identify the problem that needs to be rectified

Diagnosis – Break down the problem into component parts

Solution – Analyse possible alternatives
– Select preferred solution
– Apply preferred solution

Alternatively, 'change management' could be approached from a project management perspective, in which the business dimensions of change can be broken down into the following elements:

- Business need or opportunity is identified
- Project is defined (scope and objectives of project identified)
- Business solution is designed (for example, new processes, systems and organisational structure designed)
- New processes and systems are developed
- Solution is implemented into the organisation

3.3 Lewin's three stage model (The 'ice cube' model)

Although the essence of change is that it enables a person, department or organisation to move from a current state to a future state, Lewin suggested that organisational changes actually have **three steps** (stages): '**unfreeze**', '**move**' and **'freeze'** or '**refreeze**.' (In this Study Manual we will refer to the third stage as 'Refreeze' because we think it describes the process more clearly. However, in his original model, Lewin actually referred to the stage simply as 'freeze'.)

It is important to note that change involves re-learning: not merely learning something new, but trying to unlearn what is already known and practised in an organisation. This is a key part of the 'unfreeze' stage.

Unfreeze → Change → Refreeze

3.3.1 Unfreeze

This first step involves unfreezing the current state of affairs, and creating the motivation to change. This means defining the current state of an organisation, highlighting the forces driving change and those resisting it, and picturing a desired end state.

Crucially, the unfreeze stage involves making people within an organisation ready to change: making them aware of the **need (trigger) for change**, and creating a **readiness to change** among the workforce.

A key part of this stage is **weakening the restraining forces** that are resisting change, and **strengthening the driving forces** that are promoting change.

Approaches to the unfreeze stage include:

- Physically **removing** individuals from their accustomed routines, sources of information and social relationships, so that old behaviours and attitudes are less likely to be reinforced by familiarity and social influence.
- **Consulting** team members about proposed changes. This will help them to feel less powerless and insecure about the process. It may also involve them in evaluation and problem-solving for more effective change measures – which will create a measure of ownership of the solutions. This, in turn, may shift resistant attitudes.
- **Confronting** team members' perceptions and emotions about change. Failure to recognise and deal with emotions only leads to later problems. Negative emotions may be submerged, but will affect performance by undermining commitment.
- Positively **reinforcing** demonstrated willingness to change: validating efforts and suggestions with praise, recognition and perhaps added responsibility in the change process.

If the need for change can be 'sold' to the team as immediate, and its benefits highlighted – for example, by securing individuals' jobs for the future - the unfreeze stage will be greatly accelerated.

Either way, effective **communication**, explaining the need for change is essential for the unfreeze process to work successfully.

'Unfreezing' an organisation may sound simple enough in theory, but in practice, it can be very difficult because it involves making people ready to change.

Rational argument will not necessarily be sufficient to convince individuals of the need to change, particularly if they stand to lose out from the change, or will have to make significant personal changes as a result of the change.

Sometimes the need for change may be obvious to all employees – for example, the arrival of a new competitor in the market, leading to a dramatic reduction in market share.

However, if the need for change is less obvious, then the 'unfreezing' process may need to be 'managed' in some way, to make staff appreciate the need for change.

For example:

- Encourage debate about the appropriateness or effectiveness of the current way of operating (including current management styles).
- Publish information showing how the organisation compares with its competitors in key performance areas.

3.3.2 Change (Move)

The change (move) stage involves learning new concepts and new meanings for existing concepts. This is the **transition stage**, by which an organisation moves from its current state to its future state.

It is important that an organisation encourages the **participation** and **involvement** of its staff in this phase so that they do not feel alienated by the change process.

This phase is mainly concerned with identifying the new, desirable behaviours or norms; communicating them clearly and positively; and encouraging individuals and groups to '**buy into**' or '**own**' the new values and behaviours.

Change is facilitated by:

- **Identification:** Encouraging individuals to identify with role models from whom they can learn new behaviour patterns. For example, the team leader should adopt the values and behaviours he or she expects the team to follow. Team members who have relevant skills, experience and/or enthusiasm may be encouraged to coach others.
- **Internalisation:** Placing individuals in a situation in which new behaviours are required for success, so that they *have* to develop coping behaviours. Pilot schemes or presentation of the changes to others may help in this process.

3.3.3 Refreeze (Freeze)

The refreeze stage involves internalising new concepts and meanings. It focuses on **stabilising (refreezing) the new state of affairs**, by setting policies to embed new behaviours, and establishing new standards.

It is crucial that the **changes are embedded** throughout an organisation to ensure that staff do not lapse back into old patterns of behaviour.

Once new behaviours have been adopted, the refreeze stage is required to consolidate and reinforce them, so that they become integrated into the individual's habits, attitudes and relationship patterns.

- **Habituation effects** (getting accustomed to the new situation) may be achieved over time, through practice, application and repetition.
- **Positive reinforcement** can be used to reward and validate successful change. For example, an element of a staff bonus scheme could be dependent on staff members adopting the new methodology.

In the 'unfreeze' stage of the three stage model, we highlighted the interaction of driving forces promoting change, and resisting forces preventing it. Lewin recognised the importance of this interaction, and so alongside the three stage model, he also introduced the idea of force field analysis.

3.4 Lewin's Force field analysis

Force field analysis assists change management by examining and evaluating – in a summary form – the forces 'for' and 'against' the change.

Force field analysis consists of identifying the factors that promote or hinder change. In order for change to be successfully implemented, promoting forces need to be exploited and the effect of hindering forces need to be reduced, such that the driving forces for change outweigh those forces resisting change.

The following suggests a practical route for applying the force field analysis:

(a) Define the problem in terms of the current situation and the desired future state.

(b) List the forces supporting and opposing the desired change and assess both the strength and the importance of each one.

(c) Draw the force field diagram.

(d) Decide how to strengthen or weaken the more important forces as appropriate and agree with those concerned. Weakening might be achieved by persuasion, participation, coercion or bargaining, while strengthening might be achieved by a marketing or education campaign, including the use of personal advocacy.

(e) Identify the resources needed.

(f) Make an action plan including event timing, milestones and responsibilities.

Note, however, that force field analysis itself **doesn't give any detailed insights into how to manage change**, or how to overcome the resistance to change.

Lewin's basic idea was that the change process consisted of two opposing fields of force, one encompassing the driving forces for change, the other encompassing the resisting forces.

In this form, Lewin's model is relatively straightforward: the central line represents the current situation, and in a change scenario, we can identify both those sets of forces that are trying to effect change and those which are resisting or providing barriers.

Management action therefore needs to be directed towards either reducing the resisting forces, turning them around, or overcoming them by increasing the drivers for change.

However, there are several drawbacks to force field analysis.

(a) Firstly, it depicts change as being '**insider' driven** – the presumption is that some people in the business are committed to a change and others are not, and the task is to tilt the balance in favour of those who have that commitment. Although Lewin would not have approved of it, this can easily be interpreted as a technique for enabling managers to force their decisions on an unwilling workforce.

(b) The second issue is that it **presumes that all change is desirable**. Presentations of this model do not usually include discussion of how change should be resisted, yet there are probably as many occasions when a proposal is undesirable or unworkable as there are ones where it is to be encouraged.

(c) The Lewin image as it is generally presented depicts all driving forces as operating in the same direction, and all resisting forces as running in the opposite direction. In practice, the key influences in a situation – usually the more powerful stakeholders – are pointing in varying directions, as in the following.

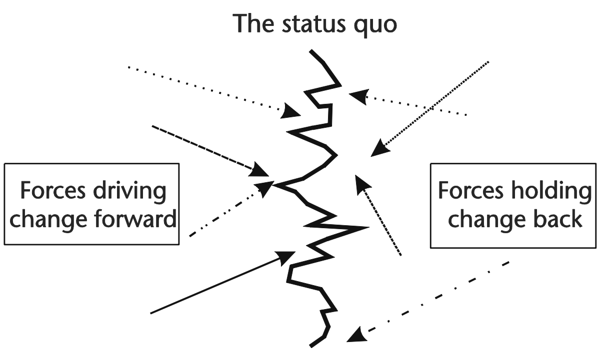


Figure 3.1: Force field analysis

The point of Figure 3.1 above is that it reflects the complexity of the force fields in a change scenario more accurately than a simple illustration. For example, people may resist change for different reasons and so different solutions will be needed to manage their resistance to change.

Resisting forces are central to Lewin's approach to change management. It is therefore important both to identify these resisting forces and then also to think of ways to deal with them. (Before doing this, though, bear in mind a point made earlier, that not all change is desirable.)

Sources of resistance are generally linked to human interests – hygiene factors mostly, to use Herzberg's concept. Senior has set out the following as the main sources of individual resistance.

- Fear of the unknown
- Dislike of uncertainty
- Potential loss of power
- Potential loss of rewards
- Potential lack of or loss of skills

These sources of resistance spring from direct human concerns. Interestingly, Senior also identifies a number of organisational resistances, such as resource constraints, or inertias resulting from the interlocked nature of the different features and processes of the organisation. But for the most part, organisational resistances feed back to human concerns. Where they do not, there is unlikely to be a strategic change problem, but perhaps a technical problem of issues such as co-ordination or process design.

Interactive question 4: Managing change **[Difficulty level: Easy]**

After a difficult few years trading, a new chief executive, Brian Parsons, has been appointed to the board of Timbermate Ltd. A large divisionalised company, it specialises in the production of wood-based products, from plywood and chipboard, to kitchens and conservatory windows.

In his initial press interview, Parsons stated that the costs incurred by the business were far too high and that efficiency and productivity were unacceptably low. He has made clear his intention to turn the business around. However, there have already been rumblings from the union to which most of the workers belong. They are not prepared to negotiate over wages or working conditions.

Timbermate is a major importer of wood. Russian and Scandinavian joinery redwood, together with spruce from North America, make up a high percentage of imports. They also import from the Baltic States. Although BDT is strong against the dollar, it has been struggling lately against the other currencies. There have been signs that some of Timbermate's overseas suppliers are considering expanding into the Bangladesh directly. There has also been an increase in the popularity of UPVC alternatives in a number of Timbermate's core business areas.

A number of operational issues need addressing. Recently, complaints about quality and product specification have become more common. Additionally, the delivery fleet has become less reliable and several key customers have been let down. However, many of the senior managers do not seem unduly concerned. They often talk of the timber crisis of 1992 and how these problems are just part of the nature of the industry. They rarely stay at their desks after 5pm. There is little in the way of knowledge sharing and it is unusual for staff in any one division to even know the names of staff in the others.

One key pillar of Parson's plan is to introduce a fully integrated information system, covering (amongst others) stock control and e-procurement, computer aided design and manufacture, resource planning and management accounting. The system is to operate across all the divisions and allow potential cross-selling and better customer management.

Requirements

(a) Analyse the forces for and against change at Timbermate Ltd.
(b) Recommend to Brian Parsons how he might best manage the change process.

See **Answer** at the end of this chapter.

3.5 Types of change

When faced with a potential change situation, an organisation has to analyse the nature of the change, in order to identify the most appropriate way of managing the change.

Change can be classified in relation to the **extent** of the change required and the **speed** with which that change needs to be achieved.

Speed – Change can range from an all-at-once, 'big bang' change to a series of step-by-step, incremental changes.

Extent – The extent of change can range from an overall **transformation** of an organisation's central assumptions, culture and beliefs to a **realignment** of its existing assumptions. Although a realignment may affect the way an organisation operates at a practical level, it will not lead to an underlying change in the organisation's culture.

In their book *Exploring Strategic Change*, Balogun and Hope Hailey illustrate that there are four main types of change, based on differences in the speed and extent of change required. They present these types of change in a matrix, with the two axes being the **nature** of the change required (speed) and the **scope** of the change required (extent).

The measure of the scope of change is whether or not the methods and assumptions of the existing **paradigm** must be replaced. (The paradigm is the set of assumptions and beliefs which are taken for granted in an organisation and define that organisation and its culture.)

The **nature** of change may be incremental and built on existing methods and approaches, or it may require a 'big bang' approach if rapid response is required, as in times of crisis.

Scope of change

Nature of change		Realignment	Transformation
	Incremental	Adaptation	Evolution
	'Big bang'	Reconstruction	Revolution

(a) **Adaptation** is the most common type of change. An adaptive change realigns the way an organisation operates, but does not require the development of a new paradigm. It proceeds step by step.

(b) **Reconstruction** can also be undertaken within an existing paradigm but requires rapid and extensive action. It is a common response to a long-term decline in performance, or to a changing competitive context.

(c) **Evolution** is an incremental process that leads to a new paradigm. It may arise from careful analysis and planning or may be the result of **learning processes**. Evolutionary change is often undertaken in anticipation of the need for future change. Its transformational nature may not be obvious while it is taking place.

(d) **Revolution** is a rapid and wide ranging response to extreme pressures for change, and can often be triggered by changes in the competitive conditions an organisation is facing. Because revolution is both wide-ranging and fast-paced, it is likely to involve a number of simultaneous initiatives, dealing with different aspects of a business. Revolution will be very obvious and is likely to affect most aspects of both what the organisation does and how it does them.

While Balogun and Hope Hailey talk about realignment and transformation, Johnson, Scholes and Whittington categorise types of strategic change as being either **incremental** or **transformational**.

Again, however, a matrix can be used; change is either **incremental** or **transformational**, and the approach to managing change is described as being either **reactive** or **proactive**.

Incremental change is characterised by a series of small steps, and does not challenge existing organisational assumptions or culture. It is a gradual process, and can be seen as an extension of the past. Management will feel that they are in control of the change process. There is also a feeling that incremental change is reversible. If the change does not work out as planned, the organisation can revert to its old ways of doing things.

Transformational change is characterised by major, significant change being introduced relatively quickly. The existing organisational structures and the organisational culture are changed. Transformational change is likely to be a top-down process, initiated, and possibly imposed, by senior management. However, unlike incremental change, it requires new ways of thinking and behaving, and leads to discontinuities with the past. Consequently, it is likely to be irreversible.

Transformational change may come about because:

- The organisation is faced with **major external events** that demand large-scale changes in response.
- The organisation **anticipates major changes** in the environment and initiates action to make shifts in its own strategy to cope with them.
- Strategic drift has led to deteriorating performance and so leaves the organisation now requiring **significant changes to improve performance**.

Johnson, Scholes and Whittington's change matrix reflects these different change categories, but also highlights how management's response differs according to the different change categories.

Nature of change

Management role		Incremental	Transformation
	Proactive	Tuning	Planned
	Reactive	Adaptation	Forced

The importance of **proactive management** is that it implies that organisational change may be undertaken **before** it is imposed by events. It may, in fact, result from the process of forecasting and be a response to expected developments.

Forced change (for example, where an organisation has to make significant and rapid change due to changes in the external environment) is likely to be both painful and risky for an organisation.

Although these change matrices are a useful summary of types of change, we also need to recognise that the degree of change varies, so in practice there is a **continuum** between **adaptive** changes and **transformation**.

Also, the **severity** of the change depends on **where** it is experienced, or by whom. Redundancies may be an **adaptive** response to changed product market conditions for an organisation, and will preserve the future of the organisation. However, for the people experiencing them, they are likely to be **transformational changes**.

3.6 Examples of change management

In the previous chapter we looked at Ansoff's product/market matrix to highlight the types of strategy organisations can pursue to generate growth.

However, it is important to remember that growth strategies – developing new products, entering new markets, diversification (either organically or through acquisition or joint venture for example) – are also likely to involve change processes in an organisation.

Equally, strategies designed to improve profitability through operational restructuring within a company will also involve change management; as will any plans to dispose of business units or under-performing assets.

Therefore, when thinking about the strategic options an organisation can implement in response to issues identified in a case study scenario, it is important to consider any change management issues the organisation may encounter in order to implement the strategy.

Case example: KPMG restructuring practice

KPMG's restructuring practice advises that some of the largest companies in the world struggle to be effective at joint ventures – particularly in emerging economies. KPMG point out that even if a good joint venture agreement is signed (which in itself is quite uncommon) this is no guarantee of success. Cultural differences can often be disruptive to the venture, and KPMG have noted that issues which threaten the value of the venture often emerge 2–4 years into the life of the venture.

However, change management can also be relevant to internal changes and performance measurement. A second illustration from KPMG's restructuring practice highlights work they did with a Group which had concerns about the accuracy of its forecasts, because it was consistently missing cash flow targets. It transpired that the Group needed a more integrated approach to forecasting and working capital management, and as a result of KPMG's work with the Group and local finance teams within the Group, new forecasting processes were planned, designed and rolled out across the Group.

Case example: Burberry

Burberry is a luxury fashion house, and its distinctive tartan patterns have become a widely copied trademark. However, despite its heritage as a luxury fashion house, in the early years of the 21st century, the Burberry brand (which was founded in 1848) had become almost synonymous with 'chav' culture.

Burberry's CEO from 1997 – 2005, Rose Marie Bravo managed to achieve a significant expansion in the company's sales and profits, but critics argued she did so by allowing the brand to be hi-jacked by football hooligans and D-list celebrities. As such, a luxury brand had been appropriated by the mainstream culture.

However, what the critics failed to notice was that Bravo had managed to extend Burberry's much-copied trademark 'checked' pattern into new designs and variants.

Nonetheless, following Bravo's departure, the brand has reconnected with its heritage and is restoring its position as a luxury fashion brand.

One element of this has been refining production segmentation. The casual component of the women's and men's clothing lines has been relabelled as Burberry Brit, while the more sartorial clothes are now labelled as Burberry London. Burberry Prorsum remains the base line for the other brands.

Product development – Burberry's management also identified that 'non-apparel' categories (eg handbags, shoes, scarves, belts) offered significant opportunities for growth. For example, in 2009/10 revenue for 'non-apparel' increased by 10% compared to 1% for Burberry as a whole, with handbags contributing about half of non-apparel sales.

Implementing process excellence – As well as developing its brands, Burberry has also pursued a goal of operational excellence, and has looked to make improvements across its supply chain. Burberry has developed more sophisticated global planning and inventory management functions. As a result, and through enhanced sales forecasting and monitoring, combined with more disciplined procurement, inventory levels for 2009/10 were reduced by 36% compared to the previous year.

Market development – A third element of the group's strategy has been to focus on, and invest in, under-penetrated markets. For Burberry, these have consisted of both development markets like the US and emerging markets including China, India, Bangladesh and the Middle East. A range of distribution channels (retail, wholesale and licensing) have been used to optimise these opportunities. For example, of the 111 Burberry stores in emerging markets at the end of March 2010, 97 were operated under franchise, 12 by the Burberry Middle East joint venture and two by the Burberry India joint venture.

3.6.1 Turnaround

One specific situation when change management will be required is a turnaround situation.

When a business is in terminal decline and faces closure or takeover, there is a need for rapid and extensive change in order to achieve cost reduction and revenue generation. This is a **turnaround strategy**. Johnson, Scholes and Whittington identify seven elements of such a strategy.

Crisis stabilisation

The emphasis is on reducing costs and increasing revenues. An emphasis on reducing direct costs and improving productivity is more likely to be effective than efforts to reduce overheads.

(a) **Measures to increase revenue**

- (i) Tailor marketing mix to key market segments
- (ii) Review pricing policies to maximise revenue
- (iii) Focus activities on target market segments
- (iv) Exploit revenue opportunities if related to target segments
- (v) Invest in growth areas

(b) **Measures to reduce costs**

- (i) Cut costs of labour and senior management
- (ii) Improve productivity
- (iii) Ensure clear marketing focus on target market segments
- (iv) Financial controls
- (v) Strict cash management controls
- (vi) Reduce inventory
- (vii) Cut unprofitable products and services

Severe cost cutting is a common response to crisis but it is unlikely to be enough by itself. The **wider causes of decline** must be addressed.

Management changes

It is likely that new managers will be required, especially at the strategic apex. There are four reasons for this.

(a) The old management allowed the situation to deteriorate and **may be held responsible by key stakeholders**.

(b) **Experience of turnaround management** may be required.

(c) Managers brought in from outside will not be **prisoners of the old paradigm**.

(d) A **directive approach** to change management will probably be required.

Communication with stakeholders

The support of key stakeholder groups – groups with both a high level of power and a high degree of interest in an organisation – such as the workforce and providers of finance, is likely to be very important in a turnaround; it is equally likely that stakeholders did not receive full information during the period of deterioration. A **stakeholder analysis** (as discussed in Chapter 1 earlier in this Study Manual) should be carried out so that the various stakeholder groups can be informed and managed appropriately.

Attention to target markets

A **clear focus on appropriate target market segments** is essential; indeed a lack of such focus is a common cause of decline. The organisation must become customer-oriented and ensure that it has good flows of marketing information.

Concentration of effort

Resources should be concentrated on the best opportunities to create value. It will almost certainly be appropriate to **review products and the market segments** currently served and eliminate any distractions and poor performers. A similar review of internal activities would also be likely to show up several candidates for **outsourcing**.

Financial restructuring

Some form of **financial restructuring** is likely to be required. In the worst case, this may involve trading out of insolvency. Even where the business is more or less solvent, capital restructuring may be required, both to provide cash for investment and to reduce cash outflows in the shorter term.

Prioritisation

The eventual success of a turnaround strategy depends, in part, on management's ability to **prioritise necessary activities**, such as those noted above.

4 Cost reduction

Section overview

- Cost reduction has become increasingly important in an increasingly competitive world. In order to remain competitive, companies have had to keep prices low and the only other way to influence the bottom line is to squeeze costs as far as possible.
- There are numerous cost reduction programmes that a company can use and various ways in which they can be implemented. It is a matter of what is most suitable for the company, given its other objectives.
- Cost reduction should be viewed as an on-going exercise rather than being a panic reaction to a profit crisis.
- Operations management is concerned with the transformation of 'inputs' into 'outputs' that meet the needs of the customer. It is characterised by the four Vs of volume, variety, variation in demand, and visibility.
- Capacity planning and some of the modern IT/IS applications supporting them are reviewed.
- Quality assurance and Total Quality Management (TQM) are essential components of many modern manufacturing approaches.

4.1 Introduction

Cost reduction has become the battle-cry of the 21st Century. As prices are slashed in a bid to remain competitive, companies have to find other ways of boosting profits. The only other way to affect the bottom line is to squeeze costs as far as possible and, hopefully, more effectively than competitors.

One of the most quantifiable means of reducing costs is to tackle fixed costs. Fixed costs are those costs that cannot be avoided, regardless of activity levels – if you can find a way of getting rid of some of the sources of fixed costs permanently, then you are on the way to a successful cost reduction programme.

The best way to reduce costs is to develop a culture within the organisation whereby everyone thinks strategically about cost reduction. How do you reduce costs? In the simplest terms, by avoiding them as much as possible. Of course that is easier said than done but if employees can be educated to actively seek ways to reduce costs, then this will be a move in the right direction.

Case example: IKEA

The chief executive of the IKEA furniture chain famously travels economy class on all flights, whether long or short haul, thus giving lower grades of director and manager no choice but to follow suit. On a trip to the United States, the chief executive reportedly cut out a voucher for cut-price car hire in an in-flight magazine and handed it to his management colleague who was travelling with him. The colleague was expected to present the voucher to the car hire desk at their destination airport to obtain the discount. This approach to cost reduction by the chief executive reinforces IKEA's market positioning strategy as a low cost, no frills store.

4.2 Cost reduction techniques

As with all business decisions, there are right ways and wrong ways to approach cost reduction. The right techniques will result in greater efficiency of company spending; the wrong ones could lead to costs being cut that are in fact necessary for the maintenance of quality and company value. There is often a fine line between necessary costs and unnecessary ones but taking a systematic approach to cost reduction can help managers stay on the right side of that line.

Effective cost reduction techniques start with establishing what the programme is trying to achieve. If a company does not know *why* it is cutting costs, then it will have no idea *where* to cut costs. Companies try to reduce costs for many reasons, such as to allow the price of a product or service to be cut without affecting margins, to eliminate unnecessary spending and to create additional cash reserves. Ultimately, the aim is to maximise shareholders' wealth, therefore it is important that the correct costs are targeted for reduction.

There are numerous ways in which companies can institute plans to reduce costs, including across the board reductions, prioritised reductions and departmental reductions. Across the board reductions could include the implementation of a new travel policy whereby all staff must travel economy class (as we have seen in the case of IKEA) while prioritised reductions may include a strategy to reduce emissions in order to avoid pollution tax.

Whatever techniques are used, if they are the right ones they can teach a company to be more economical while maintaining its levels of service and quality. By forcing companies to regularly review spending at all levels, cost reduction techniques allow companies to become more streamlined.

4.3 Supply chain management

Definition

Supply chain management: 'The planning and management of all activities involved in sourcing and procurement, conversion, and all logistics management activities. Importantly, it also includes co-ordination and collaboration with channel partners, which can be suppliers, intermediaries, third-party service providers and customers.' *(The Council of Supply Chain Management Professionals)*

A key element of the above definition is its emphasis on the inter-organisational element of supply chain management. Effective supply chain management focuses on interactions and collaborations with suppliers and customers to ensure that the end customer's requirements are satisfied adequately. All activities in the supply chain should be undertaken with the customer's needs (or requirements) in mind; and, to this end, all supply chains ultimately exist to ensure that a customer's needs are satisfied.

4.3.1 Supply chain management and competitive advantage

Supply chain activities – procurement, inventory management, production, warehousing, transportation, customer service, order management – have all been part of business operations since business began. However, it is only far more recently that companies have started to focus on logistics and supply chain management as a potential source of competitive advantage.

In Chapter 1 we discussed the idea of capabilities and dynamic capabilities. Here, we could argue that supply chain management can now be seen as a capability for an organisation. For example, Seven-Eleven Japan is a company that has used excellent supply chain design, planning and operation to drive growth and profitability. Seven-Eleven has a very responsive replenishment system which, coupled with an excellent information system – ensures that products are available at each of its convenience stores to match customer needs. The responsiveness of Seven-Eleven's system allows it to change the merchandising mix at each stores by time of day, to match precisely with customer demand.

Similarly, Amazon is consistently rated as one of the top eCommerce companies in the world. However, critical to Amazon's on-going business success is maintaining the customer's trust that their orders will be delivered on time and with no errors. Amazon's supply chain and its warehouses are crucial to its performance in this respect.

In their text, *Supply Chain Management*, Chopra and Meindl highlight the importance of the supply chain for organisations when they write: 'Supply chain design, planning, and operation decisions play a significant role in the success or failure of a firm. To stay competitive, supply chains must adapt to changing technology and customer expectations.'

For example, in the 1990s, stores such as Borders and HMV dominated the sales of books and music by implementing a superstore concept. Compared to small independent local retailers, they were able to offer a much greater range of titles to customers, and at a lower cost by aggregating operations in large stores. This allowed the large retailers to achieve higher inventory turns than local retailers, and at higher operating margins. However, the large retailers' business model was itself under attack with the growth of online markets – in particular Amazon, which offered greater variety than Border, or HMV and was able to sell at lower cost by selling online and stock its inventories in a few distribution centres. The inability of Borders, in particular, to adapt its supply chain to compete with Amazon led to a rapid decline.

However, the appropriate design of a supply chain in any given context depends both on the customer's needs and market conditions. We can illustrate this with reference to Dell, noting that it has two different supply chain models: one for customers who want customised personal computers (PCs), and the other for customers who want standardised PCs.

Case example: Dell

Dell's success was based on two key supply chain features which supported rapid, low-cost customisation:

(i) Selling directly to the end customer, by-passing distributors and retailers

(ii) Centralising manufacturing and inventories in a few locations, where final assembly was postponed until the customer order arrived. As a result, Dell was able to provide a large variety of PC configurations while keeping low levels of component inventories.

However, although Dell had been successful at the beginning of the 21st century, changes in the marketplace presented some new challenges. Dell's supply chain had been designed for making highly customised PCs, but, from around 2007, the market demand shifted to lower levels of customisation. Customers were now satisfied with only a few models.

Although previously Dell's business model was based on selling customised PCs direct to customers, since 2007 it has also sold standardised PCs through Walmart in the United States, and through the GOME Group, China's largest electronics retailer. Both Walmart and the GOME Group hold Dell machines as inventory. This supply chain contains an extra stage compared to the direct sales model – the retailer.

However, the change in market conditions also prompted a second significant change in Dell's supply chain processes. It has now out-sourced a large proportion of its assembly to low-cost locations, and has, in effect, begun building to stock rather than to customer order.

Unfortunately, however, supply chains which are not designed appropriately can precipitate the failure of a business. The demise of the online grocery retailer Webvan (which was launched in 1999) illustrates this.

Webvan designed a supply chain with large warehouses based in several major cities in the United States. The plan was that groceries should then be delivered to customers' homes from these warehouses.

However, the design of this supply chain meant that Webvan couldn't compete with traditional supermarket supply chains in terms of cost. The distribution networks used by traditional supermarket companies mean they use fully loaded lorries to bring products to a supermarket store close to the consumer, resulting in relatively low transportation costs.

Although Webvan turned its inventory slightly faster than the supermarkets, it incurred much higher transportation costs for its home delivery system. Moreover, Webvan offered free delivery on all orders, regardless of the customer's location. As a result, it was estimated that the company was losing up to $130 on every order, and by July 2001, the company was declared insolvent after losing US $1.2bn.

Ultimately, the objective of the supply chain is to maximise the overall value generated, or the supply chain profitability – the difference between the revenue generated from the customer and the overall cost across the supply chain. Therefore, when analysing supply chain decisions, it is vital to consider what impact they will have on the profitability of the supply chain.

Equally, however, it is important to remember that supply chain profitability has to be shared across all supply chain stages and intermediaries. Therefore, the more intermediaries there are in a supply chain, the more people the profit has to be shared between.

In this context, the opportunities for disintermediation provided through IT and eBusiness can be very important. For example, if a customer can book the flights and accommodation for their holiday directly through the relevant airline and hotel's websites, the airline and the hotel no longer have to pay any commission to a travel agent for arranging the holiday for the customer.

4.3.2 Hierarchy of supply chain decisions

In Chapter 1, we noted that there is a hierarchy of decision-making and control: at strategic; business-unit (or tactical); and operational levels.

A similar hierarchy can be applied to supply chain management decisions, depending on the frequency of the decision and the time frame that it relates to. Chopra and Meindl identify the three significant elements of supply chain management decisions as design, planning and operations.

Supply Chain Design decisions include:

- Whether to perform a supply chain function in-house or to outsource it
- The location and capacities of production and warehousing facilities
- The products to be manufactured or stored at different locations
- The modes of transport to be used between different nodes in the supply chain
- The type of information systems to be used (for example, to co-ordinate ordering and production within the supply chain).

Supply Chain Planning decisions – Planning decisions establish the parameters within which the supply chain will function for a specified period of time; often a year. Companies start the planning phase with a forecast of demand in different markets for the coming year (or the period being planned); and planning includes decisions regarding which markets will be supplied from which locations; the subcontracting of any manufacturing; inventory policies to be followed, and the timing and size of any marketing promotions (which will affect demand and supply across the chain).

Supply Chain Operation decisions – The time horizon for operational decisions is much shorter: often daily, or weekly. Operational decisions are driven by customer orders, and are often related to individual customer orders. Operational decisions could also be related to individual production facilities, warehouses or distributors.

4.3.3 'Push' vs 'Pull' models of supply chain processes

All the processes in a supply chain can be classified into one of two categories: 'pull' processes and 'push' processes.

Pull processes are carried out in response to a customer order (in other words, they operate in a 'build-to-order' context). Push processes are carried out in advance of a customer order, in anticipation of those orders based on a forecast. So they represent a 'make-to-stock' environment.

Crucially, push processes operate in a context of uncertainty, because customer demand is not known. By contrast, pull processes operate in an environment in which customer demand is known. However, they may still be constrained by inventory and capacity decisions which were made during the push phase.

The push model

In a supply chain based on the push model an organisation produces goods according to schedules based on historical sales patterns.

A push-based supply chain is slow to respond to changes in demand, which can result in overstocking, bottlenecks and delays, unacceptable service levels and product obsolescence. Where there are several links in the distribution chain, the system's inability to respond to variations in consumption leads to the establishment of buffer inventory at each stage of distribution. Poor co-ordination can lead to large fluctuations in the levels of buffer inventory, even where actual consumption patterns vary only marginally. This kind of unco-ordinated amplification of minor feedback signals is called the 'bull whip effect' (which we will look at in more detail in Chapter 9 of this Study Manual).

Features of a push system

- Forecasts of sales drive production and replenishment
- Long term forecasts
- Inventory pushed to next channel level, often with the aid of trade promotions
- Inability to meet changing demand patterns
- Potential product obsolescence
- Excessive inventory and low service levels
- Bull whip effect

The pull model

Driven by eCommerce to empower clients, many companies are moving to a customer-driven **pull model**, where production and distribution are **demand driven**. The consumer requests the product and 'pulls' it through the delivery channel. There is an emphasis on the supply chain **delivering value to customers** who are actively involved in product and service specifications.

This new business model is less product-centric and more directly focused on the individual consumer. To succeed in the business environment, companies have recognised that there is an on-going **shift in the balance of power** in the commerce model, from suppliers to customers.

Features of a pull system

- Demand drives production and replenishment
- Centralisation of demand information and of replenishment decision-making
- Reduced product obsolescence
- Expanded ability to meet changing demand patterns
- Lower inventories and higher service levels
- Reduced bull whip effect

Push-based systems rely less on sophisticated IS support, since high inventory levels are used to cope with variations in customer demand. Pull-based systems, like Just-in-Time (JIT), need accurate and quick information on actual demand to move inventory and schedule production in the chain: therefore, they require integrated internal systems and linkages throughout the supply chain.

In reality, most supply chains will include a **combination of both push and pull** processes. The interface between push-based stages and pull-based stages is known as the push-pull boundary.

Dell's build-to-order supply chain can be seen as an example of this. Dell carries an inventory of standard components, and inventory levels of these components are determined by forecasting general demand ('push'). Final assembly then occurs in response to specific customer orders ('pull'). However, a key goal in supply chain management is identifying an appropriate 'push-pull' boundary such that the supply chain matches supply and demand effectively. For Dell, the 'push-pull' boundary would occur at the beginning of the assembly line, where standard components start being used to build a customised PC in response to a customer order.

Case example: Zara

As a chain of fashion stores, Zara operates in an industry in which customer demand is rapidly changing and fickle. However, Zara has been able to grow successfully by employing a strategy that combines affordable prices with being highly responsive to changing trends.

Across the apparel industry as a whole, 'design-to-sales' cycle times have traditionally averaged more than six months. However, Zara has achieved cycle times of four to six weeks. This speed allows Zara to introduce new designs every week and to change 75% of its merchandise display every three to four weeks. As a result, the clothes on display in Zara's shops match customer preferences much more closely than the clothes in competitors' shops do. Consequently, Zara sells most of its products at full price, rather than having to apply markdowns to clear old stock.

Zara manufactures its clothes using a combination of flexible and quick suppliers in Europe and low-cost suppliers in Asia. This model contrasts with the majority of clothing manufacturers who have moved most of their manufacturing to Asia. About 40% of the manufacturing capacity is owned by Zara's parent company (Inditex), with the remainder outsourced.

Products with highly uncertain demand Zara sources from its European suppliers, whereas those with more predictable demand are sourced from Asian suppliers.

More than 40% of Zara's purchases of finished-goods, and most of its in-house production, occur after a sales season starts. This compares with less than 20% production after the start of a sales season for a typical clothes retailer. This responsiveness, and the postponement of decisions until after seasonal trends are known, allows Zara to reduce inventories and to reduce the risk of error in forecasting demand.

In addition, Zara has also invested heavily in information technology to ensure that the latest sales data are available to drive replenishment and production decisions.

4.3.4 Drivers of supply chain performance

The contrast between 'push' and 'pull' processes also identifies a key balancing act at the heart of supply chain management: that is, achieving the balance between responsiveness and efficiency which best supports a company's competitive strategy. For example, holding high levels of inventory should enable a company to be very responsive to changes in customer demand, but will it be efficient? The goal for a company in relation to supply chain performance is to ensure that they achieve the desired level of responsiveness (to customer demand) at the lowest possible cost.

Chopra and Meindl argue that in order to understand how a company can improve its supply chain performance in terms of responsiveness and efficiency, we first need to examine the drivers of supply chain performance in that company. These drivers, as categorised by Chopra and Meindl, are:

(a) **Facilities** – The actual physical locations in the supply chain network where a product is produced or stored; in effect, property, plant and equipment. Decisions regarding the location, capacity, flexibility and role of different facilities can have a significant impact on performance.

(b) **Inventory** – All raw materials, work in progress, and finished goods within a supply chain. Changing inventory policies can dramatically alter the supply chain's responsiveness and efficiency. As we noted above, a company can make itself responsive by stocking large amounts of inventory and satisfying customer demand from stock, but the high inventory levels reduce efficiency. Such a strategy could be particularly dangerous in the clothing industry, for example, where frequent changes in trend would lead to inventory losing value quickly.

(c) **Transportation** – Moving inventory from one point to another in the supply chain. The mode of transport used can have a large impact on responsiveness and efficiency. For example, an on-line retailer could use a specialist logistics company (such as FedEx) to deliver a product to a customer rather than using the standard postal service. Using a faster mode of transportation makes the supply chain more responsive, but also less efficient, given the relatively higher costs of using the logistics company compared to the traditional postal service.

(d) **Information** – Consists of data and analysis about facilities, inventory, transportation, costs, prices and customers throughout the supply chain. Information is potentially the most important driver of all in the supply chain because it affects each of the other drivers. For example, Zara's supply chain system relies on accurate and timely information about trends in customer demand.

Crucially, information presents management with the opportunity to make supply chains more responsive *and* more efficient.

(e) **Sourcing** – Choosing who will carry out a particular supply chain activity, such as production, storage or transportation. One of the key choices that affects the responsiveness and efficiency of a supply chain is whether to outsource activities or to retain them in-house. Companies can improve efficiency by outsourcing production to contract manufacturers in foreign countries where labour and other operating costs are cheaper. However, responsiveness may suffer as a result of the long distances involved in shipping products to their markets. Similarly, as we saw in the case example earlier, Zara keeps responsive capacity in-house so that it can respond quickly to orders as they arrive.

Note, however, that sourcing does not only relate to production. Online retailers have outsourced next-day package delivery to specialist package carriers because it is too expensive to the retailers to develop next-day delivery capabilities on their own.

(f) **Pricing** – Deciding how much a company will charge for the goods and services it makes available through the supply chain. Pricing affects the behaviour of customers, thereby affecting supply chain performance. For example, if a logistics company varies the prices it charges based on the lead time provided by the customer, it is likely that customers who value efficiency will order early, but customers who value responsiveness will wait until just before they need a product transported to order it.

The table below summarises the differences between responsive and efficient supply chains:

	Responsive supply chains	**Efficient supply chains**
Primary goal	Respond quickly to changes in demand	Supply demand at the lowest cost
Product design strategy	Create modularity, so that product differentiation comes as late in the product process as possible	Maximise performance at a minimum product cost
Pricing strategy	Higher margins because price is not a prime consideration for customers	Lower margins, because price is a key driver for customers
Manufacturing strategy	Maintain capacity flexibility to buffer against uncertainty in demand and/or supply	Lower costs through high utilisation
Inventory strategy	Maintain buffer inventory to deal with uncertainty in demand and/or supply	Minimise inventory to lower cost
Lead-time strategy	Reduce aggressively, even if the costs of doing so are significant	Reduce where possible, but not at the expense of increasing costs
Supplier strategy	Select suppliers based on speed, flexibility, reliability and quality	Select suppliers based on cost and quality

[Table adapted from Chopra, S. & Meindl, P. (2012), *Supply Chain Management*, (5^{th} ed.), Harlow: Pearson; pg. 42]

Although we have identified the drivers of performance individually, it is also important to realise that they do not act independently of each other. Rather they all interact to determine supply chain performance. Consequently, it is crucial that entities choose supply chain strategies in which the balance between responsiveness and efficiency fits with their overall competitive strategy. For example, a retailer whose strategy is based on a low-cost model for a wide variety of mass-consumption goods is likely to emphasize the elements of efficiency in their supply chain.

In addition, although we have highlighted the contrasts between responsiveness and efficiency in a supply chain, in reality entities will try to structure their supply chain in a way that maximises responsiveness *and* efficiency.

4.3.5 The scope of supply chain management

The scope of decision-making for supply chain professionals has expanded from trying to optimise performance within a division or business unit, then throughout the entity, and now across the entire supply chain – which includes trading partners both **upstream** (eg raw material suppliers, or wholesalers) and **downstream** (eg distributors and customers). This reflects the goal of supply chain management, which is to maximise the total profitability of the supply chain.

The recognition of the importance of upstream and downstream processes reinforces the importance of **supplier relationship management** (the upstream interactions between an entity and its suppliers) and **customer relationship management** (the downstream interactions between an entity and its customers).

Chopra and Meindl summarise these different components of supply chain management as a table:

Supplier Relationship Management	Internal Supply Chain Management	Customer Relationship Management
• Sourcing	• Strategic planning	• Marketing
• Negotiating contracts	• Demand planning	• Price
• Buying	• Supply planning	• Selling
• Design collaboration	• Fulfilment	• Call centre
• Supply collaboration	• After sales service (eg setting inventory levels for spare parts)	• Order management

Supplier relationship management

Supplier resources and capabilities are likely to be a critical constraint of supply chain planning. Equally, however, effective collaboration with suppliers can have huge benefits across the supply chain. For example, once an agreement for supply has been established, the entity and the supplier can improve supply chain performance by collaborating on forecasts, production plans and inventory levels (supply collaboration).

There is perhaps even greater benefit to be gained from collaborating with suppliers on the design of products which have positive supply chain characteristics such as, for example, ease of manufacturing, or commonality across several end products (that is, where a single part can be used in a number of different end products, reducing the amount of different parts which need to be held in inventory).

Internal supply chain management

As its name suggests, internal supply chain management focuses on operations internal to an entity and includes all the processes that are involved in planning for, and fulfilling, a customer order. 'Supply planning' lies at the heart of this process. It uses the demand forecasts generated by demand planning, and the resources made available by strategic planning, to produce an optimal plan to meet this demand with the resources available.

Customer relationship management (CRM)

The goal of the CRM process within supply chain management is to generate customer demand and to facilitate the transmission and tracking of customer orders. Weaknesses in this process could lead to poor customer experiences because orders are not processed and executed effectively. However, weaknesses in CRM could also result in lost opportunities to gather information about customer demand, and the factors which influence customer demand.

Including the customer in the supply chain also identifies the role that customers can play in the value creation process. Many retailers now use self-service checkouts, while Ikea's customers create their own value by assembling their furniture at home. However, a more significant way in which customers can create value is through being involved in the product design process ('co-creation'). For example, consumer product manufacturers, including Lego and Nike, have now established online design studios where customers can customise their own products to meet their specific needs.

4.3.6 Information and supply chain management

So far in this section we have focused mainly on the supply chain as a mechanism for providing goods and services to a customer. However, as Chopra and Meindl remind us, the flow of information through the supply chain is equally important to its efficient operation: 'A supply chain is dynamic and involves the constant flow of **information, product and funds** between different stages.'

The following two short examples illustrate this:

Case examples: Information, product and funds flows within the supply chain

(i) Consider first the example of a customer walking into a supermarket to purchase detergent.

The supply chain begins with the customer and their need for detergent. The next stage of this supply chain is the supermarket store that the customer visits in order to buy the detergent.

The supermarket stocks its shelves using inventory which may have been supplied from one of the supermarket's own warehouses, or else by a distributor. In turn, the distributor is stocked by the manufacturer of the detergent.

The manufacturing plant (where the detergent is produced) receives raw material from a variety of suppliers, who may themselves have been supplied by lower-tier suppliers. For example, the manufacturer receives packaging material from a plastic producer, who may in turn receive the raw materials it needs to manufacture the plastic packaging from other suppliers.

In this example, the supermarket provides the product, as well as pricing and availability information to the customer. The customer transfers funds to the supermarket. The supermarket store conveys point-of-sales data as well as replenishment orders to the warehouse (or the distributor). In turn, the warehouse (or the distributor) provides fresh stocks of the detergent to replenish the store, and the supermarket transfers funds to the distributor to pay for the inventory which has been replenished.

(ii) When a customer purchases a computer online from Dell, the supply chain includes (among other elements): the customer, Dell's web site, Dell's assembly plant, and all of Dell's suppliers and their suppliers.

Dell's web site provides the customer with information regarding pricing, product variety, and product availability. Having made a product choice, the customer enters their order information, and pays for the product. The customer may later return to the web site to check upon the status of their order.

In turn, stages further up the supply chain use the customer information in order to fulfil the request; for example, by supplying the components necessary to assemble the computer.

Having good information helps an entity to utilise its supply chain assets more effectively and to co-ordinate supply chain flows in order to increase responsiveness and reduce costs. For example, Seven-Eleven Japan uses information to improve product availability while decreasing inventories; and airlines routinely use information to decide how many seats to offer at a discount price whilst leaving sufficient seats for business customers making reservations at the last minute who are willing to pay a higher price.

As Chopra and Meindl note, having 'the right information can help a supply chain better meet customer needs at lower cost. The appropriate investment in information technology improves visibility of transactions and co-ordinaton of decisions across the supply chain.'

We will look at information strategy in more detail in Chapter 9 in this Study Manual but it is worth noting here some of the ways information technology can help managers share and analyse information in the supply chain:

- **Electronic data interchange (EDI)** – Enabling instantaneous, paperless purchase orders with suppliers.
- **Enterprise resource planning (ERP) systems** – Integrating an entity's systems and thereby help managers co-ordinate production, resources, procurement, inventory, customer orders and sales.
- **Radio frequency identification (RFID)** – RFID tags attached to materials or inventory enable an entity to track the movement of inventory between locations more accurately, and to get an exact count of incoming items and items in storage.
- **Supply chain management (SCM) software** – Whereas ERP systems show an entity what is currently going on, SCM systems help a company decide what it should plan to do in the future.

We must add one word of caution, however. While good information can clearly help an entity improve both responsiveness and efficiency, this does not automatically mean that simply having *more* information is always better. As more information is shared across a supply chain, the complexity and cost of the infrastructure required and the follow-up analysis increase. However, the marginal value provided by information may diminish as more and more information becomes available.

Hence, entities need to achieve a balance between providing sufficient information so that supply chain activities can be planned and controlled effectively, but without producing unnecessarily complex and detailed information.

4.3.7 Supplier selection

If an entity has decided to buy in a product or service (rather than to make it in-house), then vendor selection becomes a critical sourcing decision:

How many suppliers will the entity have for a particular activity? (If the entity uses only a small number of suppliers, they could have a high degree of bargaining power over the entity; but if too many are used, and the orders placed with each are small, there is little chance of economies of scale.)

How will it choose its suppliers? Managers need to consider the performance objectives which are most important. For example, the following could be key performance characteristics when evaluating potential suppliers:

- Speed (or lead time)
- Quality
- Price
- Flexibility
- Reliability

In this respect, an entity should select suppliers with distinctive competences that are similar to its own. For example, a company selling high volume, low price products, will want suppliers who are able to supply large quantities of low price components.

The financial stability of potential suppliers is also important, so when evaluating suppliers, an entity should take up credit references, and examine potential suppliers' published accounts.

Supplier selection and assurance

Nonetheless, a key element of any outsourcing decision will be the outsourced partner's ability to deliver contracted items to the standard required. In other words, an entity needs assurance over the effective business operation of the outsource service provider.

The *Assurance Sourcebook* produced by the ICAEW Audit and Assurance Faculty includes the following mini-scenario which could be relevant in such a situation:

The outsource partner's operating criteria are all explicit in its documented systems for operating the administrative processes on behalf of clients. The company wants to be able to demonstrate the continuing effectiveness of its systems to existing and potential customers as an incentive to maintain their outsource contracts. So the outsource partner commissioned an assurance engagement to evaluate the effectiveness of its systems.

Importantly, also, an entity needs to ensure that it has a **service level agreement** in place with its outsource partners. In order to measure whether the partners are delivering the quantity and quality of goods and services required of them, these requirements first have to be specified. This can be done through a service level agreement.

Assurance and the supply chain

The supply chain of an organisation more generally can also benefit from assurance. Suppliers to organisations are increasingly asked to provide assurance over their ability to service customers' needs within a framework of control which includes a wide range of areas such as ethical trade, working conditions and human rights, anti-bribery, and financial health.

Equally, organisations seek assurance that their distribution partners are acting in line with contractual agreements and broader expectations. (For example, are customer orders being delivered in line with agreed timetables, and in good condition?)

4.4 Strategic procurement

The traditional supply chain model (see diagram below) shows each firm as a separate entity reliant on orders from the downstream firm, commencing with the ultimate customer, to initiate activity.

The disadvantages of this are:

- It slows down fulfilment of customer orders and so puts the chain at a competitive disadvantage.
- It introduces the possibility of communication errors, delaying fulfilment and/or leading to wrong specification products being supplied.

- The higher costs of holding inventories on a just-in-case basis by all firms in the chain.
- The higher transaction costs due to document and payment flows between the stages in the model.

Strategic procurement is the development of a true **partnership** between a company and a supplier of strategic value. The arrangement is usually long-term, single-source in nature and addresses not only the buying of parts, products, or services, but product design and supplier capacity.

This recognises that increasingly, organisations are realising the need for, and benefits of, establishing **close links** with companies in the supply chain. This has led to the **integrated supply chain** model (the second model in the following diagram) and the concept that it is **whole supply chains** which compete and not just individual firms.

Traditional and integrated supply chain models

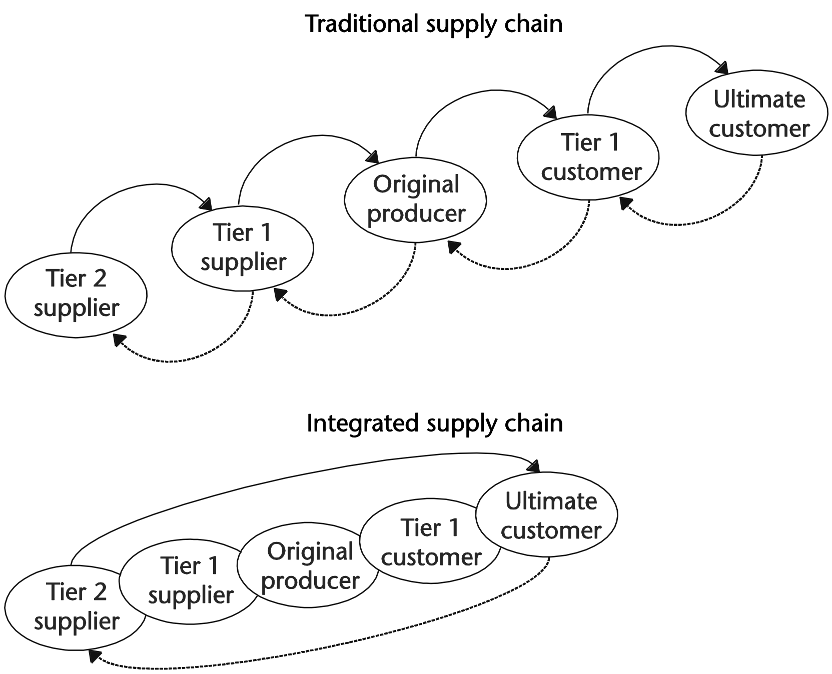


Figure 3.2: Traditional v integrated supply chain

The integrated supply chain shows that the order from the ultimate customer is shared between all the stages in the chain and that the firms overlap operations by having integrated activities as business partners. This is consistent with the idea of a **value system** and the concept of **supply chain networks** which we have already discussed in Chapters 1 and 2.

4.5 Suppliers and e-procurement

E-procurement involves using technology to conduct business-to-business purchasing over the internet.

There are huge savings to be had, especially for large corporate organisations with vast levels of procurement. Siemens believes that, since it embarked on its fully-integrated e-procurement system, this purchasing strategy saved $15 million from material costs and $10 million from process costs in the one year alone, close to a 1,000% increase in savings from the previous year and only the second year into implementation.

4.5.1 Advantages of e- procurement for the **buyer**:

- Facilitates cost savings
- Easier to compare prices
- Faster purchase cycle
- Reductions in inventory
- Controls indirect goods and services
- Reduces off-contract buying
- Data rich management information to help reduce costs and predict future trends

- Online catalogues
- High accessibility
- Improved service levels
- Controlled costs by imposing limits on levels of expenditure

4.5.2 E-procurement from a supplier's perspective

Traditionally the business of supplying goods has been about branding, marketing, business relationships, and so on. In the expanding e-procurement world, the dynamics of supplying are changing and, unlike the expectations of companies implementing e-procurement systems for cost savings, suppliers are expecting to feel profit erosions due to the e-procurement mechanism.

Nevertheless, there are obvious advantages to suppliers:

- Faster order acquisition
- Immediate payment systems
- Lower operating costs
- Non-ambiguous ordering
- Data rich management information
- 'Lock-in' of buyers to the market
- Automated manufacturing demands

4.6 Business Process Re-engineering

Business process re-engineering (BPR) involves focusing attention inwards to consider how business processes can be redesigned or re-engineered to improve efficiency. It *can* lead to fundamental changes in the way an organisation functions. Properly implemented BPR may help an organisation to reduce costs, improve customer service, cut down on the complexity of the business and improve internal communication.

- At best, it may bring about new insights into the objectives of the organisation and how best to achieve them.
- At worst, BPR is simply a synonym for squeezing costs (usually through redundancies). Many organisations have taken it too far and become so 'lean' that they cannot respond when demand begins to rise.

The main writing on the subject is Hammer and Champy's *Reengineering the Corporation* (1993), from which the following definition is taken:

Definition

Business process re-engineering (BPR): Is the fundamental rethinking and radical redesign of business processes to achieve dramatic improvements in critical contemporary measures of performance, such as cost, quality, service and speed.

The key words here are fundamental, radical, dramatic and process.

- **Fundamental** and **radical** indicate that BPR is somewhat akin to zero base budgeting: it starts by asking basic questions such as, 'Why do we do what we do?', without making any assumptions or looking back to what has always been done in the past.
- **Dramatic** means that BPR should achieve 'quantum leaps in performance', not just marginal, incremental improvements.
- **Process**. BPR recognises that there is a need to change functional hierarchies: 'existing hierarchies have evolved into functional departments that encourage functional excellence but which do not work well together in meeting customers' requirements' (Rupert Booth, *Management Accounting,* 1994).

A process is a collection of activities that takes one or more kinds of input and creates an output.

For example, order fulfilment is a process that takes an order as its input and results in the delivery of the ordered goods. Part of this process is the manufacture of the goods, but under BPR the aim of manufacturing is not merely to make the goods. Manufacturing should aim to deliver the goods that were ordered, and any aspect of the manufacturing process that hinders this aim should be re-engineered. The first question to ask might be, 'Do they need to be manufactured at all?'

A re-engineered process has certain characteristics.

- Often several jobs are combined into one
- Workers often make decisions
- The steps in the process are performed in a logical order
- Work is performed where it makes most sense
- Checks and controls may be reduced, and quality 'built-in'
- One manager provides a single point of contact
- The advantages of centralised and decentralised operations are combined

Case example: Car manufacturer

The following short example is based on a problem at a major car manufacturer.

A company employs 25 staff to perform the standard accounting task of matching goods received notes with orders and then with invoices. About 80% of their time is spent trying to find out why 20% of the set of three documents do not agree.

One way of improving the situation would have been to computerise the existing process to facilitate matching. This would have helped, but BPR went further: Why accept any incorrect orders at all? What if all the orders are entered onto a computerised database? When goods arrive at the goods inwards department, they either agree to goods that have been ordered or they don't. It's as simple as that. Goods that agree to an order are accepted and paid for. Goods that are not agreed are sent back to the supplier. There are no files of unmatched items and time is not wasted trying to sort out these files.

4.7 Examples of business process re-engineering

Some organisations have redesigned their structures on the lines of business processes, adopting BPR to avoid all the co-ordination problems caused by reciprocal interdependence.

- A move from a traditional functional plant layout to a JIT cellular product layout is a simple example.

- Elimination of non-value-adding activities. Consider a materials handling process, which incorporates scheduling production, storing materials, processing purchase orders, inspecting materials and paying suppliers.

  This process could be re-engineered by sending the production schedule direct to nominated suppliers with whom contracts are set up to ensure that materials are delivered in accordance with the production schedule and that their quality is guaranteed (by supplier inspection before delivery).

  Such re-engineering should result in the elimination or permanent reduction of the non-value-added activities of storing, purchasing and inspection.

  Be prepared to apply your knowledge of BPR to a particular scenario or to examples that you are aware of from your reading or own experience. The examiner has stated that good answers often draw on the candidate's own experience in the context of the question set.

Interactive question 5: Business process re-engineering [Difficulty level: Intermediate]

AB Ltd was established over a century ago and manufactures water pumps of various kinds. Until recently it has been successful, but imports of higher quality pumps at lower prices are now rapidly eroding its market share. The managing director feels helpless in the face of this onslaught from international competitors and is frantically searching for a solution to the problem. In his desperation, he consults a range of management journals and comes across what seems to be a wonder cure by the name of Business Process Re-engineering (BPR). According to the article, the use of BPR has already transformed the performance of a significant number of companies in the USA which were mentioned in the article, and is now being widely adopted by European companies. Unfortunately, the remainder of the article, which purports to explain BPR, is full of management jargon and he is left with only a vague idea of how it works.

Requirements

(a) Explain the nature of BPR and describe how it might be applied to a manufacturing company like AB Ltd.

(b) Describe the major pitfalls for managers attempting to re-engineer their organisations.

See **Answer** at the end of this chapter.

4.8 Implications of BPR for accounting systems

Issue	Implication
Performance measurement	Performance measures must be built around processes, not departments: This may affect the design of responsibility centres.
Reporting	There is a need to identify where value is being added.
Activity	ABC might be used to model the business processes.
Structure	The complexity of the reporting system will depend on the organisational structure. Arguably, the reports should be designed round the process teams, if there are independent process teams.
Variances	New variances may have to be developed.

4.9 Which costs should be cut?

This depends on the type of business you are in, but the easiest way to cut costs is to focus firstly on those expenses that are common to all companies. Gas and electricity, postage, stationery and telephone charges are all obvious targets. The trick is to *encourage* all staff to participate, not *demand* it. For example, notices posted next to light switches asking staff to 'switch off after use' are likely to be more effective than a dictatorial memo demanding that staff should be more careful about using power.

If cutting the more obvious costs does not achieve the required effect, management will have to adopt a more innovative approach, focusing on individual departments' spending. Whilst cutting such expenses as telephone charges and stationery can be fairly straightforward, dealing with departmental costs is more problematic. Not only do you have the issue that departments feel they are being victimised, but there is also the potential for seriously damaging the company's day-to-day operations and pursuit of objectives. If staffing levels are cut, for example, it will be more difficult to maintain product or service quality. Cutting inventory levels too far could result in the company being unable to fulfil delivery promises. That is why management must understand how different costs affect profitability and the extent to which each cost category can be reduced before the company's operations are adversely affected.

Case example: Ryanair

Ryanair, a low cost airline based in Ireland, is well known for its cost cutting exercises. Keeping costs down is part of Ryanair's overall strategy, which means that when the company releases a statement of further cost cutting schemes, no one is surprised. When asked in 2002 what was 'the gospel according to Ryanair', the company's chief financial officer responded that it was to continually ask if Ryanair could do what it was doing at a reduced cost.

At its first quarter results presentation in 2006, the company revealed that, while it had the lowest revenue per passenger out of the eight airlines with which it compared itself, it also had the highest operating margin (18%). Between 2000 and 2006, Ryanair managed to reduce its unit operating costs by 40%.

Ryanair recognised that the cost category with greatest potential for reduction was flight operating costs. In response to this, Ryanair's cost cutting exercises included charging passengers to check in bags in an attempt to reduce baggage handling costs and encouraging passengers to make greater use of web-based check-in. Ryanair has since decided to remove check-in staff completely. The use of eBusiness has helped to eliminate approximately 12% of turnover costs, including travel agents' commission.

Overall, Ryanair's cost reduction programme appears to have been successful over the last decade, with its operating costs repeatedly increasing at a slower rate than its passenger revenues. In 2010, Ryanair announced a €319m profit and by 2012, annual profits had risen to €503m.

However, Ryanair's reputation has come under significantly more pressure over the last few years. Possibly the heaviest criticisms Ryanair faced came in the aftermath of the delays to flights caused by the Icelandic volcanic ash in April 2010. Ryanair initially stated that refunds would be limited to the same amount that passengers paid for their tickets. Lawyers and consumer groups questioned the legality of this policy and Ryanair later backed down, saying it would refund all reasonable expenses to passengers. (Other airlines also initially took a harsh stance towards passenger claims and later retreated.)

Ryanair has also been criticised by the Office of Fair Trading for being 'puerile and childish' over its credit card payment policy. Ryanair adds fees when customers use all but one type of credit card to pay online. However, because it offers a prepaid booking service with a Mastercard prepaid card (**not** the most-used credit card) it is able to advertise cheap fares that don't include extra credit card charges. More generally, Ryanair's policy of charging for a large number of optional extras has come under heavier criticism.

In March 2011 Ryanair was found to have breached European Union regulations that companies selling goods online must offer customers the facility to complain via email. However, Ryanair did not provide email contact details, meaning that customer complaints had to be made by letter, fax or by phoning Ryanair's premium rate telephone number.

In February 2012 two UK newspaper ads for Ryanair were banned after complaints that they were sexist and treated women as objects. The Advertising Standards Authority ruled that the women's appearance, stance and gaze, together with the wording of the advert, linked female cabin crew with sexually suggestive behaviour and thus breached the advertising practice code. This was not the first time that Ryanair had fallen foul of the code in this area. A few years previously, it had had to withdraw an advert of a model dressed as a schoolgirl with the headline: 'Hottest back to school fares'.

Also in 2012, Ryanair again attempted to purchase its principal rival, Aer Lingus. A previous bid in 2006 had been disallowed by the European Commission. Ryanair already owned 30% of Aer Lingus and the bid was prompted by the Irish government's plans to sell its 25% share in Aer Lingus. In June 2012, however, Aer Lingus advised its shareholders to reject the bid, again on the grounds that it might not be allowed by the competition authorities. After the bid was made, shares in Aer Lingus rose 15.4%, but this was well short of the 38% premium that Ryanair offered, reflecting market doubts about the offer.

4.10 Implementing cost reduction programmes

As with choosing techniques, there is a right way and a wrong way to implement cost reduction programmes. Cost reduction is inevitably a sensitive area and the wrong approach can alienate staff, reduce motivation and have a detrimental effect on company harmony. A good cost reduction programme is as much about damage limitation as cutting costs.

Effective cost reduction programmes should result from thorough management planning, a detailed understanding of how company expenses can affect not just the bottom line, but the overall quality of the product or service and a vision of where the company is heading. Cost reduction is not about reporting smaller numbers in the income statement – it should be the culmination of extensive planning, thought and participation by directors, management and employees. Directors should not automatically assume that the most obvious cuts are the right ones. An innovative approach is often more successful than the usual 'we have to cut costs by 10% across the board' requirement.

Cost reduction programmes, as mentioned above, are ultimately implemented to improve profitability without improving revenue figures. Any improvements in revenue will further enhance profits. Programmes should be integrated into the overall company strategy, not introduced on an *ad hoc* basis.

Case example: Kraft and Cadbury

Kraft took over Cadbury in February 2010 and by July 2010, more than 100 senior Cadbury staff had left, including Cadbury's chairman, chief executive and chief finance officer, also Cadbury's marketing director and chief strategy officer. A company spokesman commented that this amount of change was not unusual when two companies merged. Critics pointed out that none of the top jobs subsequent to the acquisition had gone to Cadbury staff.

Kraft also completed the controversial closure of Cadbury's Somerdale factory at Keynsham, which had been planned before the acquisition, and moved production to Poland. In May 2010, Kraft announced it intended to cut £379 million from operational costs. These savings would be generated by changes to IT and back office operations, and process, manufacturing and supply chain improvements.

4.11 Potential problems with cost reduction programmes

While companies seek to reduce costs to remain competitive, taking the process too far can have adverse effects. Managers have to think about the extent to which cost reduction can be sustained before the business starts to suffer in other ways. Companies whose marketing strategies are based on low costs will probably get away with cost cutting for longer, but if you work in an organisation that has always promoted high quality goods and services, it is unlikely that extreme cost reduction programmes will be viewed positively, either by customers or the financial markets. Regardless of how it is marketed, cost reduction is seen by outsiders as not only reducing expenditure, but reducing quality and service as well.

Entities need to bear in mind that while cost reduction may seem tempting in order to get ahead of competitors, it should only be undertaken to the extent that it adds value to the company. As soon as shareholders' wealth starts to suffer, the programme should be halted.

Case example: Public sector cost cutting

How to cut public sector expenditure has been the subject of considerable debate in the UK, due to the perceived need to reduce the public sector deficit.

Techniques that have been suggested as particularly relevant for the public sector include the application of lean manufacturing principles to ensure that expenditure that does not add value is not undertaken, and quality management techniques such as Six Sigma that aim to eliminate errors in service delivery. Improving procurement skills has been identified as another priority area, given that the public sector is a huge buyer of products and services. Improvements in the transparency and quality of publicly available information will, it's claimed, help stimulate performance, as will using other countries' performance as 'competitive' benchmarks.

One area in which public sector expenditure may increase is on cost-cutting consultants. A story in the Daily Telegraph in July 2010 claimed that public sector bodies could recruit up to 200 cost-cutting consultants on wages of up to £1,000 a day. Doug Baird, Managing Director of consultants Interim Partners, claimed that:

> *Experienced efficiency experts do not come cheap, but they can deliver a huge return on investment and improve service delivery. A poorly executed cost-cutting programme can leave staff demoralised and undermine productivity.*

4.11.1 Cost cutting and business sustainability

The global economic slowdown after 2008 has prompted companies to re-examine their operating models as they adjust to capital becoming more scarce. In this context, many have been examining their cost structures in great detail.

However, it is important that companies consider the longer-term implications of cost cutting, and do not make indiscriminate cuts simply to reduce costs in the short term. In this respect, PwC consultants encourage firms to differentiate between 'good costs' (which are necessary for the current and future growth of a company) and 'bad costs' (which do not support growth or are not part of the core infrastructure of the business). The target of cost management and cost cutting programmes should be these 'bad costs'.

The danger for businesses (if they cut 'good costs' or stop investment in new projects and people during difficult times) is that there may be a longer-term price to pay in terms of customer loyalty, heightened risk and lower future profitability, as a result of short-term measures taken to cut costs.

In this respect, any decisions to cut costs need to be evaluated in the wider context of the longer-term sustainability of the business, rather than merely being short-term measures to boost profit.

A key element of business sustainability is that it may affect a business' ability to thrive in the long term. In this respect, before a business takes any decision to reduce costs in the short term, it also needs to consider what impact the decision will have on its customers, suppliers or staff in the longer term. For example, if measures to cut costs lead to reduction in the quality of a product, customers may stop buying that product. Therefore, the cuts will weaken the business' chances of being successful in the longer term.

However, this need to focus on the longer term can create problems for corporate decision-makers and accountants. Corporate reporting and performance measurement is often biased towards the short-term. The fact that companies report their results on a yearly basis, and may be under pressure from shareholders and market analysts to deliver results, means they may be forced into measures that boost profits in the short term, but which may create problems in the longer-term and, as a result, could potentially threaten the sustainability of the business.

4.12 The use of outsourcing in business

We have already acknowledged the potential importance of outsourcing in our discussion of supply chain management earlier in this chapter.

Outsourcing can be defined as the use of external suppliers as a source of finished products, components or services. The use of outsourcing has often been driven by it being the most cost-effective way of providing a service, particularly for smaller organisations.

In addition, the supplier of the outsourced service can provide specialist expertise which is not available in-house or it would not be worth maintaining in-house.

Outsourcing should also have the major advantage of reducing the workload of the organisation's managers, thus freeing up more time to concentrate on core competences.

Generally speaking, outsourcing is appropriate for peripheral activities: to attempt to outsource core competences would be to invite the collapse of the organisation. However, it can be difficult to identify with clarity just what an organisation's core competences are, and it is not too difficult to imagine an organisation whose core competence was, in fact, outsourcing. Certainly, the motor manufacturing industry seems to be moving in this direction.

A further advantage of outsourcing is that external suppliers may benefit from **economies of scale** and experience effects. Therefore, cost may be reduced by using services provided by external suppliers rather than trying to provide the equivalent services in-house.

Getting the best out of outsourcing depends on **successful relationship management** rather than the use of formal control systems.

4.13 Successful outsourcing

Successful outsourcing depends on three things:

- The ability to specify with precision what is to be supplied: this involves both educating suppliers about the strategic significance of their role and motivating them to high standards of performance.
- The ability to measure what is actually supplied and thus establish the degree of conformity with specification.
- The ability to make adjustments elsewhere if specification is not achieved.

There are also practical considerations relating to outsourcing.

- It can save on costs by making use of supplier economies of scale.
- It can increase effectiveness where the supplier deploys higher levels of expertise.
- It can lead to loss of control, particularly over quality.
- It means giving up an area of threshold competence that may be difficult to reacquire.

Outsourcing of non-core activities is widely acknowledged as having the potential to achieve important cost savings. However, some organisations are wary of delegating control of business functions to outsiders because of the difficulty of assessing the cost-effectiveness of what is purchased. Cost should be fairly clear, but the quality of what is purchased is extremely difficult to assess in advance. The adoption of quality standards may help to overcome this problem. By utilising such standards, businesses will have more confidence in the quality of the service being provided and suppliers will know what is expected of them.

Case example: Mars and Cadbury's

The following extract (about confectionery) illustrates the context of an outsourcing decision.

… chocolate confectionery companies in the UK sell Easter eggs promoting their brands and products every spring. Mars for instance, provides chocolate eggs containing mini Mars products, or their packaging highlights Mars products around the egg. The reason that customers might be tempted to buy one of these eggs is because it has Mars products associated with it. Mars therefore doesn't have to produce the egg itself – that activity can be outsourced. After all, it would be expensive to maintain production facilities for chocolate eggs for only a couple of months a year.

On the other hand, Cadbury has focused on marketing and sales activities to develop the Cadbury's Crème Egg into a product that is sold all year round, thereby making that manufacturing operation viable. The decision whether or not to outsource can often be bound strongly to an organisation's competitive strategy and focuses on how strategic the activity is to the organisation.

The extract was written before Kraft's acquisition of Cadbury in 2010. After the acquisition Kraft went ahead with the controversial plan to close Cadbury's Keynsham plant, but pledged there would be no further closures of manufacturing sites in the UK, and no further compulsory redundancies in manufacturing in the UK for the following two years.

4.14 The value chain, core competences and outsourcing

Core competences are the basis for the creation of value; activities from which the organisation does not derive significant value may be outsourced.

The purpose of value chain analysis is to understand how the company creates value. It is unlikely that any business has more than a handful of activities in which it outperforms its competitors. There is a clear link here with the idea of core competences: a core competence will enable the company to create value in a way that its competitors cannot imitate. These value activities are the basis of the company's unique offering.

There is a strong case for examining the possibilities of outsourcing non-core activities so that management can concentrate on what the company does best.

4.15 Outsourcing IT/IS services

This section looks at a specific example of outsourcing – namely IT/IS services – and the advantages and disadvantages of outsourcing such a key business function.

The arrangement varies according to the circumstances of both organisations.

	Outsourcing arrangement		
Feature	Timeshare	Service	Facilities Management (FM)
What is it?	Access to an external processing system on a time-used basis	Focus on specific function, eg payroll	An outside agency manages the organisation's IS/IT facilities. The client retains equipment but all services provided by FM company
Management responsibility	Mostly retained	Some retained	Very little retained
Focus	Operational	A function	Strategic
Timescale	Short-term	Medium-term	Long-term
Justification	Cost savings	More efficient	Access to expertise; better service; management can focus on core business activities

Managing such arrangements involves deciding **what** will be outsourced, choosing a supplier and the supplier **relationship**.

4.15.1 How to determine what will be outsourced?

- What is the system's strategic importance? A third party IT specialist cannot be expected to possess specific business knowledge.
- Functions with only limited interfaces are most easily outsourced, eg payroll.
- Do we know enough about the system to manage the arrangement?
- Are our requirements likely to change?

The arrangement is incorporated in a contract sometimes referred to as the Service Level Contract (SLC) or Service Level Agreement (SLA).

Element	Comment
Service level	Minimum levels of service with penalties for example: • Response time to requests for help/information • System 'uptime' percentage • Deadlines for performing relevant tasks
Exit route	Arrangements for an exit route, transfer to another supplier or move back in-house.
Timescale	When does the contract expire? Is the timescale suitable for the organisation's needs or should it be renegotiated?
Software ownership	This covers software licensing, security and copyright (if new software is to be developed).
Dependencies	If related services are outsourced, the level of service quality agreed should group these services together.
Employment issues	If the organisation's IT staff are to move to the third party, employer responsibilities must be specified clearly.

Case example: Barclays

In January 2010, Barclays decided to bring IT application development back in-house after deciding not to renew a £400m outsourcing agreement with Accenture after six years. 230 staff, who had moved to Accenture at the start of the agreement, were to move back to Barclays. Around the same time, Barclays also decided to bring the management of its desktop facilities back in-house.

The decision to return application development in-house resulted from a strategic review and a desire to have the most efficient model that supported its business. Commentators suggested that Barclays had faced a situation where the costs of outsourcing had significantly increased because of the extra expensive services added on to the original outsourcing contract. It might have reached the point where it had become more cost-effective to take the work back in-house.

4.16 Current trends in outsourcing

In an effort to cut costs, many organisations are now outsourcing activities both near shore (such as Eastern Europe) and offshore (such as the Far East and India).

Improvements in technology and telecommunications and more willingness for managers to manage people they can't see have fuelled this trend.

Before taking the decision to outsource overseas, a number of points should be considered.

(a) Environmental (location, infrastructure, risk, cultural compatibility, time differences)
(b) Labour (experience in relevant fields, language barriers, size of labour market)
(c) Management (remote management)
(d) Bad press associated with the perception of jobs leaving the home country

Case example: Call centres

The inside of a call centre will look virtually the same wherever it is in the world – similar headsets, hardware and software being used, for example. With pressure to provide adequate customer service at low cost, many organisations are closing call centres in parts of Western Europe and relocating to low-cost countries and regions, such as India and South Africa.

It is claimed that savings on call centre costs range from 35% to 55% for near shore outsourcing, and 50% to 75% for offshore outsourcing.

4.16.1 Outsourcing to Eastern Europe

The newly-enlarged EU is providing organisations in Western Europe with a range of outsourcing opportunities. The vast manufacturing facilities that were used to produce for the massive Soviet market, many of which have been re-equipped, provide the opportunity for manufacturing to be outsourced.

At the moment, labour is relatively cheap in Eastern Europe, and it is closer than the Far East – an important consideration in today's rapidly-moving environment. The fact that English is widely taught and the existence of a Westernised culture are added attractions.

There are problems associated with outsourcing to Eastern Europe, however. Operations in many countries are bound by an excess of red tape, for example, and current political and market uncertainty in Russia could constrain growth there for some time.

4.16.2 Outsourcing to India

Moving back-office functions 'offshore' began in earnest in the early 1990s when organisations such as American Express, British Airways, General Electric and Swissair set up their own 'captive' outsourcing operations in India.

The low labour cost in India has always made the outsourcing option attractive. But not only is it cheap, it is highly skilled. India has one of the most developed education systems in the world. One third of college graduates speak more than two languages fluently and of the two million graduates per annum, 80% speak English. These language skills, along with improved telecomms capabilities, make it an ideal choice for call centres. GE, Accenture and IBM have all set up call centres in India.

The vast majority of service jobs being outsourced offshore are paper-based back office ones that can be digitalised and telecommunicated anywhere around the world, and routine telephone enquiries that can be bundled together into call centres.

Case example: UK companies outsourcing to Bangladesh

The number of UK companies outsourcing to near shore or offshore destinations rose from 47% to 57% in 2007 – with all of them using India at least once as the offshore destination of choice. Phil Morris, managing director of EquaTerra for Europe (an advisory company), explained that India offered all of the economic advantages that companies were looking for, the legacy of an education system and somewhere where there is relatively good English.

However, in 2011 a trend appeared to be developing for call centre jobs to be moved back to the UK. In July 2011 telecommunications company, New Call Telecom, announced that it was moving one of its call centres from Bangladesh back to the UK. The main reason for this decision was increased salaries and property and accommodation costs in Bangladesh.

Also in July 2011 the bank Santander announced it was moving its call centres back to the UK in an effort to please customers. Santander's chief executive commented that customers had said that this issue was the most important factor in terms of their satisfaction with the bank. Reports suggested that Santander had had one of the worse complaints records in the banking industry in 2011.

4.16.3 Outsourcing and assurance reports

One of the consequences of outsourcing is that many entities are now using outside service organisations to carry out tasks which affect the entity's internal controls. However, because many of the functions that are outsourced (in particular, IT) are integral to an entity's business operations, the entity's management will want to ensure that control procedures at the service organisation complement those they employ in-house.

In addition, because many of the functions performed by service organisations (eg payroll, or pensions' administration) affect an entity's financial statements, the entity's auditors may also seek information about the control procedures at the service organisation.

Accordingly, reporting accountants may be engaged by the service organisation to provide a report on specific control procedures undertaken by the service organisation, which can then be made available to the service organisation's customers and their accountants.

Guidance on the related assurance reports is given by ISAE 3402, *Assurance Reports on Controls at a Service Organisation.* ISAE 3402 only applies when the service organisation is responsible for, or otherwise able to make assertions about, the suitable *design* of the controls. This means that it does not apply where the assurance engagement is to:

(a) Report only on whether controls at the service organisation operated as described; or

(b) To report on controls at a service organisation other than those related to a service that is likely to be relevant to user entities' internal control, as it relates to financial reporting.

Objectives of the service auditor

ISAE 3402 states that the objectives of the service auditor are:

(a) To obtain reasonable assurance about whether, in all material respects, based on suitable criteria:

  (i) The service organisation's description of its system fairly presents the system, as designed and implemented throughout the specified period, or as at a specified date

  (ii) The controls, related to the control objectives stated in the service organisation's description of its system, were suitably designed throughout the specified period

  (iii) Where included in the scope of the engagement, the controls operated effectively to provide reasonable assurance that the control objectives, stated in the service organisation's description of its system, were achieved throughout the period.

Requirements and procedures

ISAE 3402 requires the service auditor to carry out the following procedures:

- Consider acceptance and continuance issues
- Assess the suitability of the criteria used by the service organisation
- Consider materiality with respect to the fair presentation of the description, the suitability of the design of controls, and in the case of a 'Type 2' report, the operating effectiveness of controls
- Obtain an understanding of the service organisation's system
- Obtain evidence regarding:
  – The service organisation's description of its system
  – Whether controls implemented to achieve the control objectives are suitably designed
  – The operating effectiveness of controls (when providing a 'Type 2' report)
- Determine whether, and to what extent, to use the work of the internal auditors (where there is an internal audit function)

Points to note:

1 A 'Type 1' report is a report on the description and design of controls at a service organisation.

2 A 'Type 2' report is a report on the description, design and operating effectiveness of controls at a service organisation.

4.17 Operations management

Definition

Operations management: Is concerned with the **design**, **implementation** and **control** of the **processes** in an organisation that transform inputs (materials, labour, other resources, information and customers) into output products and services.

Operations management is the activity of managing the resources within an entity that produce and deliver products and services.

The overall objective of operations is to use a transformation process to **add value** and **create competitive advantage**. The operations function takes input resources and transforms them into outputs of products or services for customers. As such, operations management involves the design, implementation and control of these processes.

Case example: Operations management at Ikea

As perhaps the most successful furniture retailer ever, Ikea has clearly demonstrated that it understands its market and its customers.

Equally importantly, however, it has also been able to satisfy its customers' requirements effectively – by designing, producing and delivering products and services which satisfy those requirements. These attributes of design, production and delivery are essentially what operations management is about.

This can be illustrated by looking at some of the activities which Ikea's operations managers are involved in:

- Arranging store layouts to give smooth and effective flow of customers: process design
- Designing stylish products that can be flat-packed efficiently: product design
- Locating stores of an appropriate size in the most effective place: supply network design
- Arranging for the delivery of products to stores: supply chain management
- Responding to fluctuations in demand: capacity management
- Avoiding running out of products for sale: inventory management
- Maintaining cleanliness and safety of storage areas: failure prevention
- Monitoring and enhancing quality of service to customers: quality management
- Ensuring that staff can contribute to the company's success: job design
- Continually examining and improving operations practice: operations improvement

Although these activities are only part of Ikea's total operations management responsibilities, they give an indication of how operations management contributes to the business' success and, equally importantly, what would happen if Ikea's operations managers didn't carry out any of the activities effectively. For example, inappropriate products, poor locations, badly laid out stores, empty shelves, or disaffected staff could all turn a company that has previously been successful into a failing one.

[Adapted from a case study in Slack, N., Chamber, S & Johnston, R. (2010), *Operations Management,* (6th edition), Harlow: Pearson]

Operations in an entity

In *Operations Management*, Slack *et al*, highlight that the operations function is one of three core functions in any company.

The three are:

(a) **Marketing and sales**. This is responsible for identifying customer needs and, perhaps more significantly, for communicating information about the organisation's products or services to customers so as to procure sales orders.

(b) **Product and service development**. This is responsible for creating new or improved products and services that will meet customer needs, to generate future sales orders.

(c) **Operations**. This is responsible for fulfilling customer orders and requests through production and delivery of the products or services.

Alongside these three core functions, there are also **support functions** within an organisation that help the core functions to operate effectively. Traditionally, support functions might include accounting and finance, human resources and IT. (This conception of core functions being supported by auxiliary functions is reminiscent of Porter's value chain, which we discussed in Chapter 1.)

In practice, what is actually a core function or a support function for an organisation is likely to depend on the nature of the particular organisation. Moreover, the functions within an organisation overlap, and for any particular task or process, input is often required from more than one core function or support function.

Business processes and the operations agenda

The business environment has a significant impact on what is expected from operations management. In recent years, there have been a number of changes in the business environment; and operations functions have needed to respond to them. When businesses have to cope with an increasingly challenging environment, they look to their operations function to help them respond.

Changes in the business environment	Operations responses
For example: • Increased cost-based competition • Expectations for higher quality • Demands for better service • Increased choice and variety • Frequent introduction of new products/services (and shorter product lives) • Rapidly developing technologies • Increased ethical sensitivity • Environmental impacts are more transparent • Greater legal regulation • Increased awareness of security	For example: • Globalisation of operations networking • Mass customisation • Internet-based integration of operations activities • Supply chain management • Customer relationship management • Information-based technologies • Flexible working patterns • Fast time-to-market methods • Lean process design • Environmentally sensitive design • Supplier 'partnership' and development • Failure analysis • Business recovery planning

4.17.1 The transformation process model

In simple terms, all operations produce products or services by changing inputs into outputs through one or more transformation processes. Input resources are either used to transform something, or they are transformed themselves into a product or service that satisfies customer needs.

The following are a small sample of practical examples of the transformation process model in practice.

(a) In a manufacturing process, inputs of raw materials and components are transformed by the work force, using the facilities of the organisation, into a finished product. This is then distributed to the customer. Production and distribution are stages in the transformation process. The output is the product.

(b) In the legal profession, a client seeks clarification about a legal problem. A lawyer holds a meeting with the client and provides the necessary advice. The output is an informed client.

(c) In the rail industry, rail service providers take customers, and use their work force and facilities (eg trains) to deliver the customers from one location to another. The output is a re-located customer.

(d) In banking, instructions from a customer (information) are processed using the facilities of the bank, and the instructions are carried out, for example, by the transfer of money. The output is the completed transfer.

(e) In a health service, a patient will be admitted to hospital to receive treatment in order to cure an illness. The doctor uses his or her skill to diagnose the problem and then uses the facilities (eg medical equipment) to treat the patient. The output is a healthy patient.

An operation might process a mix of materials, information and customers. However, it is often possible to categorise operations by the type or category of transformed resource that they process.

(a) **Materials processors** include manufacturing companies, retail businesses, mining and excavation operations, goods transportation services and postal services.

(b) **Information processors** include firms of accountants and lawyers, many banking operations, newspaper publishing (although this has a strong element of materials processing too), management consultancy and market research.

(c) **Customer processors** include education organisations, transport services, hotels, theatres, hospitals and hairdressers.

Operations can also be differentiated according to the transforming inputs they use. Some are more **labour-intensive**; and some more **capital-intensive**, **than others**.

4.17.2 The hierarchy of processes

So far, we have looked at the transformation process (the 'input-transformation-output' model) as a single operation. In effect, we have adopted a **macro perspective**. However, while, for example, an operation in an advertising agency to produce a campaign for a client can be seen as a single overall operation, it can also be seen as a number of separate **micro operations**, that all have to be carried out successfully in order to transform the original input into the final finished output.

The overall macro operation contains a number of micro operations, such as TV advertisement production, copy writing and editing for magazine advertisements, artwork design and production, media selection, media buying, and so on. Within each of these micro operations, there are other operations. Producing a TV advertisement, for example, involves micro operations such as story-boarding and script writing, film production, the shooting of the film, film editing, and so on.

A **macro operation** can therefore be seen as a hierarchy of micro operations or sub-operations and sub-sub-operations. (Equally, the input-transformation-output model can be used at a number of different levels of analysis.)

Each **micro operation**, like the macro operation, can be analysed in terms of the transformation process model, transforming input materials, information or customers into an output product or service. However, either the customer or the supplier, and more commonly both the customer and the supplier, are other people within the same organisation. The terms **internal supplier** and **internal customer** are used to describe this relationship.

For example, a road haulage company might have operational units for maintenance and servicing of vehicles, loading and driving. One micro process within the overall operation is the repair and servicing of vehicles. The mechanics servicing the vehicles are the internal suppliers in the process, and the drivers of the vehicles are the internal customers. Similarly, the team that loads the vehicles is an internal supplier in the loading operation, and the drivers are the internal customers.

It can be useful in operations management to think in terms of micro processes and internal suppliers and internal customers. This can focus attention on the purpose of each micro process, the efficiency with which it is carried out, and the extent to which it satisfies the customer's needs. However, unlike external customers, internal customers cannot usually express their dissatisfaction with an internal supplier by taking their business to a different supplier.

Nonetheless, by treating internal customers with the same degree of care as external customers, the effectiveness of the whole operation can be improved.

4.17.3 Operations and business processes

For the purpose of operations management, it is also useful to remember that **operations take place in all functions** of an organisation, not just the operations function. The marketing function, for example, transforms information and materials, using staff and facilities, into marketing and sales operations. The accounting function transforms raw accounting data into usable management information and reports.

Operations are, therefore, both a **core function** within an organisation, and **activities** within other functions. The principles of operations management apply to both.

4.17.4 Operations and strategy

As we noted at the start of this section, the overall objective of operations is to **contribute to the competitive advantage** of an organisation.

Effective operations management can generate five types of advantage for an organisation:

- It can **reduce the costs** of producing products and services.
- It can increase **customer satisfaction** through good quality and service.

- It can **reduce the risk of operational failure**, because well-designed and well-run operations should be less likely to fail. If they do fail, they should be able to recover faster and with less disruption than operations which are less well run.
- It can **reduce the amount of capital that has to be employed** to provide the type or quantity of products and services which are required. The more effectively an organisation can use its resources and capacity, the less capital it should need to produce its products and services. Therefore, effective operations management can reduce the need for additional investment.
- It can provide the **basis for future innovation**. Experiences learned from operating the processes can build a base of operations skills, knowledge and capability in the business, which can then enhance innovation.

4.17.5 Operations performance objectives

In order for an organisation's operations to contribute to its competitive advantage and strategic success, the aims of its operations need to be aligned to its overall strategies.

In this respect, Slack, Chambers and Johnston in *Operations Management* identify five basic 'performance objectives.' Slack *et al* stress that the objectives will mean different things for different operations, and some may be relatively more important than others in different contexts. Nevertheless, the five objectives can be used for evaluating operations to assess how well they are satisfying customers and contributing to competitiveness and strategic success.

Quality – This entails the delivery of error-free goods or services, which are 'fit for the purpose' and provide a quality advantage. Quality is a major influence on customer satisfaction. If a customer perceives a product or service to be high quality, and is satisfied as a result, they are more likely to purchase the product or service again.

Speed – The faster a customer can have the product or service, the more likely they are to buy it, the more they will be prepared to pay for it, or the greater the benefit they receive from it. In medical emergencies, for example, the speed at which a patient is treated could, literally, mean the difference between life and death.

Dependability – This refers to the organisation consistently meeting its promises in relation to delivery of goods and services. For example, whether you can depend on your train arriving at its destination on time, and have seats available on it.

Whilst speed, quality and cost (price) are all likely to be important operations performance objectives for McDonald's fast food restaurants, it could be said that customers are most attracted by the dependability factor. For example, customers can be confident that whichever McDonald's outlet they go to, they will be able to obtain a similar burger with a standard garnish.

Flexibility – the ability or willingness to change an operation in some way.

We can identify four different types of flexibility:

- **Product/service flexibility** – The ability or willingness to introduce new products/services, or to modify existing ones.
- **Mix flexibility** – The ability or willingness to adjust the range or mix of products/services.
- **Volume flexibility** – The ability to change the level of activity or output, and to provide different quantities of a product or service over time.
- **Delivery flexibility** – The operation's ability to change the timing of the delivery of products or services; for example, a car manufacturing plant's ability to reschedule manufacturing priorities, or a hospital's ability to reschedule appointments.
- **Cost** – For companies which compete directly on price, cost is their major operating objective. The cheaper they can produce their goods or services, the lower the price they can charge their customers while still earning a profit margin. However, even companies which do not compete directly on price, will still be interested in keeping their costs low, because a reduction in costs should translate into an increase in profit (assuming other factors remain the same).

All operations therefore have an interest in keeping their costs as low as possible whilst still meeting the levels of quality, speed, dependability and flexibility which their customers require. A measure often used to express how well an operation is achieving this is productivity – the ratio of the output produced by an operation in relation to the input required to produce it.

Performance trade-offs

At the start of this sub-section, we noted that some of the five performance objectives might be more important than others for specific organisations. For example, the speed with which a hospital can carry out a life-saving operation is likely to be more important than the cost.

This idea of differential importance could be particularly relevant if an operation is faced with a trade-off between performance objectives. For example, if the cost of an operation needs to be reduced, this may only be possible by reducing the level of flexibility which can be offered.

Conversely, there will also be occasions when improving the performance of the other four operations objectives leads to an improvement in cost performance. For example, improving operations quality will lead to a reduction in the time and cost spent correcting mistakes, re-producing faulty items, or dealing with customer complaints.

4.17.6 Performance objectives and competitive factors

As we have already noted, operations play a key role in adding value and creating competitive advantage. However, both of these roles ultimately need to be referenced for the customer. As a result, performance objectives for the operations function must also be consistent with the needs and expectations of customers. For example, there is no point in producing a high-cost, high-quality product if the customers' needs are driven by speed and cost.

Factors that are used to define customers' requirements are known as **competitive factors**. Depending on the perceived strength of each competitive factor in a particular market or market niche, a mix of performance objectives can be determined.

- If customers require a **low-priced product**, operational performance objectives will focus heavily on achieving a low cost of output.
- If customers desire a **high-quality product**, and are willing to pay more to obtain it, operational performance objectives will focus on quality, perhaps within a cost constraint.
- If customers need **fast delivery** of a product or service, operational objectives should be directed towards achieving or improving speed.
- If customers want **reliable delivery**, operations should have a reliability objective. An example would be a courier service, where customers might want delivery of packages within a particular time. An operational objective for the courier company might therefore be to guarantee delivery by 9am on the following working day for all packages collected before 5pm the previous day.
- Where customers prefer tailor-made or innovative products or services, operational objectives will be expressed in terms of **flexibility in product manufacture or service delivery**. If customers demand a wide range of products or services, operational objectives should be expressed in terms of **flexibility to deliver the range of items** demanded.
- If customers want to change the timing or delivery of the products or services they receive, there should be operational objectives for **flexibility in volume and speed**.

4.18 Operations: The four Vs

The characteristics of different operations will also affect the way in which they are organised and managed. These characteristics can be summarised as 'the four Vs':

- The **volume** of their output
- The **variety** of their output
- The **variation** in the demand for their output
- The degree of **visibility** which customers have of the production of their output.

	Type	Implication
Volume	Operations differ in the volume of inputs they handle and the volume of output they produce. For example, there is a big difference between the volume of output at a McDonalds and at a small restaurant, even though both provide a dining service.	High volume might lend itself to a capital-intensive operation, with specialisation of work and well-established systems for getting the work done. Unit costs should be low. Low-volume operations mean that each member of staff will have to perform more than one task, so that specialisation is not achievable. There will be less systemisation, and unit costs of output will be higher than with a high volume operation.
Variety	Variety refers to the range of products or services an operation provides, or the range of inputs handled. For example, an operation might produce goods to customer specification, or it might produce a small range of standard items.	When there is large variety, an operation needs to be flexible and capable of adapting to individual customer needs. The work may therefore be complex, and unit costs will be high. When variety is limited, the operation should be well defined, with standardisation, regular operational routines and low unit costs.
Variation in demand	For some operations, demand might vary with the time of the year (for example, operations in the tourist industry) or even the time of day (eg telecommunications traffic and commuter travel services). Variations in demand might be predictable, or unexpected. For other operations, demand might be fairly stable and not subject to variations.	When the variation in demand is high, an operation has a problem with capacity utilisation. It will try to anticipate variations in demand and alter its capacity accordingly. For example, the tourist industry takes on part-time staff during peak demand periods. Unit costs are likely to be high because facilities and staff are under-utilised in the off-peak periods. When demand is stable, it should be possible for an operation to achieve a high level of capacity utilisation, and costs will accordingly be lower.
Visibility	Visibility refers to the extent to which an operation is exposed to its customers, and can be seen by them. Many services are highly visible to customers. High visibility operations need staff with good communication and inter-personal skills. They tend to need more staff than low visibility operations and so are more expensive to run. Some operations are partly visible to the customer and partly invisible, and organisations might make this distinction in terms of front office and back office operations. For example, in an airport, the check-in desks, information desks, passport control and security staff are all clearly visible to customers. By contrast, whilst baggage handling, aircraft cleaning, and loading food/drink onto aircraft are all crucial in the smooth running of the operation, they are low-visibility tasks.	When visibility is high, customer satisfaction with the operation will be heavily influenced by their perceptions. Customers will be dissatisfied if they have to wait for high visibility processes, so staff will need high customer contact skills. Unit costs of a visible operation are likely to be high. When visibility is low, there can be a time lag between production and consumption, allowing the operation to utilise its capacity more efficiently. Customer contact skills are not important in low-visibility operations, and unit costs should be low.

The four Vs and unit costs

All four dimensions (the four Vs) have significant implications for the cost of producing products or services. In summary, high volume, low variety, low variation in demand, and low visibility all help to keep operations processing costs low. In contrast, low volume, high variety, high variation in demand, and high customer contact usually generate higher costs for the operation.

For example, McDonald's restaurants epitomise high-volume burger production. Within this high-volume operation, the tasks carried out by McDonald's are systemised and repeated, and can be carried out using specialised fryers and ovens. The relatively narrow range of meals on the menu also reduces the level of variety in McDonald's output. All of these factors help McDonald's keep its unit costs low.

4.19 Capacity planning

Various types of capacity plan may be used.

- **Level capacity plan:** Plan to maintain activity at a constant level over the planning period, and to ignore fluctuations in forecast demand. In a manufacturing operation, when demand is lower than capacity, the operation will produce goods for inventory. In a service operation, such as a hospital, restaurant or supermarket management must accept that resources will be under-utilised for some of the time, to ensure an adequate level of service during peak demand times. Queues will also be a feature of this approach.
- **Chase demand plan:** Aim to match capacity as closely as possible to the forecast fluctuations in demand. To achieve this aim, resources must be flexible. For example, staff numbers might have to be variable and staff might be required to work overtime or shifts. Variations in equipment levels might also be necessary, perhaps by means of short-term rental arrangements.
- **Demand management planning:** Reduce peak demand by switching it to the off-peak periods such as by offering off-peak prices.
- **Mixed plans**: Capacity planning involves a mixture of level capacity planning, chase demand planning and demand management planning.

4.20 Capacity control

Capacity control involves reacting to actual demand and influences on actual capacity as they arise. IT/IS applications used in manufacturing operations include:

- **Materials requirements planning (MRP I):** Converts estimates of demand into a materials requirements schedule.
- **Manufacturing resource planning (MRP II):** A computerised system for planning and monitoring all the resources of a manufacturing company: manufacturing, marketing, finance and engineering.
- **Enterprise resource planning (ERP)** software**:** Encompasses a number of integrated modules designed to support all of the key activities of an enterprise. This may comprise managing the key elements of the supply chain such as product planning, purchasing, stock control and customer service, including order tracking.

4.21 Just-in-time systems

Definition

Just-in-time: An approach to planning and control based on the idea that goods or services should be produced only when they are ordered or needed. Just-in-time production can also be called lean production.

Three key elements in the JIT philosophy

<table>
<tr><th>Element</th><th>Comment</th></tr>
<tr><td>Elimination of waste</td><td>Waste is defined as any activity that does not add value. Examples of waste identified by Toyota were:
Overproduction, ie producing more than was immediately needed by the next stage in the process.
Waiting time: Measured by labour efficiency and machine efficiency.
Transport: Moving items around a plant does not add value. Waste can be reduced by changing the layout of the factory floor so as to minimise the movement of materials.
Waste in the process: Some activities might be carried out only because there are design defects in the product, or because of poor maintenance work.
Inventory: Inventory is wasteful. The target should be to eliminate all inventory by tackling the things that cause it to build up.
Simplification of work: An employee does not necessarily add value by working. Simplifying work reduces waste in the system (the waste of motion) by eliminating unnecessary actions.
Defective goods are quality waste. This is a significant cause of waste in many operations.</td></tr>
<tr><td>The involvement of all staff in the operation</td><td>JIT is a cultural issue, and its philosophy has to be embraced by everyone involved in the operation if it is to be applied successfully. Critics of JIT argue that management efforts to involve all staff can be patronising.</td></tr>
<tr><td>Continuous improvement (or 'kaizen')</td><td>The ideal target is to meet demand immediately with perfect quality and no waste. In practice, this ideal is never achieved. However, the JIT philosophy is that an organisation should work towards the ideal, and continuous improvement is both possible and necessary.</td></tr>
</table>

4.21.1 JIT purchasing

With JIT purchasing, an organisation establishes a close relationship with trusted suppliers, and develops an arrangement with the supplier for being able to purchase materials only when they are needed for production. The supplier is required to have a flexible production system capable of responding immediately to purchase orders from the organisation.

4.21.2 JIT and service operations

The JIT philosophy can be applied to service operations as well as to manufacturing operations. Whereas JIT in manufacturing seeks to eliminate inventories, JIT in service operations seeks to remove queues of customers.

Queues of customers are wasteful because:

- They waste customers' time.
- Queues require space for customers to wait in, and this space is not adding value.
- Queuing lowers the customer's perception of the quality of the service.

The application of JIT to a service operation calls for the removal of task specialisation, so that the work force can be used more flexibly and moved from one type of work to another, in response to demand and work flow requirements.

Worked example: JIT in a postal service

A postal delivery has specific postmen or postwomen allocated to their own routes. However, there may be scenarios where, say, Route A is overloaded whilst Route B has a very light load of post.

Rather than have letters for Route A piling up at the sorting office, when the person responsible for Route B has finished delivering earlier, this person might help out on Route A.

Teamwork and flexibility are difficult to introduce into an organisation because people might be more comfortable with clearly delineated boundaries in terms of their responsibilities. However, the customer is usually not interested in the company organisation structure because he or she is more interested in receiving a timely service.

In practice, service organisations are likely to use a buffer operation to minimise customer queuing times. For example, a hairdresser will get an assistant to give the client a shampoo to reduce the impact of waiting for the stylist. Restaurants may have an area where guests could have a drink if no vacant tables are available immediately; such a facility may even encourage guests to plan in a few drinks before dinner, thereby increasing the restaurant's revenues.

4.22 Quality management

Definitions

Quality assurance: Focuses on the way a product or service is produced. Procedures and standards are devised with the aim of ensuring defects are eliminated (or at least minimised) during the development and production process.

Quality control: Is concerned with checking and reviewing work that has been done. Quality control therefore has a narrower focus than quality assurance.

4.22.1 Cost of quality

The **cost of quality** may be looked at in a number of different ways. For example, some may say that producing higher quality output will increase costs – as more costly resources are likely to be required to achieve a higher standard. Others may focus on the idea that poor quality output will lead to customer dissatisfaction, which generates costs associated with complaint resolution and warranties.

The demand for better quality has led to the acceptance of the view that quality management should aim to **prevent** defective production, rather than simply detect it, because it reduces costs in the long run.

Most modern approaches to quality have therefore tried to assure quality in the production process, (quality assurance) rather than just inspecting goods or services after they have been produced.

4.22.2 Total Quality Management (TQM)

Total Quality Management (TQM) is a popular technique of **quality assurance**. Main elements are:

- **Internal customers and internal suppliers**: All parts of the organisation are involved in quality issues, and need to work together. Every person and every activity in the organisation affects the work done by others. The work done by an internal supplier for an internal customer will eventually affect the quality of the product or service to the external customer.
- **Service level agreements**: Some organisations formalise the internal supplier-internal customer concept by requiring each internal supplier to make a **service level agreement** with its internal customer, covering the terms and standard of service.
- **Quality culture within the firm**: Every person within an organisation has an impact on quality, and it is the responsibility of everyone to get quality right.
- **Empowerment**: Recognition that employees themselves are often the best source of information about how (or how not) to improve quality.

5 Evaluating functional strategies

Section overview

- Once the corporate strategy has been agreed, a number of functional sub-strategies will need to be designed and implemented in support of these. For instance, a move towards differentiation via improved customer service levels may necessitate investment in IT improvements to support improved customer retention via a Relationship Marketing strategy.

5.1 Functional strategies

Definition

Functional strategies: Are concerned with how the component parts of an organisation deliver effectively the corporate- and business-level strategies in terms of resources, processes and people.

(*Johnson, Scholes and Whittington)*

Much functional strategy is created by individual business functions and delivered by them.

Functional area	Comment
Marketing	Devising products and services, pricing, promoting and distributing them, in order to satisfy customer needs at a profit. Marketing and corporate strategies are interrelated.
Production	Factory location, manufacturing techniques, outsourcing and so on.
Finance	Ensuring that the firm has enough financial resources to fund its other strategies by identifying sources of finance and using them effectively.
Human resources management	Secure personnel of the right skills in the right quantity at the right time, and to ensure that they have the right skills and values to promote the firm's overall goals.
Information systems	A firm's information systems are becoming increasingly important, as an item of expenditure, as administrative support and as a tool for competitive strength. Not all information technology applications are strategic, and the strategic value of IT will vary from case to case.
R&D	New products and techniques.

Interactive question 6: Levels of strategy [Difficulty level: Easy]

Ganymede Co is a company selling widgets. The finance director says: 'We plan to issue more shares to raise money for new plant capacity – we don't want loan finance – which will enable us to compete better in the vital and growing widget markets of Latin America. After all, we've promised the shareholders 5% profit growth this year, and trading is tough.'

Identify the **corporate**, **business** and **functional** strategies in the above statement.

See **Answer** at the end of this chapter.

5.2 Evaluating functional strategies in support of corporate strategy

A change of corporate strategy will inevitably require new functional strategies. For instance, in Section 3.1 the case study on Marks & Spencer detailed some of the challenges faced by the new CEO in the year 2000. In their attempts to modernise both the brand and product offerings, Luc Vandevelde and his successors have identified at various times that changes were needed to the following areas of M&S's functions:

(a) **Marketing** – TV advertising was undertaken for the first time in 25 years and celebrity endorsements were introduced. The promotional brand, 'Your M&S' was introduced.

(b) **Procurement** – UK based suppliers such as Baird Clothing were dropped in favour of cheaper overseas suppliers.

(c) **Products** – The M&S Money business was rapidly expanded and subsequently sold to HSBC as part of the successful defence against the Philip Green hostile takeover bid.

(d) **R&D** – George Davis, the man behind the successful 'George' brand at Asda, was recruited to launch the Per Una brand.

(e) **IS** – In January 2009, M&S signed a deal with IBM to implement SAP retail applications aimed at providing improved inventory visibility and data management.

Perhaps more importantly, online sales grew as M&S embraced the idea of becoming a multichannel business. Online sales grew 31% in the financial year 2010-2011 following a number of enhancements to the website, improving customer experience and encouraging more shoppers to complete their transactions online.

In its 2011 Annual Report, M&S also noted that 'The use of social media is enabling use to engage with our customers and gain further insights into their shopping habits and preferences.

6 Business plans

Section overview

- A convincing and thorough business plan will be essential for any company looking to raise additional finance. Whether it be a loan for a new business start-up, or funds for expansion, the lender will want to be assured that their investment is in good hands.

6.1 Contents of a business plan

A business plan is the foundation upon which a funding application will be made. Although there is no universal proforma, the table below indicates the type of content that a lender would expect to be presented with for review.

Section	Contents
Statutory data	Company name and number, address and other contact details.
Executive summary	An outline of the business alongside a summary of the costs and revenues projections for the proposed investment.
Marketing	Detailed summary of the market research findings. This should include the market size, entry methods, projected market share, competitor profiles, competitive advantage to be levered and proposed pricing and marketing ploys.
Product/service details	A detailed analysis of the products / services to be delivered. This should also cover the supply chain and distribution channels.
Management team	The trading and educational background of the directors and senior management team.
Plant & Equipment	Summary of fixed assets to be deployed.
Start-up costs	Analysis of start-up costs and how they are to be financed.
Business plan	Summary of cashflow forecasts, alongside a commentary outlining the assumptions made, plus sensitivity analysis to key risks such as sales volumes and prices.
Summary	A narrative detailing why the investment will succeed.
Appendices	Tables, spreadsheets or graphs providing detailed financial forecasts.

6.2 Constructing the business plan

The starting point for constructing the plan will be to project forward the current financial statements. In doing so, the lender's major interest will be in cash generation, as it will be the ability to generate cash to repay the loan that will ultimately determine whether an offer to provide finance is made. Therefore, it is important that the logic behind a cashflow forecast can be demonstrated. The potential cashflows to be included would be:

Cash inflows

- Cash sales
- Cash from receivables
- Interest receipts
- New finance issues

Cash outflows

- Payments to payables
- Capital expenditure
- Loan repayments
- Interest payments
- Tax payments
- Dividend payments

It will also be expected that the borrower can reconcile these projections to the current and projected financial forecasts, ie you must be able to show how the forecast profit and cashflows reconcile. As you will be aware from your Financial Reporting studies, these differences arise from:

- **Timing differences** – A sale or purchase is recorded in the financial statements when they are made, as opposed to when the cash is physically paid or received.

- **Non-cash movements** – Accounting adjustments such as depreciation, amortisation and movements in provisions will not appear in a cashflow forecast.

6.3 Critiquing the business plan

If a business plan is being used to start a new enterprise, the decision of the financier will rest in part on the credibility of the plans they are presented with. As such, it will be essential that the proprietor reviews their plan to ensure that they are able to present a compelling, but realistic case for finance. The questions that the proprietor should ask will include:

- Are the sales and revenue forecasts reasonable/achievable? This could be assessed against external estimates of market growth, but also need to be considered in conjunction with an organisation's **capacity**, and consideration of any **limiting factors**.

- Are the costs understated? Over time, costs will rise due to inflationary pressures. The headline government measure of inflation may be misleading, therefore the specific rates of inflation relevant to the raw materials used, or labour hired should be used instead. Do costs accurately reflect new initiatives (eg expansion plans)?

- Are market share projections realistic? This could be assessed against external market research data.

6.3.1 Assurance over prospective financial information

To the extent that a business plan is prepared in order to help a company raise additional finance, it can also be seen as prospective financial information.

However, any potential investor needs prospective financial information which is understandable, relevant, reliable and comparable. We could argue that prospective financial information is actually of more interest to users of accounts than historic information.

That said, prospective financial information is highly subjective in nature, and a significant amount of judgement has to be exercised in its preparation.

Therefore, auditors do not produce a statutory report on prospective information in the way that they do on historic information – they can still provide an alternative service, in the form of a review or assurance engagement. Reporting on prospective financial information is covered by ISAE 3400, *The Examination of Prospective Financial Information*.

ISAE 3400 states that the procedures the auditor carries out should be designed to obtain sufficient evidence as to whether:

- Management's best-estimate assumptions, on which the prospective financial information is based, are **not unreasonable**, and, in the case of hypothetical assumptions, such assumptions are **consistent** with the purpose of the information
- The prospective financial information is **properly prepared** on the basis of the assumptions
- The prospective financial information is **properly presented** and all material assumptions are adequately disclosed, including a clear indication as to whether they are best-estimate assumptions or hypothetical assumptions, and
- The prospective financial information is prepared on a **consistent basis with historical financial statements**, using appropriate accounting principles.

ISAE 3400 identifies that the key issues that projections relate to are profit, capital expenditure and cash flows. In this context, it suggests the auditor should undertake procedures to:

- Verify projected **income** figures to suitable evidence (for example, by reviewing the company's proposed prices against prices charged by competitors).
- Verify project **expenditure** figures to suitable evidence (for example, by reviewing quotations provided to the organisation, or by reviewing current bills for existing services).
- Check **capital expenditure** for reasonableness (for example, if the proposal relates to new premises, the cost of purchasing these should be reviewed against prevailing market rates).
- Review **cash forecasts** to ensure the timings are reasonable, and the cash forecast is consistent with any profit forecasts (ie income/expenditure should be the same, just at different times).

Summary and Self-test

Summary

Making an acquisition could enable an organisation to enter a market or increase market share more quickly than if it grew organically, but there are also considerable risks involved in making an acquisition, particularly in relation to acquiring a foreign company. This again highlights the importance of due diligence in the acquisition process.

As environmental conditions are becoming more complex and dynamic, organisational structures are also becoming less rigid. However, the structures, processes and relationships within an organisation still have to work effectively if the organisation is to be successful.

Although there are a number different structures an organisation can take (eg functional, matrix etc), there is no single 'best' structure; the most appropriate for an organisation is likely to depend on its situation.

Change is often an integral part of strategic management process: analysis of its current position may have identified the need for change, but the successful implementation of a new strategy is also likely to involve change management within an organisation.

The way in which change is managed will depend on the extent of the change and the speed with which it is required (eg evolution or revolution).

As force field analysis highlights, a key part of the change process is weakening the restraining forces that are resisting change and strengthening the driving forces that are promoting change.

Cost reduction is becoming increasingly important for businesses in an increasingly competitive environment (eg activities may be outsourced to reduce costs).

However, cost reduction also needs to be viewed in relation to value creation – cutting activities which add value for customers will be counter-productive for a business, particularly in the longer-term.

Effective supply chain management is becoming increasingly important in ensuring that customer requirements are satisfied adequately. However, at the heart of supply chain management there is balancing act between the need for responsiveness and the need for efficiency.

Traditionally, supply chains have been based on a 'push' model, but many companies have now switched to a demand-driven, customer-driven 'pull' model. JIT production is a demand 'pull' system.

Change and dynamism in the business environment has a significant impact on operations management within organisations, and the objectives of organisation's operations (quality, speed, dependability, flexibility, cost) need to be aligned to the organisation's overall strategy to contribute to its competitive advantage.

In many cases, an organisation may need to raise additional finance to achieve growth. Potential investors are likely to scrutinise an organisation's business plan before making a decision about whether to invest or not.

Self-test

Self-test question 1

Chemico is a chemical engineering company, based in an eastern European country. It is the largest and most important employer in the region, which is a relatively poor area with only one small town in reasonable commuting distance.

Chemico's main shareholders are international financial institutions, who have also provided finances in the form of loans.

At the moment, the company is performing well. Annual sales and profits have been increasing, the share price is strong, and the company has a number of large orders on its order book. It also has a favourable reputation among customers, which include some major household names.

However, Chemico's directors realise that the company's profitability is likely to diminish in the longer term, because new engineering technologies are being developed that will reduce (although not eliminate) the demand for their products.

The directors have been considering the option to diversify by developing a new product, using the same basic engineering and chemical processes as the existing products. However, this new product can present higher risks of toxic incident, and environmental campaigners have written to the local authorities highlighting the inherent risks involved in developing the new product.

Chemico's directors are also aware that one of its competitors is also developing a similar new product. Initial scientific research has concluded that Chemico's new product is generally more effective than its rival's in terms of the process it was designed for. However, the rival product doesn't pose any toxic risk.

Chemico's directors are currently considering the possibility of entering a strategic alliance with the competitor for the joint development of the new product.

Chemico is also considering a move into manufacturing specialist plastics. The plastics manufacturing business is one of the major users of Chemico's current products. However, Chemico would need to develop completely new manufacturing processes for it to be able to make the plastics in house.

The directors feel the investment required could be justified because there is strong growth in western Europe for the plastics, and the margins earned would be much higher than on their current products. However, initial investigations have also shown that Chemico could enter the market by buying a small local plastics company from the current owner who wishes to retire.

Requirements

(a) Assume Chemico decides to pursue the first proposal and develop the new chemical product itself. Discuss the main stakeholders' likely reactions to that proposal, and the degree to which they are likely to resist the proposal.

(b) Evaluate the issues which Chemico's directors should consider with respect to entering a strategic alliance with the competitor for the joint development of the new product.

(c) Discuss the change implementation issues that are likely to arise if Chemico decides to acquire the plastics company.

Self-test question 2

The insurance industry is characterised by large organisations producing, packaging and cross-selling a number of different 'products' to their client base. Typical products include life insurance, health insurance, house insurance and house contents insurance. Therefore, cost efficiency, repeat business and database manipulation are of significant importance.

GetInsure is a medium sized insurance company that has grown over the past fifty years by a number of relatively small mergers and acquisitions. Its business is focused on life, automobile and private property insurance. Over the last few years, the insurance industry has undergone significant change with increasing consolidation and the squeezing of margins.

The Board of GetInsure recognises that it is quite old fashioned in its approach to business, particularly in its attitude to information technology. Much of the computing is done on personal computers, many of which are not networked, using a variety of 'user written' programs. There are a number of different computer systems in the organisation that have been inherited from the companies that have been acquired in the past. However, these computer systems have not been fully consolidated. It is recognised that this lack of compatibility is causing efficiency problems.

GetInsure has recently been approached by Insura, an insurance company of a similar size, with a view to a merger. Although GetInsure has never combined with an organisation of this size before, the Board recognises that this merger could present an opportunity to develop into a company of significant size but that this may also present further problems of system incompatibility.

GetInsure has decided to proceed with the merger, but the Board recognises that this might only make the situation worse with regards to the information management strategy of the resulting combined company.

The finance director has asked you, as project accountant, to investigate the potential of outsourcing the information technology function as part of the post-merger consolidation process.

Requirement

Discuss the advantages and disadvantages of outsourcing the IT function for the merged organisation at each of the strategic, tactical and operational levels of the organisation.

Self-test question 3

Slick Fashions ('Slick') is a company based in Russia but with a listing on the London Stock Exchange. It produces the internationally-successful 'Slick' and 'Slick Force' brands of fashion clothes. The company has acquired a global reputation for good-quality, well-designed and reasonably-priced fashion clothing. The Slick brand is used for fashion clothes for men and women, and the Slick Force brand is for fashion clothes for a younger age group (late teenage and early twenties).

The company was established in 1921, as a family business, and the founding family developed Slick into the successful brand that it has now become. The company was sold in 2006 to a Russian billionaire investor, who then sold the majority of his shares when the company acquired its UK stock market listing in 2008. The corporate head office was transferred to Moscow in 2007.

Like other fashion clothing companies, Slick must continually design and produce new clothes for the fashion market. During the course of one year, the company produces over 15 000 new fashion designs, and it has a large in-house team of fashion designers. The company's top designers, who are based in Paris and Moscow, have an international reputation.

The company's products are sold mainly through stores. Some of these ('retail stores') are managed by Slick itself and sell only goods that have the Slick or Slick Force brand. Other sales are made through larger department stores, in which Slick is given space for selling its products. Currently, Slick operates about 800 of its own retail stores, and this number is increasing each year. In addition, it sells through about 7,000 department stores, although this figure is declining each year.

Most of the stores are in western Europe, particularly the countries of the Eurozone. Some stores in Russia sell Slick goods, but sales to Russia currently account for less than 10% of sales. There are also some stores in Hong Kong, Japan and the east coast of the USA. Slick has also established 'e-shops' in two countries for on-line selling.

Although all clothing products are designed by the company's own staff, most manufacturing is outsourced to small manufacturing companies. Virtually all of these manufacturers are located in Russia or in Malaysia. The company's policy of relying on large numbers of small suppliers has been successful in the past, but more recently there have been disagreements with a number of suppliers who have been demanding higher prices for their work due to increases in their own costs. The rising prices of cotton and fuel in particular, have been a cause of concern for manufacturers.

The company also has its own manufacturing subsidiary, located near Moscow, but this produces less than 5% of the company's total annual requirements by volume.

Slick's strong reputation in the market has been built largely on the success of its fashion designs. The company displays its fashions regularly at the major fashion fairs around the world, and its design team members are continually searching for new fashion ideas. Most fashion products are designed in advance of each season, and there are four fashion seasons each year. Orders are placed with manufacturers and the manufactured items are delivered to a central distribution centre that the company operates near Moscow. Goods are either sent to department stores direct from Moscow, or they are sent to a subsidiary distribution centre in France, from where they are sent to Slick's own stores and department stores in the Eurozone. However, many department stores reduced their pre-orders of items in 2012, and placed additional (supplementary) orders with Slick later in the fashion season, when they knew what items were selling well and which were not.

Slick's design team have been experimenting with a new just-in-time (JIT) system of purchasing and production for some of its fashion items. With this system, only limited quantities of products are manufactured for the start of each season. Members of the sales team in each region check the strength of demand for each product and inform Slick's Head Office in Moscow which products are selling well and which are selling badly. Orders for additional quantities of the popular items are then placed with manufacturers, and distributed as quickly as possible to meet the sales demand.

Experiments with this just-in-time purchasing/manufacturing system have been only partially successful, due to the long lead time between placing orders with small manufacturers and getting delivery into the distribution centre near Paris.

Slick has three main competitors in its main, western European markets. These are TCZ, QM, and BTN. TCZ's success has been built on a rapid product development cycle and a fast production cycle. It uses a large number of small manufacturers in the same area of Spain, where TCZ has a large and modern distribution centre. QM has also been highly successful in the European fashion market. By contrast, BTN has been less successful than these other two rivals, but is trying to recover lost ground through an expensive advertising campaign and refurbishment of many of its stores. BTN's turnover has doubled in the past ten years, whereas the turnover at Slick has risen three-fold; QM has increased four-fold; and TCZ, by six times.

BTN's problem, and also one facing Slick, is that in the large European market, companies which have a relatively slow design and distribution system are unable to meet the demand from consumers for fast cheap copies of the latest popular fashions. BTN is an Italian company, and at the moment, almost half of its sales are in Italy. However, it is developing a strategy for further expansion into Asia, and in particular India, where its brand name is still very strong.

Requirements

(a) Analyse the supply chain in which Slick operates and identify any current weaknesses in it.

(b) In terms of Porter's Five Forces model, discuss the strength of competition in the segment of the fashion industry in which Slick operates.

Technical Reference

ISAE 3402: *Assurance Reports on Controls at a Service Organisation*

- A global assurance standard for reporting on the controls at service organisations — **Overview**

ISAE 3400: *The Examination of Prospective Financial Information*

- To establish standards and provide guidance on engagements to examine and report on prospective financial statements, including examination procedures for best-estimate and hypothetical assumptions. — **Overview**

Supply chain management and operations management texts

Although this Study Manual is designed to provide you with comprehensive coverage of the material you need for your SBM, if you wish to undertake further reading around the supply chain management and operations management topics discussed in this chapter, we recommend the following texts:

Chopra, S. & Meindl, P. (2012) *Supply Chain Management*, (5^{th} edition), Harlow: Pearson.

Slack, N., Chambers, S. & Johnston, R. (2010), *Operations Management*, (6^{th} edition), Harlow: Pearson.

Answers to Interactive questions

Answer to Interactive question 1

The shareholders will be assured by the following forms of diligence:

- Review of financial statements for accuracy
- Specialist reports on the size of Beta's proven reserves
- Actuarial calculations on the state of Beta's pension fund and any shortfalls
- An assessment of the value and condition of Beta's assets such as oil rigs and drills
- A review of any exploration rights that Beta has acquired and whether these can be transferred upon a takeover to Alpha
- An assessment of Beta's legal status: Are there any active legal claims, and the likelihood and impact of losing these?
- An environmental audit (think: BP and Deepwater Horizon explosion)

Answer to Interactive question 2

(a) **Organic growth**

Advantages

Low risk – Organic growth is generally considered to involve less risk than making an acquisition, and JKL's past experience of its failed acquisition illustrates the risk involved in growing externally.

Expanding through organic growth means that JKL can exploit its own strengths whilst maintaining its existing **style of management** and **corporate culture.** Also, JKL will not face problems of having to integrate operating systems between different companies.

Growth in stages – JKL is a small company and so may only have limited resources. Organic growth is likely to be less onerous on its cash flow than making an acquisition. Organic growth can be managed gradually or in stages, whereas to make an acquisition JKL is likely to have to commit a large amount of funds in one go.

Disadvantages

Speed of growth – It is likely to take longer for a firm to grow organically, than if it acquires another firm. Organic growth is often achieved by a company reinvesting its profits into its growth. However, this means the speed of growth will be restricted by the level of profits available for reinvestment, and this could be a particular issue for JKL as is it is still a small company.

Nature of growth – Organic growth is most suited to situations where a company is growing gradually, and using its existing markets. However, in this case, JKL is looking to break into a new market – in a foreign country (France) – and this represents a more significant change in JKL's strategy.

Access – As France is a new market for JKL, it is likely to lack the access to key suppliers and customers that established competitors will already have there. Moreover, none of JKL's staff speak fluent French, which could make it harder to establish contacts in the country.

(b) **Acquisition**

In many ways, the advantages and disadvantages of making an acquisition can be seen as a mirror image of those for organic growth:

Advantages

Speed of growth – Making an acquisition would allow JKL to enter a new market (France) much more quickly than by growing organically. It may even allow JKL to gain access to a market that would otherwise be unattainable (given the absence of any customer contracts, and weak linguistic skills).

Acquiring skills – XYZ has a very good reputation in France, and acquisition will offer JKL the opportunity to widen its skill set. One of the criticisms of acquisitions is often that they benefit the company being acquired more than the company making the acquisition. However, in this case, XYZ's reputation and skill set look like it could be valuable for JKL to acquire.

Disadvantages

Risk – Acquisitions are likely to involve greater risk than organic growth, in particular with respect to the way the post-acquisition integration is managed.

Post-integration issues – JKL's experience has highlighted the potential problems involved in trying to integrate different cultures and systems. There could be clashes if the culture and management style of the acquired company is different to the acquiring one, and the likelihood of this happening could be increased by the fact that the company being acquired is in a foreign country. Post-integration problems could mean that the anticipated benefits of the acquisition are not actually realised.

Answer to Interactive question 3

Existing structure

The current organisation structure is divisional with the divisions based on type of product. With the decision to close down the sports car division and the necessity to increase profits, a revision of the structure is necessary.

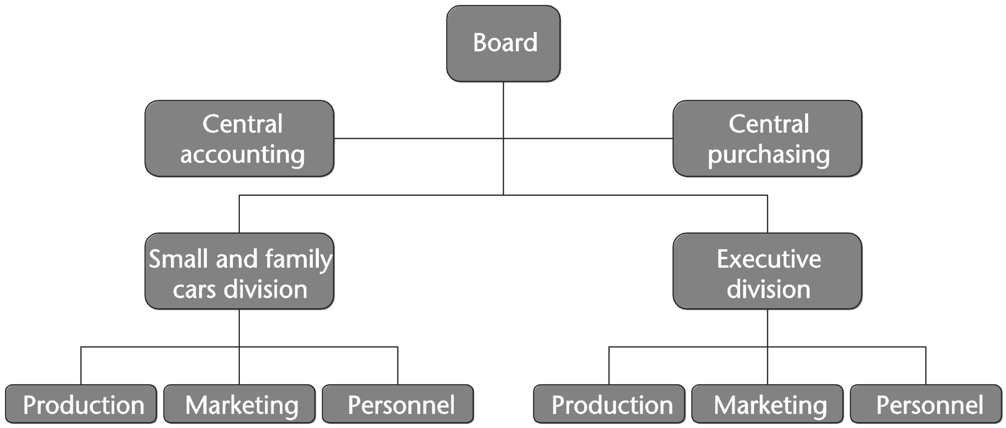
Proposed structure

It is proposed that the existing divisional structure be maintained with two divisions – small and family cars, and executive cars. There are two reasons for this.

(1) Geography: The two divisions are based in Luton and Newcastle, making control more difficult if a functional structure were to be adopted (eg production under the control of one manager).

(2) Product type: The products, although similar in some ways (ie cars), are sold in different markets requiring different skills in, for example, marketing and production.

The proposed structure is shown below.



All purchasing and accounting functions are provided centrally, rather than having a repetition of functions within each division. The reasons for this are that the same suppliers are used by both divisions for components and both divisions have the same accounting systems. This should reduce costs.

Each division has its own personnel function in order that it does not seem too remote from employees, which would be the case if, for example, a central personnel function were established in Luton or Newcastle.

Answer to Interactive question 4

(a) **Forces for and against change**

Forces for change

The forces for change in Timbermate appear to be both external and internal.

External factors would include:

- **Overseas competitors**: Current suppliers may be able to undercut Timbermate if they set up their own operations in Bangladesh. It will be essential for them to bring down their own cost base to survive.
- **Exchange rates**: Weakening BDT will make imports more expensive, putting up Timbermate's costs still further.

C H A P T E R 3

- **Growth in plastic alternatives** may reduce demand in a number of key areas. Unless they can fight back, share will be lost, reducing economies of scale and brand strength.

Internal factors would include:

- **Leadership**: Brian Parsons' determination to make the changes needed.
- **Customers**: Increasing dissatisfaction with the current standard of service has already given rise to complaint and may, if not addressed, lead to loss of current customers and brand image.
- **Shareholders**: A period of poor results cannot have been satisfactory for the shareholders which is presumably why they have appointed Parsons.

Forces against change

- **Attitude of managers**: The managers lack a sense of urgency and are therefore likely to resist any major change programme as unnecessarily disruptive.
- **Attitude of staff**: It is likely that the laid back culture permeates the whole organisation and staff may not understand the need for change. They will undoubtedly also be fearful for their jobs.
- **Unions** have already expressed their intention to resist any changes to wages or working conditions. This could lead to walk-outs and strikes.

(b) **Managing change**

A useful method of managing change was proposed by Lewin. This divides the process of change into three stages, unfreezing, changing and refreezing.

Unfreezing

The forces for change must be used to encourage the change, and the forces against it must be weakened. Methods might include:

- Carrying out a **PEST analysis t**o identify the exact nature of the threats from the outside environment (issues such as deforestation may also have potential impact and have been overlooked).
- These issues and their consequences should then be stressed to the managers. **Forecasts** of market performance (and its impact on bonuses) if no change is made should be communicated. **Workshops** to involve senior managers in the process may help them to appreciate the urgency of the situation.
- **Consultation and negotiation** with the unions will have to be entered into. They will need to be persuaded of the importance of change now to protect jobs in the future.

Change

The new information system must be introduced. Training in all aspects will be required – not just in how to use the system, but in its potential benefits, so that staff start to identify ways in which it could further improve business.

- **New working practices** will need to be introduced. Some processes may need re-engineering.
- Greater **collaboration** between different divisions needs to be encouraged.
- Efforts must be made to **change the culture** of the organisation. Stories about problems being caused by economic cycles that can be ignored, rituals such as leaving work on the dot, and an organisation structure so rigid that there is little or no horizontal communication suggests a 'jobs worth' paradigm where bureaucracy has taken on all its worst characteristics. Whilst education may start the process, it may be necessary to remove those managers who are unwilling or unable to change.

Refreezing

This is the process of trying to ensure planned changes become the norm.

- **Reward systems** should be developed to focus on issues such as cost management, customer satisfaction, productivity and innovation.
- **Continual training**: The staff should be given regular training updates to deepen their understanding of the new system.
- **Communication**: Interdivisional meetings should be scheduled on a monthly basis. The agenda should be collaborative problem solving and sharing of best practice. It may be that major customers should be provided with a single point of contact, who will then liaise with all divisions on their behalf (a matrix structure within the divisional one).

Answer to Interactive question 5

(a) **The nature of BPR and its application to AB Ltd**

A process is 'a collection of activities that takes one or more types of input and creates output that is of value to the customer'.

Part of this process is the manufacture of goods, and so is relevant to AB Ltd. However, a process is more than just manufacturing – it involves the ordering and delivery of goods to the customer. Arguably, AB Ltd does not need to manufacture. All aspects of the process, from ordering to delivery, must be considered.

Key features of BPR and how these can be implemented.

(i) Focus on the outcome, not the task.

(ii) Ignore the current way of doing business. For example, AB Ltd may be divided into departments. The current organisation structure is not relevant to the process. Indeed, having a large number of departments may make the process harder to manage, as it is split between several different responsibilities. The same customer's order may be passed from department to department.

(iii) Carefully determine how to use technology. IT has often been used to automate existing processes rather than redesign new ones. This means that AB Ltd must have an information strategy for the company as a whole.

(iv) Review job design. Scientific management splits jobs into their smallest components. BPR suggests that, in some cases, enlarged jobs are more efficient if they lead to fewer people being involved in the process.

(v) Do the work where it makes most sense. This might affect where sales order processing and credit controls are carried out.

(vi) Work must be done in logical sequence. This can affect factory layout but also the sequence of clerical activities.

(vii) Those who perform the process should manage it. The distinction between managers and workers should be eroded; decision aids such as expert systems should be provided.

(viii) Information provision should be included in the work that produces it.

(ix) The customer should have a single point of contact in the organisation.

In effect, BPR requires the asking of the fundamental question: 'If we were starting from scratch, what would we do?'

(b) **Pitfalls**

(i) BPR is an all or nothing proposition. It is thus expensive and risky, requiring major expenditure on consultancy, investment in IT systems and disruption. It is not worth doing unless there is a good reason.

(ii) AB Ltd is concerned about overseas competition. There may be other competitive responses more appropriate than BPR, such as improving quality, outsourcing, a focus strategy or a differentiation strategy.

(iii) Implementation is difficult, as organisations fail to think through what they are trying to achieve, and the process becomes captured by departmental interest groups. In AB Ltd, the production director, sales director and finance director may well conflict. The customer may deal with all three of them.

(iv) Managers take a departmental view, rather than the view of the business as a whole.

(v) BPR becomes associated only with across the board cost cutting rather than a fundamental re-evaluation of the business. Managers will fight very hard to avoid any threats to their position.

(vi) Management consultants responsible for the ideas often fail to come up with realistic strategies for implementation. Managers are thus left with a BPR formula that they may not fully understand and have to implement it in a hostile work environment.

Answer to Interactive question 6

The corporate objective is profit growth. The corporate strategy is the decision that this will be achieved by entering new markets, rather than producing new products. The business strategy suggests that those markets include Latin America. The operational or functional strategy involves the decision to invest in new plant (the production function) which is to be financed by shares rather than loans (the finance function).

Answers to Self-test questions

Answer to Self-test question 1

Part (a)

Shareholders

Profitability – The shareholders will be keen that the **profitability** of the company is maintained because this will affect the return on their investments. Consequently, if developing the new product helps sustain profits, they would be expected to support the proposal rather than resist it.

We do not know whether the shareholders are aware of the **alternative proposals** Chemico's directors have been considering (the alliance or the acquisition). If they are, and they think one of them would serve Chemico better commercially, then they may resist this first proposal in favour of one of these alternatives.

Risk of environmental pollution – As well as short term profitability, the shareholders are also likely to consider the longer term growth of their shares. In this respect, they may feel that the opportunities for enhancing the overall value of their investments would be jeopardised by the risk of toxic accidents.

Moreover, some of the larger institutional investors may decide they do not want to be associated with Chemico if its **corporate social responsibility** (CSR) policies are called into question.

The wider issue here is that Chemico must not been seen to be **sacrificing safety in the search for profits**.

Employees

Saving jobs – Given the lack of alternative employment opportunities in the region, keeping their jobs at the factory is crucial for the workers. So, from this perspective, the employees will support a change that seeks to preserve their jobs.

Health risks – However, avoiding health risks is also important to the workers. So, the increased risk of toxic incidents attached to the new product will be a concern to them.

There is also a secondary issue here. We have assumed that the workers know about the health risks attached to the new product (because they have been highlighted by environmental campaigners). However, the directors may have convinced the workers that the risks are low, so that they are even less likely to resist the proposal.

Either way, the economic need to preserve their jobs is likely to mean that the workers are unlikely to resist the proposals.

Local residents

Conflicting interests – The local residents are likely to have the same dual interests as the staff. On the one hand, the community benefits from the **presence of a large employer** in the region (for example, people have more money to spend at local stores). If the proposal doesn't go ahead, redundancies are likely, and this could have a knock-on effect throughout the rest of the regional economy (via the multiplier effect).

However, as with the employees, the local residents will not welcome the introduction of a process which could potentially spill out **toxic waste**.

The residents are probably more likely to resist the proposal than the workers, but it is debatable how much power residents alone could have to stop development.

Environmental campaigners

Environmental issues – The environmental campaigners will strongly oppose the proposals, because of the potential risk of toxic incident they present. The campaigners will be more concerned with the environmental costs of the proposal rather than the economic arguments for it.

Moreover, the campaigners have shown themselves to be **active in resisting the proposal**, and have already written to the local authorities. In terms of a force field analysis, the campaigners are likely to be the strongest resisting force acting against the proposal.

Regional government

Divided interests – Like the residents, the local authorities may also have split interests about the proposal.

On the one hand, they will want to **support Chemico as the largest employer** in the region, and they will want to keep income and jobs in the region. In this context, if they resist the proposal, this could also discourage other potential investors who might have been looking to invest in the area.

However, on the other hand, the authorities will be aware of the **potential environmental risks** of the proposal, and will be concerned about any health risks the chemical processes might present.

Ultimately, the strength of their resistance is likely to depend on the level of toxic risk they think the new product presents.

Part (b)

Sharing competences – Alliances can be a valuable learning exercise for each partner. Entering into an alliance would allow Chemico and its partner to exploit complementary competences for their mutual advantage. Therefore, before agreeing to form any alliance, Chemico should consider what distinctive competences both it and the potential partner are bringing to the venture. Can they be used for mutual advantage?

Risk sharing – New product development presents many uncertainties as well as opportunities. So sharing the funding of expensive research via an alliance can spread the risk. However, it also means that future profits will have to be shared.

Goal congruence – One of the most important things for Chemico to do before entering an alliance will be to work out where there might be potential conflicts of interest between the two companies.

Disagreements may arise over profit shares, resources invested, management issues (including project management), overall control of the specification of the product to be developed, and marketing strategy.

These issues must be resolved in advance, and agreed on a contractual basis, so that each party is clear about its rights and responsibilities.

People and culture – The directors should also consider staff and cultural issues, and whether the companies can work together. For example, it may take a while for staff from both companies to trust each other, and to share ideas with each other. If the two companies cannot develop this trust between themselves, then the alliance is unlikely to be successful.

Partnership costs – The alliance will involve sharing tangible expenses such as capital contribution, but also intangibles such as expertise. Having **joint ownership of patents for products** that are developed by an alliance could lead to disputes about a fair share of future returns from them, unless the agreement is carefully and thoroughly worded. There could also be similar issues surrounding the **ownership** and **use of any intellectual property** generated by the alliance. The alliance may, therefore, include significant legal costs to deal with any such issues.

Business risk – Chemico is a big company, and so is likely to be the larger partner in the alliance. There is a risk, therefore, that the alliance partner might use the alliance as a means of finding out about its Chemico's technology.

Alternatively, Chemico might decide it wants to use the alliance as a stepping stone to a future takeover of the smaller company.

Part (c)

Acquiring the plastics company would represent a **major organisational change** for Chemico. It will be necessary to integrate the target company's operations, techniques and people into the expanded company, while continuing to run the existing Chemico business.

Cultural issues – Mergers and acquisitions often fail to produce the expected benefits due to cultural incompatibilities between the two companies combining.

In this case, a small owner-managed business is being incorporated into a much bigger business. The policies and procedures which the staff from the small company are used to are likely to be very different to those in Chemico. If the acquisition is to be successful, the new staff will need to adapt to working within Chemico's structures. However, Chemico's management and staff can assist this process by making the new staff feel welcome into the business, and explaining how things are done.

Leadership – The success of the takeover will depend on effective leadership from Chemico's management.

The takeover is a **planned change**, and so the change process must be driven by the senior management. To be successful, the management must have a **clear vision** of their strategy for where the merged business is going, and how to achieve it.

In turn, this vision must be used to establish goals, and performance indicators, so that **performance across the whole business can be measured** against them.

Communication – Effective communication will be essential for both existing Chemico staff and staff from the newly acquired company to appreciate the reasons behind the deal, but perhaps more importantly, to understand their roles and responsibilities in the new organisation going forward.

If staff from the local plastics company will be expected to use Chemico's policies and procedures, then they will **need to be trained** so that they know what to do.

External communication – Chemico will need to decide how far the plastics business is rebranded (for example, will it be renamed Chemico Plastics?) and how the change of ownership is communicated to customers. It may be that the most practical solution is to allow the business to retain its current trading name, and reassure customers that business will continue as usual.

Management skills – The owner of the plastics business plans to retire, so ensuring a succession plan for running the plastics business will be essential. There may already be some managers in the business who can do this and effectively run it as an autonomous business unit within the Chemico 'group'.

It will be very important to establish what skills the staff within the business do have, because it is unlikely that Chemico's management know much about plastics manufacturing. Depending on the skills and commitment of the existing staff, it may be that Chemico have to recruit externally, to find a manager to run the new plastics division.

Redundancies – There are likely to be some redundancies after the acquisition, for example in the marketing and administration functions of the company being acquired. However, there may also be some redundancies in Chemico's production departments, because there is no guarantee the acquisition will completely reverse the decline in demand for Chemico's products.

The staff in both organisations will inevitably be apprehensive about the possibility of job losses. The best way to deal with such fears is to act as quickly as possible and determine whether any cuts are necessary. If they are, the cuts must be implemented fairly – for example, on the basis of the skills required going forward.

Given the lack of alternative employment opportunities in the region, losing their job will be a major problem for individual staff members. There is a chance that losing some of their colleagues will affect the morale of the staff who remain with the company.

To this end, Chemico could consider offering training and outplacement support to the staff being made redundant to help them try to find new jobs.

Answer to Self-test question 2

The **strategic level of management** is concerned with decisions that set the overall, long-term direction the organisation is to take.

Potential advantages at this level include the following.

The supplier ought to be able to deploy **IT competences, skills and techniques of a higher order** than GetInsure can provide internally, thus equipping the company to handle the much greater complexity inherent in doubling in size by merger with Insura. This should also make future acquisitions easier to absorb.

Outsourcing ought to bring cost benefits through the **exploitation of the supplier's economies of scale**, though actually achieving these benefits would depend on satisfactory contract negotiations.

The merged company will have to do something about its IT strategy. Outsourcing should **reduce the risks involved** in what will be a major project.

Access to state-of-the-art IT systems may spur a **complete strategic reappraisal** of internal methods and procedures, producing **transformational** rather than **incremental** improvement in the way the company does things. One obvious example of such change is **delayering and empowerment**. An insurance business runs on assessment of risk: much of the process can now be automated. Also, the role of middle managers as filters and processors of routine information can now be largely eliminated by the use of modern IT systems. Much flatter and more effective structures can result.

Potential disadvantages at the strategic level

There are two important strategic dangers involved in outsourcing such an important function. First, there is the **risk of losing internal IT capability**: this could stunt future developments.

Alongside this, and linked to it, is the **risk of losing control of the IT function** and the services it provides. This is a very serious problem, since IT may represent a **core competence** for a large insurance company: the growth of direct, telephone-based insurance services is a good example. A more immediate danger is, perhaps, the possibility that the chosen contractor will **exploit its position by raising charges unreasonably** at some future time.

The every day, **routine (operational) level of management** will also be affected by outsourcing.

Potential advantages at the operational level

Advantages should include the provision of **more capable, reliable and faster systems**, which should enhance customer service; better and faster response to operational IT problems; and a reduction in the training effort currently needed to keep the existing legacy systems in operation. Junior managers should find they have more time for non-IT related aspects of their jobs and will have more flexibility in the management of their staff, since work will be simplified and more standardised.

Potential disadvantages at the operational level

Disadvantages will revolve around the **reliability and efficiency of the contractors and their staff**. It is at this level that there must be the greatest integration of work; contractor staff will be expected to understand and support operational rather than technical IT priorities.

The **tactical level of management** between the strategic and the routine will be affected by the levels both above and below it, since it will be responsible for implementing strategic decisions and for providing the first response to the operational problems that junior managers cannot solve.

Potential advantages at the tactical level

These will include improved **reliability and continuity** of systems, with a reduced risk of significant failure.

Access to **IT staff of a high quality for advice and assistance**: it may be possible to recruit some contractor staff for any remaining internal IT activities. **IT training resources** should also be improved.

Potential disadvantages at the tactical level

However, there will be the possibility of disadvantages too. These will be similar to those experienced by junior managers, though of greater significance.

Outsourcing would constitute a **significant change**, as would the merger with Insura. The management of these changes and the stress associated with it would fall to this level of management. Staff would be unsettled and would require a clear lead. Also, staff at all levels must keep their eyes on the ball and not allow the changes taking place to distract them from their primary responsibilities to their customers. Middle managers such as department heads must make sure that this happens.

There is also a potential problem in the degree of retraining these managers would themselves require. They will tend to be older and **possibly less able to adjust** to the new methods and practices.

Answer to Self-test question 3

Part (a)

The upstream supply chain begins with producers of cloth and other materials for fashion clothes. Materials are purchased by the businesses that manufacture the clothing for Slick.

The manufacturers are mainly small independent firms in Russia and Malaysia, but the company has its own small manufacturing subsidiary. The manufactured goods are transported to the company's distribution centre in Russia.

Slick buys the manufactured clothes that it has designed, and distributes them to retailers directly from its Russian distribution centre, or through the distribution centre in France. Retailers may be department stores or its own stores. There are also some online sales, where Slick sells clothes directly to customers rather than using physical stores as intermediaries.

There appear to be a number of weaknesses in Slick's supply chain however:

- Most sales are in western Europe but manufacturing is in Russia (Eastern Europe) or Malaysia. Although these areas may be cheaper for manufacturing, the costs of transporting the clothes to the distribution centre in Russia and then to the distribution centre in France may be quite high.
- There is no information about the efficiency of Slick's delivery system, but operating with two distribution centres may be inefficient and slow down the transfer of manufactured goods to shops. Its competitor TCZ has a manufacturing centre in Spain and a modern distribution system. This may give TCZ a strategic advantage because transport costs should be lower; and distribution times, quicker. TCZ operates a just in time system for ordering goods from manufacturers, and this seems to be more successful than Slick's attempts to do the same thing.
- The speed with which the supply chain between Slick and its manufacturers responds to changes in customer demand appears to be slower than its rivals (particularly TCZ and QM), and this is likely to put Slick at a disadvantage, compared to these competitors.

Part (b)

- Threat of new entrants (and barriers to entry) – It may be possible for small fashion designers to enter the market, but a new entrant would have the problem of finding a sufficient number of retailers willing to sell their products which would also need to appeal to fashion-conscious customers. There may be a greater threat from small fashion designers and manufacturers who are trying to grow their business, rather than from new entrants.
- Customers are either the end consumer or department stores. The number of wholesale outlets stocking Slick's products has been falling, which may suggest that department stores are switching to competitors. If this is the case, department stores may have a reasonable amount of bargaining power over Slick. Alternatively, the decline may be due to the number of department stores themselves falling, which suggests they be struggling to remain profitable.
- For own store sales and e-shopping, customers will only buy Slick's goods if they are attracted by the design and the price. In this respect, although an individual customer will have minimal bargaining power, customers as a whole are likely to have much greater bargaining power. The costs of switching to a rival brand are low, so, for example, customers may switch between rival brands, depending on whose clothes are perceived to be the most fashionable at any given time. However, because Slick's brands are internationally successful, this may encourage some customers to remain loyal to it.
- Slick's suppliers are mainly small manufacturing firms in Russia and Malaysia, so they may not have strong bargaining power compared to Slick and the other major retailers. The rising cost of cotton and fuel mean that the manufacturers are demanding higher prices for their goods. An important issue in the value system will be how much of the price increase retailers are prepared to accept, and also how much they are willing to pass on to customers. (This could be a particular issue for Slick, given that it has developed a reputation for selling 'reasonably-priced' goods.)
- There are probably no direct substitutes to fashion clothes, although customers may be able to switch to cheaper fashion goods retailers. However, there is insufficient information in the scenario to assess the strength of this force in the industry.
- Competition between fashion goods producers seems to be strong, although the strength of the competition may vary between different parts of the world. Although we do not know the relative sizes of Slick, TCZ, QM and BTN, the fact that the industry segment appears to be dominated by these four firms suggests that there is likely to be considerable rivalry between them. However, competition may be on fashion design and the popularity of different clothing ranges, rather than price. It seems plausible, however, that the strength of competition between the firms keeps prices lower than they might otherwise be.

CHAPTER 4

Strategic performance management

Introduction

Topic List

1 Performance management
2 Information for strategic decision making
3 Performance measurement
4 Rewards, behaviour and performance
5 Corporate social responsibility and performance

Summary and Self-test

Technical reference

Answers to Interactive questions

Answers to Self-test

Introduction

Learning objectives

Tick off

- Advise on, and develop, appropriate performance management approaches for businesses and business units
- Explain and demonstrate how a business can analyse complex data from multiple sources to provide strategic management accounting information to implement, monitor and modify a strategy at an appropriate organisational level in order to create competitive advantage
- Use financial and non-financial performance data to measure multiple aspects of performance at a variety of organisational levels
- Advise on, and develop, appropriate remuneration and reward packages for staff and executives linked to performance, considering agency relationship issues; and evaluate the impact of corporate reports arising from *BAS 19, Employee Benefits*, and *BFRS 2, Share-Based Payment*
- Develop measures to evaluate performance in the context of social responsibility, sustainability and environmental matters

Knowledge brought forward

You should already be familiar with the financial and non-financial performance measures which can be used to measure an organisation's financial performance, because they have been covered in the *Business Strategy* syllabus.

Examination context and syllabus links

It is important to distinguish between performance measurement and performance management.

Whilst it is important for organisations to measure how well they are performing (or for accountants to measure how well their organisations are performing) this measurement takes place within the wider context of strategic planning and control, and it is subject to both internal and external factors which can affect performance. (We have looked at these factors in Chapter 1.)

At this level, it is vital to appreciate that you try to link any performance measures you calculate to an organisation's context, and assess what impact that context has had on the organisation's performance.

Equally, it is important to remember that performance management also considers how an organisation's performance can be improved, using the results of performance measurement. For example, an organisation's performance can be improved if performance measures are introduced which encourage staff to improve their performance. (In this respect, there is a link between performance management and human resource management, which we look at in Chapter 10.)

In Chapter 8 of this Study Manual, we will look in more detail at data analysis, and how you should use the information provided in case study scenarios to help explain an organisation's performance, and to think about the strategic implications of any issues identified in an organisation's performance data.

Equally, however, before we can analyse an organisation's performance, we need reliable and timely information about that performance. This highlights the importance of information systems in performance management, and we look at information systems in more detail in Chapter 9 of this Study Manual.

1 Performance management

Section overview

- In order to assess whether or not an organisation is meeting its goals, some form of measurement versus expectations will be required. Historically, this has taken the form of budgeting. In this chapter we will look at the increasing importance of non-financial measurement in performance management.
- A second element of performance management is the improvement of performance. The metrics developed as part of the performance management systems can be used to track improvements in business processes and thus be used to drive greater efficiencies.

1.1 Performance measurement and control

All systems of control can be analysed using the **cybernetic model**. The essence of this model is the **feedback** of control action to the controlled process: the control action itself being generated from the comparison of actual results with what was planned.

Performance measurement has become such an accepted part of business life that sometimes we lose sight of its purpose.

(a) Performance measurement is part of the overall cybernetic (or feedback) control system, providing the essential **feedback** spur to any necessary control action.

(b) It is a major input into communications to **stakeholder groups**, including the widening field of corporate reporting.

(c) It is intimately linked to **incentives** and **performance management** systems, providing evidence of results against agreed objectives.

(d) Motivation may be enhanced since managers will seek to achieve satisfactory performance in areas that are measured.

1.1.1 Feedback loops

To some extent, planning and controlling are two sides of a single coin, since a plan is of little value if it is not put into action, while a system of control can only be effective if the people running it know what it is they are trying to achieve.

In the cybernetic system, an objective is established: for the organisation, this might be the current year's budget.

Actual achievement is measured, perhaps by means of monthly reports, and a process of comparison takes place (for example, by comparing actual figures to budgeted ones).

Managers can then take control action to try to make up for any failures to achieve the plan. This control action feeds back into the activity of the organisation and its effects should become apparent in the next monthly report.

This kind of feedback loop is the essence of any control system, though sometimes it may be difficult to discern its existence and operation.

Definition

Feedback: Feedback occurs when the results (outputs) of a system are used to control it, by adjusting the input or behaviour of the system. Businesses use feedback information to control their performance.

However, when considering feedback loops, it is important to distinguish between single loop feedback and double loop feedback.

In **single loop feedback**, changes are made to the system's behaviour in order to try to meet the plan.

By contrast, **double loop feedback** can result in changes being made to the plan itself.

Using a simple example, if an organisation's operating profit is below budget, managers could be asked to identify ways to reduce costs in order to help bring profits back in line with budget. This is single loop feedback.

Alternatively, the organisation might realise that an over-spend on costs is due to a rise in raw material costs which is outside its control. Therefore, the organisation could reforecast its original cost budget, but it could also consider whether it needs to revise its sales prices in the light of the change in costs. Any such changes to re-forecast the original budget would be double loop feedback.

Organisations as open systems

Importantly, the simple illustration above in relation to double loop feedback shows how external factors (in this case, a rise in raw material input costs) can affect an organisation's performance.

However, external factors can affect performance more generally. In Chapter 1 we highlighted the importance of 'PESTEL' analysis in identifying opportunities and threats to an organisation, but the changing business environment and other external factors can equally have a significant influence on an organisation's current performance.

The fact that performance is influenced by external and environmental factors highlights that organisations are open systems, and therefore, there are likely to be aspects of performance which are beyond an organisation's control.

However, this can raise difficulties in relation to performance management in an organisation.

Consider the following simple example. An organisation has noticed that it has been failing to meet revenue targets in recent weeks, and it has identified that problems with its website have meant that some customers have not been able to make orders online. Consequently, the organisation devoted a considerable amount of resources to improving its website to make it more reliable and user-friendly.

However, when the improved website went live, the organisation noticed that its revenues were still behind budget. Now managers realised that one of the organisation's major competitors had reduced their prices and another competitor had launched a new market-leading product. Both of these initiatives had enabled the competitors to increase their market share at the organisation's expense.

This simple example illustrates that the 'open system' nature of organisations means that, often, managers cannot attribute performance to a single issue, but need to look at it as a combined effect of many variables.

Equally, the idea that different business units or functions within an organisation are also open systems, means that managers need to be aware of the **inter-dependencies of different operations and processes** within an organisation, as well as the overall environment in which the organisation operates.

1.1.2 Scope of performance management

Our discussion of feedback and control has looked mainly at organisational performance. However, performance management can be applied at different levels within an organisation (corporate, business unit, team, individual).

This highlights the issue of **goal congruence** when designing performance reward systems. In particular, reward systems need to be designed in such a way that individuals' goals (in order to earn their rewards) are aligned to team goals and the organisation's goals overall.

It is also important to note that aspects of human resource management (HRM) (such as setting **performance objectives** and **reward management**) play an important role in the performance management and control of the organisation.

In this respect, HRM follows a similar control model as is used for the overall strategic and operational control of an organisation:

Step 1: Goals are set (for individuals).
Step 2: Performance is measured and compared with target.
Step 3: Control measures are undertaken in order to correct any shortfall.
Step 4: Goals are adjusted in the light of experience.

However, it is crucial to recognise that the goals set for individuals should link to, and support the achievement of, the key strategic and operational success factors for an organisation.

Effective performance management requires that the strategic objectives of the organisation are broken down into layers of more and more detailed sub-objectives, so that **individual performance** can be judged against personal goals that support and link directly back to corporate strategy.

1.2 Budgetary control systems

Budgetary control systems are used by many companies to compel planning, co-ordinate activities and motivate employees, as well as to evaluate performance. Deviations from the plan are corrected via **control action**.

A budget is a **plan expressed in monetary terms.** It is prepared and approved prior to the budget period and may show income, expenditure and capital to be employed.

Purpose of budgets

- To compel planning
- To co-ordinate activities
- To communicate ideas
- To provide a framework for responsibility accounting
- To motivate employees and management
- To evaluate performance

Negative effects of budgets include

- Limited incentives if the budget is unrealistic
- A manager may add a percentage to his expenditure budget to ensure that he can meet the figure
- Manager achieves target but does no more
- A manager may go on a 'spending spree'
- Draws attention away from the longer term consequences

Problems with budgetary control

- The managers who set the budgets are often not responsible for attaining them
- The goals of the organisation as a whole, expressed in the budget, may not coincide with the personal aspirations of the individual managers
- Control is applied at different stages by different people

How to improve behavioural aspects of budgetary control

- Develop a working relationship with operational managers
- Keeping accounting jargon to a minimum
- Making reports clear and to the point
- Providing control and information with a minimum of delay
- Ensuring actual costs are recorded accurately
- Allow for participation in the budgetary process

Limitations to the effectiveness of participation

- Some people prefer tough management
- A manager may build slack into his own budget
- Management feels that they have little scope to influence the final outcome

1.3 Criticisms of traditional budgeting

According to the co-founders of the 'Beyond Budgeting' movement, Jeremy Hope and Robin Fraser, traditional budgets hold companies back, restrict staff creativity and prevent them from responding to customers. Hope and Fraser quoted a 1998 survey which found that 88% of respondents were dissatisfied with the budgeting model. They also highlighted some surprising statistics:

(a) 78% of companies do not change their budget during the annual cycle. Managers tend to 'manage around' their budgets.

(b) 60% do not link strategy and budgeting.

(c) 85% of management teams spend less than one hour a month discussing strategy.

Budgets tend to focus upon financial outputs rather than quantitative performance measures, and are not linked to employee performance. Hope and Fraser believe that organisational and behavioural changes are required, and they link these with the new business environment to suggest 'a management model that really supports strategy'. We summarise this in the table below:

Change in environment	How to succeed?	Key success factors	'Budget barriers'
• Rising uncertainty	• Cope with uncertainty by adapting quickly	• Devolve authority • Fast information • Strategy an adaptive process	• Too many rules • Restricted information flows • Fixed cycles are difficult to change

Change in environment	How to succeed?	Key success factors	'Budget barriers'
• Importance of intellectual capital	• Find (and retain) good people	• Recruit and develop good staff and set up a fair reward system	• Budgets tend to ignore people and lead to 'management by fear' and a cost-cutting mentality
• Increasing pace of innovation	• Create an innovative climate	• Share knowledge • See the business as a series of investments, not just components of a budget	• Central planning and bureaucracy encourage short-termism, and stifle creativity
• Falling prices and costs	• Operate with low costs	• Adopt a low cost network structure • Challenge costs • Align resources and costs with strategy	• Budgets prevent costs being challenged, they simply become 'entitlements'
• Declining customer loyalty	• Attract and keep the right customers	• Set up strong customer relationships • Establish a customer-facing strategy	• Budgeted sales targets and product focus tends to ignore customer needs
• More demanding shareholders	• Create consistent shareholder value	• Take a long term view of value creation • Base controls on performance	• Budgets tend to focus on the short term, with no future view

According to Hope and Fraser, 'giving managers control of their actions and using a few simple measures, based on key value drivers and geared to beating the competition, is all that most cases require'.

Case example: Svenska Handelsbanken

Challenging costs is inevitably part of such a process. Hope and Fraser identified Swedish bank Svenska Handelsbanken as a key exponent. Its low costs are the product of several factors:

(a) Small head office staff, and a flat, simple hierarchy

(b) People in regions and branches are self sufficient and well-trained and are measured by competitive results, which has produced an attitude keen to weed out unwarranted expenses

(c) Lower credit losses because front line staff feel more concerned to make sure that the information on which they base lending decisions is correct

(d) Central services and costs are negotiated rather than allocated

(e) Internet technology is used to reduce costs, with the benefit accruing to the customer's own branch

The European Vice President of Svenska Handelsbanken believes that 'devolving responsibility for results, turning cost centres into profit centres; squeezing central costs, using technology and … eradicating the budgeting "cost entitlement" mentality are just some of the actions we have taken to place costs under constant pressure'.

Another criticism of the annual budgeting and planning process is that it does not add value. Instead, it uses a large amount of senior managers', budget holders' and finance team's time, but creates an output which can be almost meaningless in times of rapid change.

Establishing a rolling quarterly forecast may be more appropriate in times of rapid change, and these forecasts should also be linked to CSFs rather than simply be a summary of financial targets.

1.4 Beyond Budgeting

There is much debate about whether the traditional budgeting models evaluated above are suitable in many modern organisations. Much of this debate revolves around whether traditional models can operate effectively in a changing environment. 'Beyond Budgeting' is one response to the perceived weaknesses in traditional budgeting.

Jeremy Hope (who championed the idea of 'Beyond Budgeting' with Robin Fraser) highlights two fundamental differences between Beyond Budgeting and traditional management and budgeting models:

(a) It is a more **adaptive** way of managing. Instead of fixed annual plans and budgets which tie managers to predetermined actions, targets are reviewed regularly and based on goals that link to performance against best-in-class benchmarks, competitors and prior periods.

(b) It enables a more **decentralised** way of managing. Instead of a traditional hierarchy and centralised leadership, Beyond Budgeting enables decision-making and performance accountability to be devolved to line managers, and creates a culture of personal responsibility and self-management. Hope and Fraser believe this change in culture, in turn, leads to increased motivation, higher productivity and better customer service.

Juergen Daum, a business consultant who sat on the Beyond Budgeting round table has argued on his website (www.juergendaum.com):

> *Fixed budgets don't work today. A budget is too static an instrument and locks managers into the past - into something they thought last year was right. To be effective in a global economy with rapidly shifting market conditions and quick and nimble competitors, organisations have to be able to adapt constantly their priorities and ... put their resources where they can create most value for customers and shareholders. In order to do that, they need the right concepts, management processes and tools – concepts such as the Beyond Budgeting Management Model.*
>
> *The introduction of new management instruments such as the Balanced Scorecard, which help to better align the entire organisation with corporate strategic objectives and to focus it on the essentials, has created the right foundation. Because if corporate strategy and the objectives are clear for all people in an organisation, one can, in principle, react faster to changing market conditions. But then the fixed budget comes into the way and prevents organisations from really doing the right things. What is often missing is a more flexible operational planning and control model. The Beyond Budgeting model aims to fill this gap.*

By contrast, it is interesting to note the results of a survey of budgeting practices in UK companies by Lyne and Dugdale (*Budgeting Practice and Organisational Structure;* a report sponsored and published by CIMA, 2010).

The survey looked into the management attitudes toward beyond budgeting in particular, and involved financial and non-financial managers. The survey concluded that, overall, managers *were* satisfied with budgeting and budgeting processes. The writers concluded that their findings were very different from the arguments made in favour of beyond budgeting, which claim managers are very dissatisfied with conventional budgeting systems.

1.5 Traditional budgeting v 'Beyond Budgeting'

Hope and Fraser argue that 'traditional' budgeting processes do not meet the purposes of performance management. The table below illustrates the ways in which Hope and Fraser feel Beyond budgeting differs from 'traditional' budgeting, and also how 'Beyond Budgeting' meets the purposes of performance management better.

Purposes of performance management	Traditional budgeting processes	Beyond Budgeting processes
Goals – To balance the need for short-term and long-term profitability	**Short-term focus**: Fixed annual targets drive short-term actions with a view to meeting annual targets.	**Longer-term focus**: KPIs and aspirational goals focus on sustained competitive success.

Purposes of performance management	Traditional budgeting processes	Beyond Budgeting processes
Rewards – To provide an effective basis for motivating and rewarding performance	Individual departments or divisions have to meet their own targets in order to gain rewards. This focus on individual incentives means departments are not willing to share expertise, skills and information with others, preferring to **defend their 'own turf'** instead.	Recognition of team-based success is important, but the organisation needs to be **viewed as one team**, thereby breaking down barriers and encouraging people to share resources and knowledge. There is an **emphasis on learning and continual innovation**.
Plans – To direct actions to maximise market opportunities	Planning is based on a premise of '**predict and control**' and is highly deterministic. This means plans are difficult to change even if the assumptions on which the plans were based become unrealistic. Organisations adopt a '**company led**' rather than 'customer led' approach to strategic management.	The future is inherently unpredictable so plans need to be **continuously updated** to adapt to events as they happen. Organisations adopt a '**customer led**' approach to strategic management.
Resources – To ensure that resources are available to support agreed actions	Budgets are seen as a way of enabling senior managers to allocate resources to operating units. The process is **centralised**, and the 'head office' exerts control over the operating units or cost centres. But head offices are usually risk averse and prefer to allocate resources to existing products and businesses rather than to new ideas and opportunities.	Resources are available on demand, to enable a fast response to new opportunities. Resources are **allocated to strategic initiatives** rather than to departmental budgets.
Co-ordination – To harmonise actions across the business	Leaders attempt to co-ordinate plans by linking one functional budget to another. But these centrally-linked budgets provide slow solutions that often fail to meet customer needs.	Co-ordination should focus around a dynamic linking of customer demands in order to provide fast, seamless solutions that **meet customer needs**.
Controls – To provide relevant information for strategic decision-making and controls	Performance reports are based primarily on **financial indicators**, and usually contain lagging indicators (connected with past performance and past events). But financial indicators give little insight into the root causes of performance, and provide a poor basis for learning.	Strategic decisions are based on **multi-faceted** and **multi-level information**, which gives insight into where performance is heading in the future as well as in the past. Information systems need to be able to provide fast, transparent information for multi-level control.

2 Information for strategic decision making

Section overview

- **Strategic information** is used to **plan** the **objectives** of the organisation, and to **assess** whether the objectives are being met in practice. Therefore, it is important that organisations have an information systems strategy so that it can meet its information requirements.
- Organisations often have to consider three different strategies in relation to information: information systems (**IS**) strategy, information technology (**IT**) strategy and information management (**IM**) strategy. We will look at these in more detail throughout this chapter, but it is important you are aware of the different aspects of information strategy overall as you are reading through the chapter.
- **Strategic management accounting** provides information that can be used to support strategic planning and control. It differs from traditional management accounting in that it provides an external orientation and a future orientation.

2.1 Levels of information and decision making

In Chapter 1, we highlighted the idea of a hierarchy of performance in organisations: covering strategic, tactical and operational levels of performance.

This idea of a hierarchy is also important in relation to the data and performance information required for decision-making and control in organisations. We will look at information systems and the different levels of information again in Chapter 9 of this Study Manual.

Robert Anthony suggested that there are **three levels** or tiers within an organisation's **decision making hierarchy**.

Strategic planning is the process of deciding on objectives of the organisation, on changes in these objectives, on the resources used to attain these objectives, and on the policies that are to govern the acquisition, use and disposition of these resources.

Management control is the process by which managers assure that resources are obtained and used effectively and efficiently in the accomplishment of the organisation's objectives.

Operational control is the process of assuring that specific tasks are carried out effectively and efficiently.

The 'management' level is sometimes also called the tactical level; eg tactics or tactical planning.

2.2 Strategic information

Strategic planning, management control and operational control may be seen as a hierarchy of planning and control decisions. (This is sometimes called the Anthony hierarchy, after the writer Robert Anthony

Figure 4.1: The Anthony hierarchy

As well as highlighting the three levels in the hierarchy, it is also important to note the different characteristics of the information produced (and required) at different levels in the hierarchy:

Strategic information	Management (tactical) information	Operational information
Derived from both internal and external sources • Summarised at a high level • Relevant to the long term • Concerned with the whole organisation • Often prepared on an *ad hoc* basis • Both quantitative and qualitative • Focus on planning; future orientation • Uncertain, as the future cannot be accurately predicted	• Primarily generated internally (but may have a limited external component) • Summarised at a lower level • Relevant to the short and medium term • Concerned with activities or departments, and with the efficiency/effectiveness of resource usage • Prepared routinely and regularly • Based on quantitative measures (eg budgets, benchmarks) • Some focus on planning, but greater focus on control	• Derived from internal sources; often includes 'transaction data' from transaction processing systems • Detailed, being the processing of raw data • Relevant to the immediate term • Task-specific • Prepared very frequently • Largely quantitative, but often expressed in operational measures (eg units produced, transactions processed) rather than monetary terms • Focus on control (rather than planning)

Case example: An evening newspaper

- **Operational information** will include supplies to and returns from vendors to support invoicing, costs of production, controls over inventories of paper, ink etc, hours worked by staff to support payroll, health and safety compliance.
- **Managerial (or tactical) information** will include levels of sales to plan production runs of each edition (up to seven a day in some cities), the quality of stories and likely interest in them to plan production runs, advertising sales and success of special editions, supplements etc, the weather on the day and its effects on sales. Clearly, the main information that will be used at this level will be the articles and stories themselves and the editorial team will decide inclusion and position of each.
- **Strategic information** includes the plans of rival newspaper owners, the policies of the press watchdogs, potential sources of new advertising revenues, new printing technologies, the costs and efficiency of the various printing plants operated by the firm, potential new markets for newspapers (eg free morning papers).

Interactive question 1: Levels of performance [Difficulty level: Intermediate]

ST University (STU) is a higher educational institution in a European country, with approximately 8,500 full time students. It employs 360 academic staff and 450 other staff.

STU currently receives a significant amount of government funding, which covers its capital budget (for buildings and equipment), teaching, and research.

However, a recent visit from government appointed auditors has been critical of STU's performance in a number of areas:

- For the last two financial years, STU has operated at a deficit, with its expenditure being greater than its income.
- The percentage of students dropping-out of courses is greatly in excess of the national average, as is the failure rate.
- The number of student complaints was very high, and has been increasing over the past five years.
- It has had an abnormally high level of staff turnover.
- STU's internal control of cash receipts is weak, and in several areas there were discrepancies between the cash actually held and the expected amount.

- It also had a large number of debtors (receivables), mainly ex-students, but was not taking any action to collect outstanding debts.
- STU could not accurately produce a head-count of the number of students enrolled on its courses.
- Overall, the quality of education provided by STU has been graded as 'Poor', which is the lowest possible rating.

Although STU's senior management team were disappointed at the level of the auditors' criticism overall, they were particularly surprised at some comments made about its computing facilities. Over the past two years, STU has made a major capital investment in upgrading all the computing facilities across the university.

The auditors' report made reference to this investment, but pointed out that some department faculties are making much better use of them to promote learning than others.

Requirement

Discuss the extent to which the criticisms made about the University are strategic or operational.

See **Answer** at the end of the chapter.

2.3 Strategic information systems

Crucially in order for managers or accountants to be able to measure the performance of their organisations, the relevant performance information needs to be available to them. This highlights the importance of information systems. Moreover, the reference to Anthony's hierarchy (above) also highlights the importance of having different types of information systems which provide performance information at different levels (strategic, tactical and operational).

Strategic IT systems include Executive Information Systems **(EIS)**, Management Information Systems **(MIS)** and Decision Support Systems **(DSS)**. **Value added networks** facilitate the strategic use of information in order to add value.

2.3.1 Executive Information Systems (EIS)

Definition

Executive Information Systems (EIS): A system that pools data from internal and external sources and make information available to senior managers in an easy-to-use form. EIS helps senior managers make strategic, unstructured decisions.

An EIS should provide senior managers with easy access to key **internal and external** information. The system summarises and tracks strategically critical information, possibly drawn from internal MIS and DSS, but also including data from external sources eg competitors, legislation, and external databases such as Reuters.

An EIS is likely to have the following **features**.

- Flexibility
- Quick response time
- Sophisticated data analysis and modelling tools

2.3.2 Management Information Systems (MIS)

Definition

Management Information Systems (MIS): Systems that convert data from mainly internal sources into information (eg summary reports, exception reports). This information enables managers to make timely and effective decisions for planning, directing and controlling the activities for which they are responsible.

An MIS provides regular reports and (usually) on-line access to the organisation's current and historical performance.

MIS usually transform data from underlying transaction processing systems into summarised files that are used as the basis for management reports.

MIS have the following characteristics:

- Support **structured** decisions at operational and management control levels
- Designed to report on **existing** operations
- Have little analytical capability
- Relatively **inflexible**
- Have an **internal** focus

2.3.3 Decision support systems (DSS)

Definition

Decision Support Systems (DSS): Systems that combine data and analytical models or data analysis tools to support semi-structured and unstructured decision making.

DSS are used by management to assist in making decisions on issues which are subject to high levels of uncertainty about the problem, the various **responses** which management could undertake or the likely **impact** of those actions.

Decision support systems are intended to provide a wide range of alternative information gathering and analytical tools with a major emphasis upon **flexibility** and **user-friendliness**.

DSS have more analytical power than other systems, enabling them to analyse and condense large volumes of data into a form that helps managers make decisions. The objective is to allow the manager to consider a number of **alternatives** and evaluate them under a variety of potential conditions.

Executives at small and medium sized companies are making critical business decisions every day based on the information available to them.

This information can come from a variety of sources: opinions from peers and colleagues; a personal sense of intuition or business judgment; or data derived internally or externally to the organisation. This is worrying, however, given the lack of confidence in the data available to decision makers.

Case example: Information for decision making

A 2007 report conducted by the Economist Intelligence Unit (EIU) found that nine out of ten corporate executives admit to making important decisions on the basis of inadequate information.

This suggests that there are problems in the quality, amount and timeliness of information which is available as the basis for decision making.

It also suggests that today's small and medium sized companies are destined to make a number of uninformed decisions on an alarmingly regular basis. Executives simply do not have the relevant information required to make the best decision in a timely manner.

Therefore business solutions software – such as SAP Business One – is becoming increasingly valuable for businesses. The technology can help companies improve operational efficiency, customer service and innovation.

2.3.4 Value added networks

Definition

Value added networks: VANs are networks that facilitate the adding of value to products and (particularly) to services by the strategic use of information. Typically, VANs will link separate organisations together through electronic data interchanges (EDIs), contributing to the development of **business networks**.

Also, they are often business ventures in their own right, with companies subscribing to the services available. Good examples are the SABRE, Amadeus and Galileo airline flight booking systems. A simpler example is the electronic data interchange systems between manufacturers and their suppliers that facilitate the operation of just-in-time (JIT) logistics.

VANs give mutual competitive advantage to all their subscribers, but only so long as some competitors are left outside of the system. As soon as membership of the VAN (or a competing VAN) becomes a standard feature of the industry, the original competitive advantage is lost. Competitive advantage based on VAN membership can then only exist if there is more than one VAN and each VAN in the industry offers a different degree of benefit in terms of cost reduction or differentiation.

2.4 Strategic information systems

Definitions

Information Systems (IS) strategy is the long-term plan for systems to exploit information in order to support business strategies or create new strategic options.

Information Technology (IT) strategy is concerned with selecting, operating and managing the technological element of the IS strategy.

Information Management (IM) strategy deals with the roles of the people involved in the use of IT assets, the relationships between them and design of the management processes needed to exploit IT.

Strategic Information Systems are systems at any level of an organisation that change goals, processes, products, services or environmental relationships with the aim of gaining competitive advantage.

Michael Earl's analysis of information strategy into three elements (IS, IT and IM) is useful. The first distinction he made was between the strategies for **information systems** and **information technology**.

2.4.1 Levels of information strategy

Information systems (IS) strategy

An information systems (IS) strategy is concerned with specifying the systems (in the widest meaning of the word) that will best **enable the use of information to support the overall business strategy** and to deliver tangible benefits to the business (for example, through increased productivity, or enhanced profits). In this context, a 'system' will include all the **activities, procedures, records** and **people** involved in a particular aspect of the organisation's work, as well as the **technology** used.

The information systems strategy is focussed on **business requirements**, the demands they make for information of all kinds and the nature of the benefits that information systems are expected to provide.

This strategy is very much **demand-led** and **business-driven**: each SBU in a large organisation is likely to have its own information systems strategy.

The IS strategy is supported by:

Information technology (IT) strategy

The information technology strategy, by contrast is technology-focussed and looks at the resources, technical solutions and systems architecture required to enable an organisation to implement its information systems (IS) strategy.

IT strategies are likely to look at the **hardware and software** used by the organisation to produce and process information. They may also include aspects of data capture and data storage, as well as the transmission and presentation of information.

Information management (IM) strategy (IM)

Earl subsequently also highlighted the need for an information management strategy. The emphasis here is on management: managing the role and structure of IT activities within an organisation, and managing the relationships between IT specialists and the users of information. In this respect, a key feature of IM strategy is its focus on **roles and relationships**.

IM strategy also plays an important part in ensuring that information can be accessed by all the people who need it, but, at the same time, access to information is restricted to those people who need access to it.

We might sum up the three levels of information strategy in very simple terms by saying that: IS strategy defines **what** is to be achieved; IT strategy determines **how** hardware, software and telecommunications can achieve it; and the IM strategy describes **who** controls and uses the technology provided.

This model of information strategy has the advantage of being **internally consistent** and quite **simple** to understand. Unfortunately, the picture is spoiled by a different use of the term information management. You may come across a rather narrow use of this term to mean 'the approach taken to storing and accessing data'. Since this is really just an aspect of the information technology strategy, as defined above, we do not recommend the use of the term in this way.

2.5 The challenge for accountants

The availability and appreciation of the myriad of new information systems has challenged the role of the accountant in the control framework. These new systems, such as EIS, have highlighted a number of perceived failings in the **traditional accounting systems organisations had relied upon**.

(a) **Direction towards financial reporting**. Historical costs are necessary to report to shareholders, but the classifications of transactions for reporting purposes are not necessarily relevant to decision-making.

(b) **Misleading information** – particularly with regard to overhead absorption.

(c) **Neatness** rather than **usefulness**.

(d) **Internal focus***.* Management accounting information has been too inward looking, (for example focusing on achieving internal performance targets, like budgets). However, organisations also need to focus on customers and competition.

(e) **Inflexibility** and an inability to cope with change.

The challenge lies in providing more relevant information for **strategic planning**, **control** and **decision making**. Traditional management accounting systems may not always provide this.

(a) **Historical costs** are not necessarily the best guide to decision making. However, management accounting information is often criticised for **focusing on the past** rather than the future.

(b) **Strategic issues** are not easily detected by management accounting systems.

(c) **Financial models** of some sophistication are needed to enable accountants to provide useful information.

2.5.1 Objectives of management accounting information

Management accounting information is used by managers for a variety of purposes:

(a) **To measure performance**. Management accounting information can be used to analyse the performance of the business as a whole, and of the individual divisions, departments or products within the business. Performance reports provide feedback, most frequently in the form of comparison between actual performance and budget.

(b) **To control the business**. Performance reports are a crucial element in managing a business. In order to be able to control their organisation, managers need to know the following:

(i) What they want the business to achieve (targets or standards; budgets)
(ii) What the business is actually achieving (actual performance)

By comparing the actual achievements with targeted performance, management can decide whether corrective action is needed, and then take the necessary action when required.

Much control information is of an accounting nature because costs, revenues, profits and asset values are major factors in how well or how badly a business performs.

(c) **To plan for the future**. Managers have to plan, and they need information to do this. Much of the information they use is management accounting information.

(d) **To make decisions**. As we have seen, managers are faced with several types of decision:

(i) Strategic decisions (which relate to the longer term objectives of a business) require information which tends to concern the organisation as a whole, is in summary form and is derived from both internal and external sources.

(ii) Tactical and operational decisions (which relate to the short or medium term and to a department, product or division rather than the organisation as a whole) require information that is more detailed and more restricted in its sources.

2.6 What is strategic management accounting?

The aim of strategic management accounting is to provide information that is relevant to the process of strategic planning and control.

Definition

Strategic management accounting: A form of management accounting in which emphasis is placed on information about factors which are external to the organisation, as well as non-financial and internally-generated information.

2.6.1 External orientation

The important fact, which distinguishes strategic management accounting from other management accounting activities, is its **external orientation**, towards customers and competitors, suppliers and perhaps other stakeholders. For example, whereas a traditional management accountant would report on an organisation's own revenues, the strategic management would report on market share or trends in market size and growth.

(a) **Competitive advantage is relative**. Understanding competitors is therefore of prime importance.

For example, knowledge of competitors' costs, as well as a firm's own costs, could help inform strategic choices: a firm would be unwise to pursue a cost leadership strategy without first analysing its costs in relation to the cost structures of other firms in the industry.

(b) **Customers** determine if a firm has competitive advantage.

2.6.2 Future orientation

A criticism of traditional management accounts is that they are **backward looking**.

(a) Decision making is a forward- and outward-looking process.
(b) Accounts are based on **costs**, whereas decision making is concerned with **values**.

Strategic management accountants will use **relevant costs** (ie **incremental** costs and **opportunity** costs) for decision making. We return to this topic later in this Study Manual.)

Worked example: Tesco

The supermarket giant, Tesco, has a seven part strategy which aims to broaden the scope of its business, and enable it to deliver strong, sustainable long-term growth.

The seven parts of the strategy are:

(1) To grow the UK core
(2) To be an outstanding international retailer in stores and online
(3) To be as strong in everything we sell as we are in food
(4) To grow retail services in all our markets
(5) To put our responsibilities to the communities we serve at the heart of what we do
(6) To be a creator of highly valued brands
(7) To build our team so that we create more value.

www.tescoplc.com

However, beneath these overall strategic objectives, Tesco sets more specific targets that it monitors via the 'Steering wheel', which is Tesco's own version of the balanced scorecard.

Targets are defined under five separate headings: Customers, Community, Operations, People and Finance; and these headings allow performance to be monitored with due regard for all the key stakeholders.

Heading	Desired aspects of performance
Customers	'The staff are great; I don't queue; The prices are good; I can get what I want; The aisles are clear; Earn lifetime loyalty'
Community	Actively supporting local communities; buying and selling their products responsibly; caring for the environment; providing customers with healthy choices; creating good jobs and careers
Operations	Try to get it right first time; deliver consistently every day; make their jobs easier to do; know how vital their roles are; always try to save time and money
People	An opportunity to get on; an interesting job; a manager who helps his staff; being treated with respect.
Finance	Grow sales; maximise profit; manage their investment

Tesco recognises that good financial performance is the outcome of good performance in the other areas of customers, community, operations and people (staff). The remuneration of the executive directors is closely linked to performance against targets.

Consequently, through its 'Steering wheel,' Tesco has also created a specific system for controlling and managing performance.

3 Performance measurement

Section overview

- Historically business performance was measured via profitability, which led to a strong emphasis on growing profits. The danger in this approach is that profit is pursued to the detriment of long-term performance. The balanced scorecard offers a performance framework that balances the need to grow profits, alongside the actual drivers of improved performance ie Innovation, Quality and Efficiency.

Performance measures must be relevant to both a clear objective and to operational methods, and their production must be cost-effective.

3.1 Deciding what measures to use

Clearly different measures are appropriate for different businesses. Determining which measures are used in a particular case will require **preliminary investigations** along the following lines.

(a) The **objectives/mission** of the organisation must be **clearly formulated** so that when the factors critical to the success of the mission have been identified, they can be translated into performance indicators.

(b) **Measures** must be **relevant** to the way the organisation operates. Managers themselves must believe the indicators are useful.

(c) **The costs and benefits of providing resources** (people, equipment and time to collect and analyse information) to produce a performance indicator must be carefully **weighed up**.

3.1.1 Critical success factors

In Chapter 9 we will look at the way organisations use **critical success factors (CSFs)** to determine their information requirements.

However, CSFs are also relevant here. CSFs highlight the elements of performance that are vital to an organisation's success. In turn, however, this means it is important for organisations to measure how well they are performing in those key areas of performance. For example, if an organisation identifies that 'quality of service' is a CSF, then the organisation also needs to monitor the level of service it is providing its customers.

3.2 Financial modelling and performance measurement

Financial modelling might assist in performance evaluation in the following ways.

(a) **Identifying the variables** involved in performing tasks and the relationships between them. This is necessary so that the model can be built in the first place. Model building therefore shows what should be measured, helps to explain how a particular level of performance can be achieved, and identifies factors in performance that the organisation cannot expect to control.

(b) **Setting targets for future performance**. The most obvious example of this is the traditional budgetary control system.

(c) **Monitoring actual performance**. A flexible budget is a good example of a financial model that is used in this way.

(d) **Co-ordinating long-term strategic plans with short term operational actions.** Modelling can reflect the dynamic nature of the real world and evaluate how likely it is that short-term actions will achieve the longer-term plan, given new conditions.

3.3 Profitability, activity and productivity

In general, there are three possible **points of reference for measurement**.

(a) **Profitability**

Profit has two components: **cost and income**. All parts of an organisation and all activities within it incur costs, and so their success needs to be judged in relation to cost. Only some parts of an organisation receive income, and their success should be judged in terms of both cost and income.

(b) **Activity**

All parts of an organisation are also engaged in activities (activities cause costs). Activity measures could include the following.

(i) Number of orders received from customers, a measure of the effectiveness of marketing
(ii) Number of machine breakdowns attended to by the repairs and maintenance department

Each of these items could be measured in terms of **physical numbers**, **monetary value**, or **time spent**.

(c) **Productivity**

This is the quantity of the product or service produced in relation to the resources put in, for example, so many units produced per hour or per employee. It defines how efficiently resources are being used.

The **dividing line between productivity and activity is thin**, because every activity could be said to have some 'product'; or if not, can be measured in terms of lost units of product or service.

Interactive question 2: Performance measures [Difficulty level: Easy]

An invoicing assistant works in a department with three colleagues. She is paid CU16,000 per annum. The department typically handles 10,000 invoices per week.

One morning she spends half an hour on the phone to her grandfather, who lives in Australia, at the company's expense. The cost of the call proves to be CU32.

Requirement

From this scenario, identify as many different performance measures as possible; explaining what each is intended to measure. Make any further assumptions you wish.

See **Answer** at the end of the chapter.

3.4 Financial performance measures

Financial measures (or **monetary measures**) are very familiar to you. Here are some examples, accompanied by comments from a single page of the *Financial Times.*

Measure	Comment
Profit	The commonest measure of all. Profit maximisation is usually cited as the main objective of most business organisations: 'ICI increased pre-tax profits to £233m'; 'General Motors... yesterday reported better-than-expected first-quarter net income of $513m (£333m) ...
Revenue	'The UK businesses contributed £113.9m of total group turnover of £409m'.
Costs	'Sterling's fall benefited pre-tax profits by about £50m while savings from the cost-cutting programme were running at around £100m a quarter'; 'The group interest charge rose from £48m to £61m'.
Share price	'The group's shares rose 31p to 1278p despite the market's fall'.
Cash flow	'Cash flow was also continuing to improve, with cash and marketable securities totalling $8.4bn on March 31, up from $8bn at December 31'.

The important point to note here is that the monetary amounts stated **are only given meaning in relation to something else**. Profits are higher than last year's; cashflow has improved compared with last quarter's and so forth.

We can generalise the above and give a list of yard-sticks against which financial results are usually placed so as to become measures.

- **Budgeted** sales, costs and profits
- **Standards** in a standard costing system
- The **trend** over time (last year/this year, say)
- The **results of other parts** of the business
- The **results of other businesses**
- The **economy** in general
- **Future potential** (eg a new business in terms of nearness to breaking even)

3.5 The profit measure

Profit has both advantages and disadvantages as a measure of performance.

Measure	Comment
Single criterion	Easier to manage, as the sole concern is the effect on the bottom line
Analysis has a clear objective: ie the effect on future profits	Easier than cost/benefit analysis, for example
A broad performance measure that incorporates all other measures	'If it does not affect profit it can be ignored'
Enables decentralisation	Managers have the delegated powers to achieve divisional (and therefore group) profit
Profitability measures (eg ROI) can compare all profit-making operations even if they are not alike.	This ignores the balance between risk and return
Encourages **short-termism** and focus on the annual cycle, at the expense of long term performance	Examples: cutting discretionary revenue investments, manipulating of accounting rules, building up inventories
Profit differs from **economic income**	Profit does not always equate to creating long term value
A firm has to satisfy **stakeholders** other than shareholders, such as the government and the local community	This may include environmental/ethical performance measures
Liquidity is at least as important as profit	Most business failures derive from liquidity crises

Measure	Comment
Profit should be related to **risk**, not just capital employed	Rarely done
Profits can **fluctuate** in times of rapid change	For example, as a result of exchange rate volatility
Profit measures cannot easily be used to motivate **cost centre** managers	They do not control profit
Not useful for new businesses	Most start-ups will be unprofitable for at least two years
Easily manipulated	Especially over a single period: think back to your accounting studies and the effect of inventory changes on profit under absorption costing, for example
Pure profit based measures do not consider **capital spending**	Growth in asset levels can be uncontrolled; alternatively, productive capacity may be allowed to decline

When evaluating the use of profit as a performance measure, also remember the concept of **value based management** we discussed in Chapter 1 of this Study Manual. Value based management suggests that performance measures should show how well an organisation is creating value for its shareholders; however, this value should be measured in relation to discounted future cash flows, rather than profit.

3.5.1 Ratios

Ratios are a **useful** way of measuring performance for a number of reasons.

(a) It is easier to look at **changes over time** by comparing ratios in one time period with the corresponding ratios for periods in the past.

(b) Ratios are often **easier to understand** than absolute measures of physical quantities or money values. For example, it is easier to understand that 'productivity in March was 94%' than 'there was an adverse labour efficiency variance in March of CU3,600'.

(c) Ratios relate one item to another, and so help to **put performance into context**. For example the profit/sales ratio sets profit in the context of how much has been earned per CU1 of sales, and so shows how wide or narrow profit margins are.

(d) Ratios can be **used as targets**. In particular, targets can be set for ROI, profit/sales, asset turnover, capacity fill and productivity. Managers will then take decisions which will enable them to achieve their targets.

(e) Ratios provide a way of **summarising an organisation's results**, and **comparing them with similar organisations**.

3.6 Measuring performance in the new business environment

As well as arguing that organisations need to rethink the basis on which they prepare budgets ('Beyond Budgeting', Hope and Fraser have also argued that if organisations are serious about gaining real benefits from decentralisation and empowerment, they need to **change the way in which they set targets, measure performance and design reward systems**.

Hope and Fraser suggested the following scenario to highlight the relationship between targets and management responsibilities:

A strategic business unit (SBU) manager is asked for a **'stretch target'.** However, under the Beyond Budgeting model, the manager knows that 'stretch' really means their best shot with **full support** from the centre (including investment funds and improvement programmes) and a sympathetic hearing should they fail to get all of the way. Moreover, the manager alone carries the **responsibility** for achieving these targets. There is neither any micro-management from above, nor any monthly 'actual versus budget' reports.

Targets are both strategic and financial, and they are underpinned by clear action plans that cascade down the organisation, building **ownership and commitment at every level**. Monthly reports comprise a **balanced scorecard** set of graphs, charts and trends that track progress (eg financial, customer satisfaction, speed, quality, service, and employee satisfaction) **compared with** last year and with other **SBUs within the group**

and, where possible, with **competitors**. Quarterly **rolling forecasts** (using broad-brush numbers only) are also prepared to help manage production scheduling and cash requirements, but these forecasts are not part of the measurement and reward.

Performance review. If there is a significant blip in performance (and the fast/open information system would flag this immediately), then a performance review would be signalled. Such reviews focus on the effectiveness of action plans and what further improvements need to be made. The review might even consider whether the targets (and measures) themselves are still appropriate.

There are a number of reasons why this approach is **successful**.

(a) Managers are not punished for failing to reach the full target.

(b) The use of the balanced scorecard ensures that all key perspectives are considered.

(c) Because managers set their own targets and plan the changes needed to achieve them, real ownership and commitment are built. Feedback and learning takes place as a result of the tracking of action plans. (Contrast this with numerical variances that tell managers nothing about what to do differently in the future.)

(d) Beating internal and external competitors is a constant spur to better performance.

(e) Managers share in a bonus pool that is based on share price or long-term performance against a basket of competitors. Resource and knowledge sharing is therefore encouraged.

3.7 Leading and lagging indicators

An important element of performance management is developing appropriate performance metrics. As far as possible, performance measures should be linked to a company's strategy, value drivers and critical success factors, as well as short-term and long-term goals.

Many companies now adopt the balanced scorecard concept – or a similar multi-dimensional performance model – with performance measures in a number of categories, such as financial, operations, customers, human resources.

However, whilst it can be beneficial to monitor performance in a range of areas, managers should avoid measuring too many aspects of performance. Instead they must concentrate on the metrics that are most important, in order to avoid succumbing to information overload.

Nonetheless, when identifying which metrics to measure, it is important to balance traditional financial measures with non-financial ones.

In particular, measures should be selected to provide a balance of leading and lagging indicators.

Most traditional, financial performance measures are lagging indicators, connected with past performance and past events. However, such indicators do not necessarily help managers or directors to understand the future challenges an organisation will face.

By contrast, leading indicators can point to future performance successes or problems. For example, declining customer satisfaction levels could point to future revenue issues and a longer-term erosion of the value of a company's brand.

3.8 Non-financial performance measures

Definition

Non-financial performance measures: These are measures of performance based on non-financial information which may originate in, and be used by, operating departments to monitor and control their activities without any accounting input. Non-financial performance measures may provide a more timely indication performance than financial measures do.

The following are some examples of non-financial performance measures:

Areas assessed	Performance measure
Service quality	Number of complaints Proportion of repeat bookings Customer waiting time On-time deliveries
Production performance	Set-up times Number of suppliers Days' inventory in hand Output per employee Material yield percentage Schedule adherence Proportion of output requiring rework Manufacturing lead times
Marketing effectiveness	Trend in market share Sales volume growth Customer visits per salesperson Client contact hours per salesperson Sales volume forecast versus actual Number of customers Customer survey response information
Personnel	Number of complaints received Staff turnover Days lost through absenteeism Days lost through accidents/sickness Training time per employee

Interactive question 3: Hotel [Difficulty level: Easy]

Suggest some suitable performance criteria for a hotel.

See **Answer** at the end of the chapter.

Interactive question 4: Training college [Difficulty level: Intermediate]

Southside College (SC) offers a wide range of courses aimed at vocational and professional qualifications. It has been operating for over 30 years now, and is well-established. It has been accredited as an approved training provider by a number of the qualification-awarding bodies.

Although it competes with not-for-profit universities and colleges in some of its markets, SC is a limited company. Throughout its history, SC has always traded profitably.

In recent years, there have been a number of new entrants into the professional qualifications market. However, to date, SC has managed to retain the largest market share. SC's students consistently achieve higher pass rates than the national averages for the qualifications they are sitting.

SC has always concentrated on the quality of the teaching on its courses and the accompanying study materials. In recent years, however, a number of SC's competitors have begun to offer their students online tutorials to supplement their taught courses and these have proved very popular. SC's customer services team is receiving an increasing number of enquiries from prospective students about whether SC offers similar online tutorials. SC is developing its own online tutorials, but the development process is taking longer than had been hoped.

SC's management team have never been convinced of the need for market research or customer research, arguing that the company has always achieved its sales targets and has always been profitable. Similarly, they point out that SC has established a good reputation and a position as a market leader, despite investing relatively little in marketing activities.

Historically, SC has had a very low rate of employee turnover, but in recent years this has begun to increase as some of SC's tutors have left to join the new entrants in the market. This increase in employee turnover has concerned SC's management team.

Accordingly, SC's management team are keen to identify the critical success factors which will enable SC to maintain its performance levels in the future.

Requirements

(a) Identify four Critical Success Factors that would be appropriate to use at SC.

(b) For each Critical Success Factor you have identified, recommend, with reasons, two Key Performance Indicators which could be used to support that Critical Success Factor.

See **Answer** at the end of the chapter.

The beauty of non-financial performance measures is that anything can be compared if it is meaningful to do so. The measures should be tailored to the circumstances so that, for example, the number of coffee breaks you take for every hour you study indicate to you how hard you are studying!

3.8.1 The advantages and disadvantages of non-financial measures

Unlike traditional variance reports, non-financial measures can be provided **quickly** for managers, per shift or on a daily or hourly basis, as required. They are likely to be **easy to calculate**, and **easier for non-financial managers to understand** and therefore, to use effectively.

There are problems associated with choosing the measures and there is a danger that **too many such measures could be reported**, overloading managers with information that is not truly useful, or that sends conflicting signals. There is clearly a need for the information provider to work more closely with the managers who will be using the information to make sure that their needs are properly understood.

Research on more than 3,000 companies in Europe and North America has shown that the strongest drivers of competitive achievement are the intangible factors, especially **intellectual property, innovation** and **quality.** Non-financial measures have been at the forefront of an increasing trend towards **customer focus** (such as TQM), **process re-engineering** programmes and the creation of **internal markets** within organisations.

Arguably, some non-financial measures may be **less likely to be manipulated** than traditional profit-related measures and they should, therefore, **offer a means of counteracting short-termism**, since short-term profit at any expense is rarely an advisable goal.

However, while there may be a danger of manipulation in financial information systems, which may be exacerbated by inappropriate reward systems (eg a 'bonus culture'), this does not mean that financial performance indicators are inherently more vulnerable to manipulation than non-financial performance indicators. For example, which are likely to be subject to the more stringent controls: financial, or non-financial information systems?

Remember also, the ultimate goal of commercial organisations in the long run is likely to remain the maximisation of profit, and so the **financial aspect cannot be ignored**.

A further danger of non-financial measures is that they might lead managers to pursue detailed operational goals and become blind to the overall strategy in which those goals are set. Consequently, using a combination of financial and non–financial measures is likely to be most successful; as, for example, in the Balanced Scorecard.

3.8.2 The performance measurement manifesto

Eccles argues that financial measures alone are inadequate for monitoring the progress of business strategies based on creating customer value, satisfaction and quality, partly because they are **historical** in nature and partly they cannot measure current progress with such strategies directly. He also notes the impulse to **short-termism** given by such measures.

There is a need for a performance measurement system that includes both financial and non-financial measures. The measures chosen must be **integrated**, so that the potential for discarding non-financial measures that conflict with the financial ones is limited. Eccles argues that too often firms prioritise financial measures above non-financial ones, and if the two clash the financial priorities take priority. However, Eccles points out that **non-financial measures** such as quality, customer satisfaction and market share are now equally important as purely financial measures.

Eccles says that the development of a good system of performance measurement requires activity in five areas.

(a) The **information architecture** must be developed. This requires the identification of performance measures that relate to strategy and the gradual, iterative development of systems to capture the required data.

(b) An appropriate **information technology strategy** must be established.

(c) The company's **incentives system** must be aligned with its performance measures. Eccles proposes that qualitative factors should be addressed by the incentive system.

(d) **External influences** must be acknowledged and used. For example, benchmarking against other organisations may be used, while providers of capital should be persuaded to accept the validity of non-financial measures.

(e) **Manage the implementation** of the four areas above by appointing a person to be responsible overall as well as department agents.

3.9 Value for money (VFM) audits

Value for money audits can be seen as being of particular relevance in not-for-profit organisations. Such an audit focuses on **economy, efficiency** and **effectiveness.** These measures may be in conflict with each other. To take the example of higher education, larger class sizes may be **economical** in their use of teaching resources, but are not necessarily **effective** in creating the best learning environment.

3.10 The Balanced Scorecard

A key theme so far has been that financial measurements do not capture all the strategic realities of the business, but that it is equally important that financial measurements are not overlooked. A failure to attend to the 'numbers' can rapidly lead to a failure of the business.

Nonetheless, financial measurements do not capture all the strategic realities of a business, so businesses need to look at both financial and non-financial measures.

Case example: Business failures

The global recession in 2008-9 has meant that there have been stories about business failures almost every day in the newspapers. These articles often mention the reason given for the failure, and the state of the economy is often seen as the number one cause.

However, this tends to obscure a rather more painful truth. The reason for the business failure is usually the business itself.

An article in a local newspaper in Tupelo, Mississippi illustrated this point. The article looked at three food outlets in the town which had failed in 2009, and noted the owners' reasons for the failure. The reasons given were 'poor timing and the economy'.

However, customers who had been to the businesses noted that all three had three things in common: high prices, poor service and mediocre food.

One in particular – a sandwich shop – stood out. It had an ordering process that involved standing in line to order, and then moving to another station and standing in line to repeat your order and pay for it. The total wait for an expensive and really poor take out sandwich was over 45 minutes. The shop was located in a mall, and four units away from a Mexican restaurant that was not only surviving but positively thriving. So it seems the economy was not the main reason for business failure after all!

The more pertinent point is that businesses – and particularly small businesses – are often launched and operated without the resources needed to succeed. To be successful, a business needs to supply a cost effective solution to customer needs.

If business don't understand their markets, their customers or their competition, and if they don't have a clear vision or direction which is executed by management, they are likely to fail.

(Adapted from article: Harshberger, M. (2010), Who's to blame for most business failures, 19 January, www.articlesbase.com

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The balanced scorecard has been developed to try to integrate the different measures of performance, highlighting the linkages between operating and financial performance. This scorecard offers four perspectives on performance:

- Financial
- Customer
- Innovation and learning
- Internal business

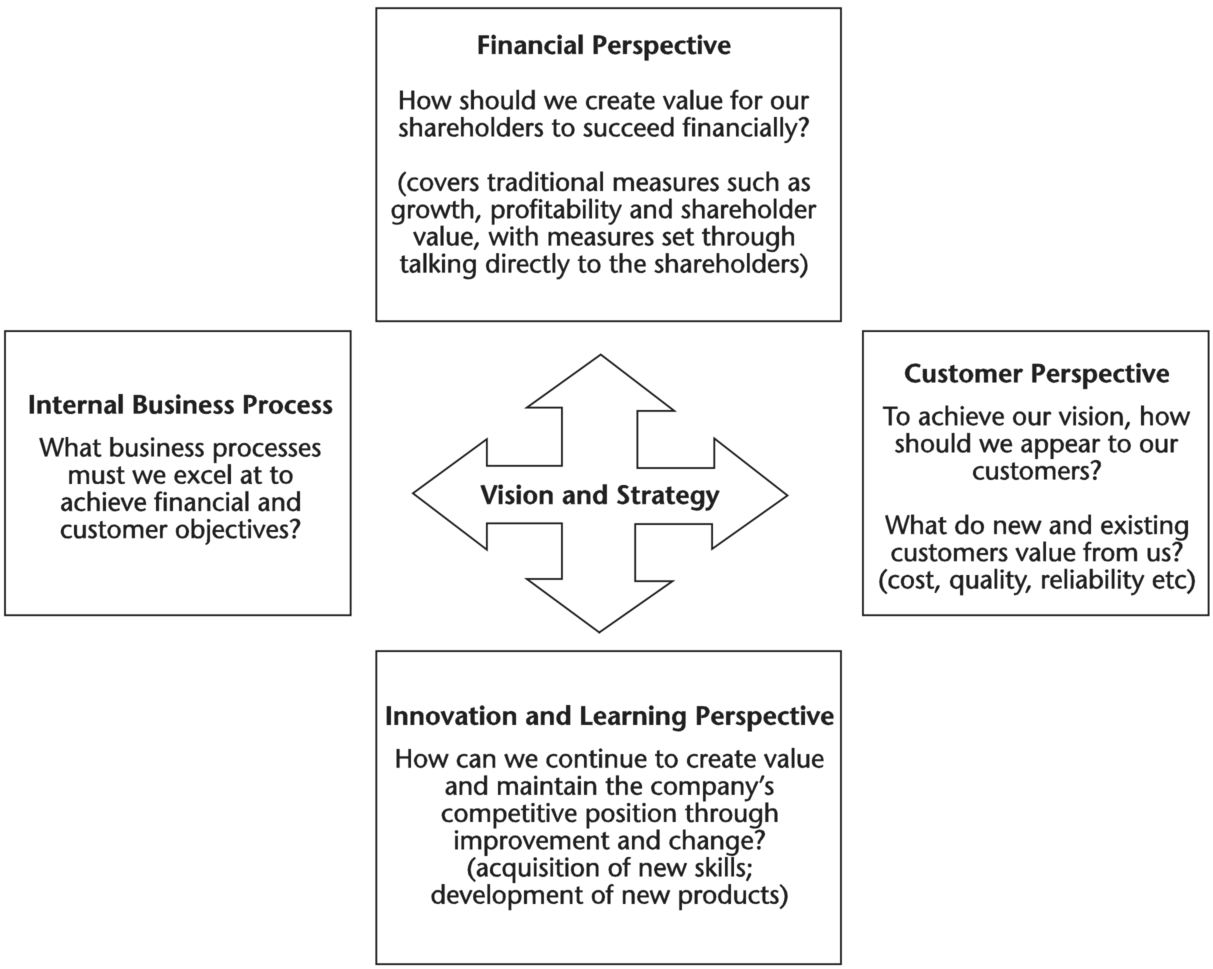


Figure 4.2: Balanced scorecard (after Kaplan & Norton)

The balanced scorecard seeks to translate **mission** and **strategy** into **objectives** and measures, and focuses on **four different perspectives**. For each of the four perspectives, the scorecard aims to articulate the **outcomes** an organisation desires, and the **drivers** of those outcomes.

Performance targets are set once the key areas for improvement have been identified, and the balanced scorecard is the **main monthly report**.

The scorecard is **balanced** in the sense that managers are required to think in terms of all four perspectives, to **prevent improvements being made in one area at the expense of another**.

Broadbent and Cullen identify the following **important features** of this approach:

- It looks at both **internal and external matters** concerning the organisation
- It is related to the key elements of a company's strategy
- Financial and non-financial measures are linked together

Kaplan and Norton have found that organisations are using the balanced scorecard to:

- Identify and align strategic initiatives
- Link budgets with strategy
- Align the organisation (structure and processes) with strategy
- Conduct periodic strategic performance reviews with the aim of learning more about, and improving, strategy

Kaplan and Norton suggest that using the balanced scorecard can also help an organisation improve its strategic performance:

- The process of identifying key outcomes and drivers should help individuals and divisions become more aware of how their work fits in with the organisation's strategy.
- Giving individuals and divisions regular reports on their performance against key measures will help them monitor their own performance, and identify areas for improvement.
- The scorecard as a whole should provide senior management with regular information on how their organisation is performing against key measures, and therefore how well strategies are being implemented.

3.11 Linkages

Disappointing results might arise from a **failure to view all the measures as a whole**. For example, increasing productivity means that fewer employees are needed for a given level of output. Excess capacity can be created by quality improvements. However, these improvements have to be exploited (eg by increasing sales).

The **financial element** of the balanced scorecard reminds executives that improvements in quality, response time, productivity or new products, only benefit a company when they are translated into improved financial results, or if they enable the company to achieve a sustainable competitive advantage.

3.12 Implementing the balanced scorecard

The introduction and practical use of the balanced scorecard is likely to be subject to all the problems associated with balancing long-term strategic progress against the management of short-term tactical imperatives.

Kaplan and Norton recognise this and recommend an iterative, four stage approach to the practical problems involved.

(a) **Translating the vision**: The organisation's mission must be expressed in a way that has to have clear operational meaning for each employee.

(b) **Communicating and linking**: The next stage is to link the vision or mission to departmental and individual objectives, including those that transcend traditional short-term financial goals. This stage highlights an important feature of the scorecard – that it translates strategy into day-to-day operations.

(c) **Business planning**: The scorecard is used to prioritise objectives and allocate resources in order to make the best progress towards strategic goals.

(d) **Feedback and learning**: The organisation learns to use feedback on performance to promote progress against all four perspectives.

3.13 Strategic application of the balanced scorecard

If an organisation decides to introduce and use a Balanced Scorecard, it will then have to decide what performance indicators (KPIs) should be collected, and how should these be reported in a way that helps the organisation make better decisions.

The choice of KPIs could be informed via the hierarchy identified by Robert Anthony (see Section 2.1). Once the organisational strategy has been defined, this can be distilled into a sequence of vertically consistent **objectives**. These objectives should be orientated in a manner that allows the organisation to improve performance in the business critical processes that support its **Critical Success Factors** (those things the organisation must excel in to be competitive). The balanced scorecard can then be used to track performance against the CSFs via the KPIs selected.

It follows therefore, that the balanced scorecard can be used to track performance at the hierarchical levels identified by Anthony. Thus, some KPIs will be derived to track operational efficiency; others, to assess management's tactical performance; and still others, to illustrate the success of the overall organisational strategy.

3.14 Example indicators

The exact measures an organisation uses will depend on its context, but the indicators below suggest some possible measures for each scorecard category:

Financial perspective
Increase monthly turnover
Increase monthly operating profit (by division)
Improve asset utilisation
Increase market share
Increase ROI
Increase cash flow
Customer perspective
Increase market share
Number of new customers attracted
Extend product range
Customer satisfaction rating
Number of recommendations or referrals
Customer retention rates
Level of returns/refunds
On-time delivery
Percentage of sales from new products (introduced in the last two years)
Internal business processes
Reduce inventory levels
Reduce lead times
Minimise wastage/errors
Actual delivery dates of new products/services in line with plan
Reliability and usability (for websites in online business)
Security of transactions and credit card handling
Innovation and learning perspective (learning and growth)
Develop new products
Time to market (time taken for new product ideas to become 'live')

Financial perspective
Percentage of sales from new products (introduced in the last two years)
Number of new products introduced (< last two years) compared to competitors
Ideas from employees
Adaptability and flexibility of staff
Reward and recognition structure for staff

3.15 Using the balanced scorecard

(a) Like all performance measurement schemes, the balanced scorecard can influence behaviour among managers to conform to that required by the strategy. Because of its comprehensive nature, it can be used as a wide-ranging driver of organisational change.

(b) The scorecard emphasises **processes** rather than **departments**. It can support a competence-based approach to strategy, but this can be confusing for managers and may make it difficult to gain their support.

(c) Deciding just what to measure can be difficult, especially since the scorecard **vertical** vector lays emphasis on customer reaction. This is not to discount the importance of meeting customer expectations, purely to emphasise the difficulty of establishing what they are.

3.16 Strategy maps

As an extension to the balanced scorecard, Kaplan and Norton also developed the idea of strategy maps, which could be used to help implement the scorecard more successfully.

Strategy maps identify six stages:

(a) Identify **objectives**. Identify the key objectives of the organisation.

(b) **Value creation**. In the light of the key objectives identified, determine the main ways the organisation creates value

(c) **Financial perspective**. Identify financial strategies to support the overall objective and strategy

(d) **Customer perspective**. Clarify customer-orientated strategies to support the overall strategy

(e) **Internal processes**. Identify how internal processes support the strategy and help to create value

(f) **Innovation and learning**. Identify the skills and competences needed to support the overall strategy and achieve the objectives.

The sequence of these stages also suggests there is a **hierarchy among the different perspectives**. The financial perspective is the highest level perspective, and the measures and goals from the other perspectives should help an organisation achieve its financial goals.

Perspective	*Measures*
Financial	ROCE; Shareholder value
↑	↑
Customer	Relationships and loyalty; timeliness of service
↑	↑
Internal business	Quality, efficiency and timeliness of processes
↑	↑
Innovation and learning	Employee skills

In this way, the strategy map highlights how the four perspectives of the scorecard help create value, with the overall aim of helping an organisation achieve its objectives. It can also help staff appreciate the way that different elements of performance management are linked to an organisation's overall strategy.

However, it is also important to recognise that the balanced scorecard only **measure**s performance. **It does not indicate that the strategy an organisation is employing is the right one.** Therefore, if improvements in operational performance do not result in improved financial performance, managers may need to rethink the company's strategy or its implementation plans; for example, whether the areas which have been targeted for operational improvements really are the ones which are critical in delivering value for the organisation.

3.17 Problems with using the balanced scorecard

As with all techniques, problems can arise when the balanced scorecard is applied.

Problem	Explanation
Conflicting measures	Some measures in the scorecard such as research funding and cost reduction may naturally conflict. It is often difficult to determine the balance which will achieve the best results.
Selecting measures	Not only do appropriate measures have to be devised but the number of measures used must be agreed. Care must be taken that the impact of the results is not lost in a sea of information. The innovation and learning perspective is, perhaps, the most difficult to measure directly, since much development of human capital will not feed directly into such crude measures as rate of new product launches or even training hours undertaken. It will, rather, improve economy and effectiveness and support the achievement of customer perspective measures. When selecting measures it is important to measure those which actually add value to an organisation, not just those that are easy to measure.
Expertise	Measurement is only useful if it initiates appropriate action. Non-financial managers may have difficulty with the usual profit measures. With more measures to consider, this problem will be compounded. Measures need to be developed by someone who understands the business processes concerned.
Interpretation	Even a financially-trained manager may have difficulty in putting the figures into an overall perspective.
Management commitment	The balanced scorecard can only be effective if senior managers commit to it. If they revert to focusing solely on the financial measures they are used to, then the value of introducing additional measures will be reduced. In this context, do not overlook the cost of the scorecard. There will be costs involved in data-gathering and in measuring the performance of additional processes.

It may also be worth considering the following issues in relation to using the balanced scorecard:

- It doesn't provide a single aggregate summary performance measure. For example, part of the popularity of ROI or ROCE comes from the fact that they provide a convenient summary of how well a business is performing.
- In comparison to measures like economic value added (EVA), there is no direct link between the scorecard and shareholder value.
- Culture: Introducing the scorecard may require a shift in corporate culture; for example, in understanding an organisation as a set of processes rather as departments.
- Equally, implementing the scorecard will require an organisation to move away from looking solely at short-term financial measures, and focus on longer-term strategic measures instead.

The scorecard should be used **flexibly**. The process of deciding **what to measure** forces a business to clarify its strategy. For example, a manufacturing company may find that 50% – 60% of costs are represented by bought-in components, so measurements relating to suppliers could usefully be added to the scorecard. These could include payment terms, lead times, or quality considerations.

3.18 Assurance and performance indicators

We have mentioned a number of potential performance measures in this chapter, but in order to use any of them effectively, an organisation needs to have reliable information about the relevant measures.

In relation to this, if there are concerns about the reliability or accuracy of performance measures presented, an organisation might seek assurance over the way in which these figures are produced or presented.

Many companies now publish a selection of key performance indicators (KPIs) in their annual reports. By definition, these KPIs should focus on the aspects of performance that are most important to the continued success of the company.

Some KPIs may be financial (such as ratios based on the financial statements) but the majority of KPIs should be non-financial. Therefore, despite the insight they can give into a company's performance, these KPIs will not have been audited as part of the financial statements.

In this respect, it could be useful for a company to seek additional assurance over these KPI figures.

The assurance approach towards KPIs would consider how the KPIs have been defined, how they have been calculated, and why they are reported.

In their assurance work, practitioners could face problems in relation to the lack of any precise definitions for KPI targets, the lack of developed systems to capture KPI data, and the potential for KPIs to be manipulated to achieve a desired result.

4 Rewards, behaviour and performance

Section overview

- Formulating executive pay is a difficult balancing act. The market for top executives is truly global, and with the transparency afforded by financial reporting, top directors are able to compare their total emoluments very easily. From the company and investors' perspective, there is a clear need to balance pay with performance, whilst remaining competitive as an employer.
- Pay for non-executive staff is a similarly tricky balancing act. From the perspective of both the employer and employee, both will want to feel they are getting value for money, whilst investors will again want to see any increases in salary cost as being commensurate with increases in shareholder wealth.

In this Section we look at a range of issues surrounding remuneration and reward. A key issue to consider in relation to performance management is how remuneration and reward packages influence directors' and employees' performance. We will look at this issue again in Chapter 10 in the context of human resource management.

4.1 Executive pay

The perception that some directors are being paid excessive salaries and bonuses has been seen as one of the major corporate abuses for a large number of years. It is thus inevitable that the corporate governance provisions have targeted it. The **Greenbury Committee** in the UK set out principles which are a good summary of what remuneration policy should involve.

- Directors' remuneration should be set by **independent members** of the board.
- Any form of bonus should be related to **measurable performance** or enhanced shareholder value.
- There should be **full transparency of directors' remuneration**, including pension rights, in the annual accounts.

What the Greenbury Report was, in part, recognising was one of the undesirable side-effects of **agency theory** and the **principal-agent problem** we mentioned in Chapter 3 of this Study Manual. In the context of executive pay, the directors are considered to be the agents of the company, and as such should be acting in the best interests of the principals (the shareholders) and not themselves. If the agents are allowed to set their own pay, there is an inevitable conflict of interest whereby the agent (directors) will be tempted to pay themselves far in excess of what their performance merits. As such, the remuneration committee acts as a barrier against the principal-agent problem.

4.2 The remuneration committee

The remuneration committee plays the key role in establishing remuneration arrangements. In order to be effective, the committee needs both to **determine** the organisation's **general policy** on the **remuneration of executive directors** and **specific remuneration packages** for each director.

Measures to ensure that the committee is **independent** include not just requiring that the committee is staffed by non-executive directors, but also placing limits on the members' connection with the organisation. Measures to ensure independence include stating that the committee should have no personal interests other than as shareholders, no conflicts of interest and no day-to-day involvement in running the business.

4.3 Remuneration packages

Packages will need to **attract, retain and motivate directors** of sufficient quality, whilst at the same time taking into account shareholders' interests as well. However, assessing executive remuneration in an imperfect market for executive skills, may prove problematic.

The link between remuneration and company performance is particularly important. Recent UK guidance has stressed the need for the performance-related elements of executive directors' remuneration to be **stretching**, **designed to align their interests with those of shareholders** and **promote the long-term success of the company**. Remuneration incentives should be **compatible with risk policies and systems**, and **criteria for paying bonuses** should be **risk-adjusted**.

Discussion is often in terms of designing a remuneration package that encourages directors to avoid excessive risks. However, directors' remuneration can also be designed to encourage cautious directors to take more risks. Shareholders, who hold diversified portfolios, may be keener for a company that undertakes a risky investment than its directors, whose livelihood may be threatened if the investment is not a success.

4.4 Establishing remuneration arrangements

Issues connected with remuneration policy may include the following:

- The **pay scales** applied to each director's package.
- The **proportion** of the **different types of reward** within each package.
- The **period** within which performance related elements become payable.
- Determining what proportion of rewards should be related to **measurable performance** or enhanced shareholder value, and the balance between **short and long-term performance elements**.
- **Transparency of directors' remuneration**, including pension rights. A simple scheme, such as basing a bonus on profit, may make directors' actions easier to understand than a more complicated scheme where the basis for the total reward is unclear. However, a simple scheme may be easier to manipulate through creative accounting.

When establishing remuneration policy, boards have to take into account the position of their **company relative to other companies**. However, Corporate Governance Code points out the need for remuneration committees to treat such comparisons with caution, in view of the risk of an upward ratchet in remuneration levels, with no corresponding improvement in performance.

As you can see, in line with other sections of the Code, the guidance provides only a framework for decision making, rather that a prescribed formula. Inevitably, giving such wide scope for setting pay has resulted in some controversial decisions. An illustration of shareholder conflict resulting from executive pay is detailed below.

Case example: WPP shareholder revolt

In June 2012, Sir Martin Sorrell suffered a humiliating defeat at the hands of WPP shareholders, when nearly 60% rejected his annual pay package of nearly £13 million at the advertising agency's annual general meeting. The total figure comprised £6.8 million in salary, bonus, deferred shares and other benefits, plus nearly £6 million in shares (although those had been awarded in 2006 and were closely linked to performance targets).

Sorrell, who is viewed by many critics as a poster boy for excessive pay, had infuriated shareholders with his proposed payout, and they rejected the remuneration report which authorised the deal. Their protest was the largest rebellion by shareholders at a blue-chip company since 90% voted against Sir Fred Goodwin's pension arrangements at Royal Bank of Scotland in 2009.

The WPP chief executive's showdown with investors was the latest in a series of clashes between UK publicly listed companies and shareholders over boardroom pay in what has been dubbed the 'Shareholder Spring'.

Sorrell's defeat was the sixth remuneration report to be rejected by shareholders in 2012 – a record tally of defeats since the opportunity for shareholders to vote on the pay policies of UK public companies was introduced almost a decade ago. Other companies where pay reports have been voted down include Cairn Energy, car dealer Pendragon and insurer Aviva.

The WPP chief executive, who founded the company in 1985, dismissed any suggestions that he might consider resigning in the wake of the defeat. 'I have [a share stake worth] £140m riding on it, which people tend to forget,' said Sorrell, who received about 98% backing for his reappointment as chief executive.

'I'm obviously disappointed at the vote on the remuneration report. It is a democracy and the shareholders have spoken … that is their right,' he said. Nonetheless, Sorrell still believes he is worth his high salary, and in the year 2011–2012 WPP cemented its place as the world's biggest marketing services group, with its best ever annual results. It achieved £1 billion profits and £10 billion revenues for the first time over the year.

WPP also pointed out that Sorrell had not had an increase in his basic pay since 2007, and that he is paid less than his major international rivals.

Louise Rouse, a director at campaigning group FairPensions, who attended WPP's AGM, said: 'It is difficult to know whether the WPP board underestimated the level of shareholder anger or simply chose to ignore it.' She pointed out that 42% of shareholders had voted against WPP's pay report last year, which 'should have served as a wake-up call to the board that the company's remuneration practices need to be overhauled'.

Investment banker Jeremy Rosen, the head of WPP's remuneration committee, also came under fire with a quarter of shareholders voting against his reappointment or withholding their vote.

Rosen defended his decision to award Sorrell such a large pay rise – which included a 30% increase in his basic pay to £1.3m – saying he had consulted shareholders and that 'in the end we came up with what we think is right for the company and the shareholders'.

He added: 'The package did not meet with overwhelming support but [we] felt it was something that was appropriate in the circumstances.'

However, shareholder lobby group PIRC said, 'This result should be no surprise to WPP as it has been clear for some time that shareholders were not happy with recent changes to the remuneration policy. It is very important that as a high-profile FTSE 100 company, WPP responds constructively to the vote.' PIRC suggested that the vote represented a key moment in the relationship between shareholders and companies over executive pay, and it urged WPP to respond positively to it.

Guy Jubb, global head of governance at one of WPP's investors, Standard Life Investments, said investors would now push for real change to the company's approach to pay: 'The message from shareholders was unambiguous and cannot be ignored.'

Based on: Sweney, M (2012) WPP shareholders vote against £6.8m pay packet for Sir Martin Sorrell, *The Guardian,* 13 June*,* www.theguardian.com

Salmon, J. (2012) Shareholder spring strikes again: WPP shareholders vote by 60% to reject Sir Martin Sorrell's £13m pay deal, www.thisismoney.co.uk, 13 June

4.5 Basic salary

Basic salary will be in accordance with the terms of the directors' **contract of employment**, and is not related to the performance of the company or the director. Instead, it is determined by the **experience** of the director and what other companies might be prepared to pay (the **market rate**).

4.6 Performance related bonuses

Directors may be paid a cash bonus for good (generally accounting) performance. To guard against excessive payouts, some companies impose limits on bonus plans as a fixed percentage of salary or pay.

Transaction bonuses tend to be much more controversial. Some chief executives get bonuses for acquisitions, regardless of subsequent performance, and as well as further bonuses for spinning off acquisitions that have not worked out.

Alternatively, **loyalty bonuses** can be awarded merely to reward directors or employees for remaining with the company.

As we have already noted in Section 4.3, the link between remuneration and company performance is particularly important. However non-executive directors should **not** be remunerated by shares or other performance-related elements, to preserve their independence.

4.7 Shares

Directors may be awarded shares in the company with limits (a few years) on when they can be sold in return for good performance.

4.8 Share options

Share options give directors and possibly other managers and staff the right to purchase shares at a specified exercise price after a specified time period in the future. The options will normally have an exercise price that is equal to, or slightly higher than, the market price on the date that the options are granted. The time period (vesting period) that must pass before the options can be exercised is generally a few years. If the director or employee leaves during that period, the options will lapse. The options will generally be exercisable on a specific date at the end of the vesting period.

UK Corporate Governance Code states that shares granted, or other forms of remuneration, should **not vest or be exercisable in less than three years.** Directors should be encouraged to hold their shares for a further period after vesting or exercise. If directors or employees are granted a number of options in one package, these options should not all be able to be first exercised at the same date.

If the price of the shares rises so that it exceeds the exercise price by the time the options can be exercised, the directors will be able to purchase shares at lower than their market value. Share options can therefore be used to **align management and shareholder interests**, particularly options held for a long time when value is dependent on long-term performance. The main danger is that the directors will have an incentive to manipulate the share price if a large number of options are due to be exercised.

Options can also be used to encourage cautious directors to take **positive action to increase the value of the company.** Shareholders should be holding a wide portfolio that diversifies away unsystematic risk, but directors have less opportunity to diversify their careers and are dependent on their recommendations being successful. An investment opportunity that would attract shareholders because the returns are high relative to the systematic risk, may be rejected by directors because they are exposed to the total risks of it going wrong.

Shareholders therefore need to find a way of encouraging directors to accept the same risks as they would tolerate themselves. Share options can assist in this process because for options, the upside risk is unlimited – there is no boundary to how much the share price can exceed the exercise price.

However, initially at least, there is no corresponding downside risk. If the share price is less than the exercise price, the intrinsic value of options will be zero and the options will lapse. In these circumstances, it will make no difference how far the share price is below the exercise price. If directors are awarded significant options, the value of these options will rise if a risky investment succeeds and they will not suffer any loss on their options if the investment fails. However, if the options become in-the-money over a period of time, then directors may become risk averse as they stand to lose the accumulated gains on the options if an investment fails.

The performance criteria used for share options are a matter of particular debate. Possible criteria include the company's performance relative to a group of **comparable companies**.

There are various tricks that can be used to reduce or eliminate the risk to directors of not getting a reward through options. Possibilities include grants that **fail to discount for overall market gains,** or are cushioned against loss of value through **compensatory bonuses** or **re-pricing**.

The Corporate Governance Code states that non-executive directors should not normally be offered share options, as options may impact upon their independence.

4.8.1 Share options and BFRS 2

Newly established entities with limited cash resources may use the promise of share growth as a way to attract and retain high calibre individuals. Before the publication of BFRS 2, *Share-based payment*, the provision of, say, a share option was not recognised at all in the employing entity's income statement under international accounting standards. This led to significant employee benefits provided by an entity not being recognised in its financial statements.

BFRS 2 requires an expense representing the fair value of the options to be recognised over the period from the grant date to the vesting date.

The fair value is initially ascertained using a model such as Black-Scholes and includes the following variables:

- Market price of shares
- Exercise price
- Volatility
- Risk free rate of return
- Length of option

However, additional vesting conditions and long time periods make employee options more difficult to value than traded options.

We will look at share-based payments in more detail in Chapter 10 of this Study Manual.

4.8.2 Underwater options

Whilst share options can be a useful tool in helping to motivate employees to work hard and stay loyal to a company, this will only be effective if the exercise price is below the market price at the date of maturity. For instance, an employee of A plc who holds the right to purchase 1,000 shares at CU2.50 each, is left without any benefit if A's shares are trading at CU2.20 on the date the option matures. In such circumstances, the option is worthless and is referred to as being '**underwater**' (ie where it is significantly out-of-the-money). Of course, the employee is able to track the real-time share price versus the price of their options at all times and may therefore realise well in advance that the benefit will not come to fruition. In such circumstances, the motivational impact of the option scheme may be nil or negative.

A further negative aspect of share options is that they may tie unhappy employees into an ongoing employment relationship past the point at which they wish to leave. For instance, an unhappy worker may stay in a post and be consequently unproductive, merely to stay on long enough to collect a share option pay-out.

4.9 Benefits in kind

Benefits in kind could include transport (eg a car), health provisions, life assurance, holidays, expenses and loans. The remuneration committee should consider the benefit to the director and the cost to the company of the complete package. Also the committee should consider how the directors' package relates to the package for employees. Ideally, perhaps the package offered to the directors should be an extension of the package applied to the employees.

Loans may be particularly problematic. Some high-profile corporate scandals have included a number of instances of abuses of loans, including a $408 million loan to WorldCom Chief Executive Officer, Bernie Ebbers. Using corporate assets to make loans when directors can obtain loans from commercial organisations seems very dubious, and a number of jurisdictions prohibit loans to directors of listed companies.

4.10 Pensions

Many companies may pay pension contributions for directors and staff. In some cases however, there may be separate schemes available for directors at higher rates than for employees. The UK Corporate Governance Code states that, as a general rule, only **basic salary** should be **pensionable.** The Code emphasises that the remuneration committee should consider the pension consequences and associated costs to the company of basic salary increases and any other changes in pensionable remuneration, especially for directors close to retirement.

The Walker report on UK financial institutions responded to concerns raised about aspects of pension arrangements. It recommended that no executive board member or senior executive who leaves early should be given an automatic right to retire on a full pension – that is, through enhancement of the value of their pension fund.

4.10.1 Pensions and strategic decision making

Increasingly pension fund liabilities are influencing strategic decisions.

For private companies with their own pension schemes, the actuarial valuation of the company's pension plan can be a deal-breaker in relation to mergers and acquisitions, as any liability to pay future pensions will pass to the new owners in that any deficit will be charged to the company's future profits.

Under UK pension regulations, employers operating schemes that have deficits have to agree with the scheme's trustees a plan to pay off the deficit, generally by making extra payments.

4.10.2 Accounting for Pensions

One of the key financial reporting problems in recent years has been the issue of how to account for large pension deficits arising for example, from falling equity values, interest rate changes and changes in life expectancy.

Although pension plans are generally operated by independent trustees, they are set up for the benefit of the employing entity's employees, with the employing entity often retaining significant obligations under the plans, which need to be accounted for. In some cases, pension plans may, in substance, be assets and liabilities of the employing entity itself. To ensure that all pension plans are accounted for and presented in a consistent manner, BAS 19, *Employee benefits* sets out the accounting requirements.

Employees generally receive a number of different benefits as part of their complete remuneration package, and these are also addressed in BAS 19.

A key purpose of BAS 19 is to ensure that employer obligations in respect of future liabilities to pay pensions are recognised in the statement of financial position, less any funds specifically allocated to cover them, making the financial statements more transparent. We will look at employee benefits and the impact they can have on an organisation's financial statements in more detail in Chapter 10 of this Study Manual.

Case example: The impact of pension deficits on strategic decisions

Royal Mail

In the UK, various governments have considered privatising or part-privatising the Royal Mail, and discussions around the process are still on-going following the passing of the Postal Services Act 2011.

Under the Act, staff will be entitled to apply for a share of 10% of the total equity with the remainder being sold via an Initial Public Offering. However, a pre-requisite to the privatisation was the transfer of the Royal Mail's pension scheme to the State. It was announced in 2012 that the transfer of the pension fund assets added £28 billion to the Exchequer, but that the liabilities of the fund totalled £37.5 billion, which was added to the UK national debt. Without the transfer of the pension fund deficit, no buyers would have been found for the Royal Mail, given that the ongoing business is likely to be valued at between £2–3 billion when the initial purchase offer is launched.

British Airways & Iberia

In the private sector, a similar issue needed to be resolved between British Airways and Iberia ahead of their merger in 2010. British Airways' two final salary schemes had a combined deficit of £3.7 billion at the time of the merger despite having been closed to new members for many years.

The larger scheme, which closed to new members in 2003, still had members contributing into it, as well as pensioners. In 2007, the scheme became less generous to contributing staff, but poor investment returns, as well as changes in life expectancy, outweighed the impact of the scheme changes. In 2010, British Airways agreed new plans with unions to increase pension contributions in order to try to reduce the deficit.

Nonetheless, the reported deficit at the time of the merger with Iberia (£3.7 billion) was around £1 billion more than BA's market capitalisation. In order to smooth the deal, it was agreed that the British Airlines part of the new 'International Airlines Group' would be solely responsible for making additional pension contributions to close the funding gap. The merger agreement also reportedly gave Iberia an option to walk away from the deal if it did not deem BA's pension recovery plan to be satisfactory.

The situation at British Airways ahead of the merger was so bad that it led some analysts to joke that 'British Airways was basically a large pension fund that flew a few aeroplanes'.

4.11 Considerations for pay at all levels

An effective reward system should facilitate both the **organisation's strategic goals** and also the goals of **individual employees**.

Within this, an organisation has to make three basic decisions about monetary reward:

- How much to pay
- Whether monetary rewards should be paid on an individual, group or collective basis
- How much emphasis to place on monetary reward as part of the total employment relationship

However, there is no single reward system that fits all organisations. Irrespective of what type of system is implemented, an organisation should pursue three behavioural objectives.

- It should support **recruitment and retention**.
- It should **motivate** employees to high levels of **performance**. This motivation may, in turn, develop into commitment and a sense of belonging, but these do not result directly from the reward system.
- It should promote **compliance** with workplace rules and expectations.

4.12 Performance related pay

Even below the executive level, it may be beneficial for an organisation to link pay to performance (PRP schemes). Should the company be able to find a way to link the personal objectives of its employees to the corporate objectives, then better goal congruence should result. If this is then linked to financial reward for the employees, perhaps in the form of bonuses or share-schemes, then there should be mutual benefits for employees, employer and owners.

When designing PRP schemes, a company must be careful not to structure incentives in such a way that poor performance is also rewarded. The financial crisis of 2007–8 has showed the dangers of linking reward schemes to performance measures if those **performance measures are poorly designed**. For example, many commentators have suggested that bank bonus schemes in the past encouraged a focus on short-term decision making and risk taking.

A European Commission report into the financial crisis suggested that, 'Excessive risk taking in the financial services industry…has contributed to the failure of financial undertakings…Whilst not the main cause of the financial crises that unfolded…there is widespread consensus that inappropriate remuneration practices…also induced excessive risk taking.'

In this case, there appears to be a direct link between the profit measures (short term profitability) and the **risk appetite of employees**. Employees were prepared to take greater risks in the hope of making higher profits, and therefore getting larger bonuses.

However, a second potential drawback for an organisation arises if it is unable to reward individuals for good performance (for instance, due to a shortage of funds) because then the link between reward and motivation may break down.

If an **individual's** goals are linked to the objectives of the organisation, then it is clear to the individual how their performance is measured and why their goals are set as they are. However, on occasions there may be a problem in linking individual rewards directly to organisational outcomes, especially if the latter are uncertain.

Another drawback is that, in striving to meet targets, some individuals may become cautious and reluctant to take risks, given that they have a stake in the outcome. Conversely, other individuals may choose riskier behaviour, especially if reward is linked to, say, revenue generation or levels of output.

4.13 Behavioural implications of performance targets

In general terms, performance management acts as a control system for measuring people's achievement against targets. However, in order for the performance management to be beneficial, it is important to select the right measures or targets at the start when performance goals are set.

There is an old adage (often attributed to the management guru, Peter Drucker): 'What gets measured, gets done.' The issue being identified here is that if particular performance targets or objectives are set, employees know that their performance is likely to be appraised against those targets and so they will concentrate on achieving them in preference to other possible aspects of their role. However, this could have negative side effects elsewhere.

For example, in recent years, there have been concerns that airport passengers have had to wait too long to pass through passport control. If performance targets were set in relation to passenger waiting times (or the length of the queues), staff might respond by trying to speed up the passenger checks they carry out. However, this could lead to a reduction in the quality or thoroughness of the checks being carried out, and in turn could lead to an increased risk of failing to detect passengers who are trying to pass through passport control without valid documentation.

The following two short examples also illustrate the potential negative side effects of setting inappropriate targets:

(i) The manager of a fast food restaurant was striving to achieve a bonus which was dependent on minimising the wastage of chicken or burgers. The manager earned the bonus by instructing staff to wait until the chicken or the burgers were ordered before cooking them. However, the long waiting time which resulted led to a huge loss of customers in the following weeks.

(ii) Sales staff at a company met their target sales by offering discounts and extended payment terms, and in some cases, even selling to customers who they felt might never pay. As a result, the staff were meeting their targets at the expense of the company's profitability. However, the sales staff were motivated by a bonus scheme which was based solely on the level of sales they achieved.

Interactive question 5: Reward systems [Difficulty level: Intermediate]

Stayzee Hotels runs a chain of twenty hotels across the country. Each hotel is wholly owned by the company. Four years ago, the chain was bought by a group of investors who installed a new management team.

The new management team introduced a new reward scheme for the hotel managers in an attempt to motivate managers to improve the revenue and profitability of the chain. The salary package devised for each manager comprised:

- A relatively low fixed salary.
- A bonus payment based on high room occupancy rate. The occupancy rate is the percentage of usable hotel beds filled every night. Managers who achieved more than 90% occupancy rate receive a significant bonus. This target is aimed at keeping the hotel full.
- A smaller bonus payment based on the net profit margin achieved by the hotel. This is aimed at improving the profitability of the hotel.

However, despite these incentives, the overall performance of the company is still declining. Managers are generally achieving a high occupancy rate but are largely failing to deliver higher net margins. It is also clear that some managers have achieved a high occupancy rate by declaring that some bedrooms were unfit for use or were being used as seminar rooms.

Also, the pursuit of high occupancy and high net profit appears to be affecting the perceived image of the hotel chain. Once regarded as a mid-market hotel chain, the chain now seems to be perceived as a budget buy. A large percentage of bookings are received through the internet broker *lastsecondhotels.com* and their view of Stayzee's hotels are given below, together with some visitor quotes from their web site.

Comments

'Great last minute bargain … very easy to get rooms at half the advertised rate'

'Full of school children on a trip … will not be using this chain again'

'No internet connections in the rooms or public areas, very disappointing'

'The bath was cracked and the windows were dirty. Cheap, but badly in need of a clean'

'Receptionists were very off-hand and unable to help. Did not seem to know much about the area surrounding the hotel'

'The staff were surly and uncommunicative. Much worse than last time we visited it. It used to be such a lovely hotel'

'Cheap, but don't eat there. The price for breakfast was extortionate'

'Cheap and cheerful but don't pay the full rate! Always lots of cheap beds available'

'Food was expensive and dull. The serving staff were uncommunicative, the cutlery was dirty and damaged. Staff were more interested in talking to each other than to the customers'

'Restaurant food was very expensive and of poor quality. The two nights I stayed there I was the only customer in the restaurant'

Lastsecondhotels.com says: 'Value for money hotels with rooms always available. Perfect for those last minute breaks'

Requirement

Analyse the unanticipated consequences of the management reward scheme at Stayzee Hotels.

See **Answer** at the end of the chapter.

4.13.1 Targets and motivation

A key consideration when setting targets is the extent to which they will motivate staff.

Too easy: If the targets set are too easy, employees will achieve their targets easily, but the targets will not serve to optimise their performance.

Too hard: If the targets set are too hard, staff are likely to treat them as unrealistic, and will not be motivated to try to achieve them.

In this respect, the most effective targets will be 'stretch' targets: targets that will be challenging for the staff, but which are potentially achievable. Employees will therefore be motivated to try to meet the targets, even if they ultimately fail to do so.

4.13.2 Controllability and responsibility accounting

Responsibility centres in an organisation are usually divided into four categories:

- **Cost centres** – Where managers are accountable for the costs that are under their control. Cost centre managers are not accountable for sales revenues. (However, it is important to note that cost centres can still affect the amount of sales revenues generated if quality standards are not met, or if goods are not produced on time.)
- **Revenue centres** – Where managers are only accountable for sales revenues, and possibly directly-related selling expenses (eg salesperson salaries). However, revenue centre managers are not accountable for the cost of the goods or services they sell.
- **Profit centres** – Managers are given responsibility for both revenues and costs.
- **Investment centres** – Managers are responsible not only for revenues and costs, but also for working capital and capital investment decisions.

When measuring the performance of a responsibility centre, a key issue is distinguishing which items the manager of that centre can control (and therefore they should be held accountable for) and those items over which they have no control (and therefore they should not be held accountable for).

This principle of controllability underpins the idea of responsibility accounting: that managers should only be made accountable for those aspects of performance they can control.

In this respect, the controllability principle suggests that uncontrollable items should either be eliminated from any reports that are used to measure managers' performance, or that the effects of these uncontrollable items are calculated and then the relevant reports should distinguish between controllable and uncontrollable items.

As with unrealistic targets, it follows that if managers feel that their performance targets are based on factors or results which they cannot control, they are unlikely to be motivated to try to achieve them.

In practice, the controllability principle can be very difficult to apply, because many areas do not fit neatly into controllable and uncontrollable categories. For example, if a competitor lowers their prices, this may be seen as an uncontrollable action. However, a manager could respond to the competitor's action by changing the company's own prices, which could then reduce the adverse effect of the competitor's actions. So, in effect, there are both controllable and uncontrollable actions here.

Similarly, if a supplier increased the price of their product, this may be seen as an uncontrollable action. However, a manager could respond by looking to change supplier or using a different product in order to reduce the adverse impact of the supplier's actions. Again, there are potentially both controllable and uncontrollable actions here.

Accordingly, any analysis of performance would need to consider the impact of the competitor's or supplier's actions as one element, and then the impact of the manager's response as a second element.

Controllable costs

Controllability can also be a particular issue when looking at costs within companies.

Consider the following example:

A company has three operating divisions and a head office. The divisional managers think it is unfair that a share of indirect costs – such as central finance, HR, legal and administration costs – are included in their divisional results because the divisional managers cannot control these costs.

Importantly, there is a distinction here between considering the divisional **manager's performance** and the **division's performance** as a whole**.**

In order to evaluate the **performance of the divisional manager**, then only those items which are directly controllable by the manager should be included in the performance measures. So, in our mini example, the share of indirect costs re-apportioned from the head office should not be included. These costs can only be controlled where they are incurred. Therefore, the relevant head office managers should be held accountable for them. As the divisional managers have suggested, it would be unfair to judge them for this aspect of performance.

However, in order for the head office to evaluate the division's overall performance for decision-making purposes (for example, in relation to growth, or divestment) it is appropriate to include a share of the head office costs. If divisional performance is measured only on those amounts the divisional manager can control, this will overstate the economic performance of the division. If the divisions were independent companies, they would have to incur the costs of those services which are currently provided by the head office (for example, finance and HR costs). Therefore, in order to measure the economic performance of the division, these central costs, plus any interest expenses and taxes, should be included within the measure of the division's performance.

Interactive question 6: Managers' performance [Difficulty level: Intermediate]

TVW is a retail company that has a number of shops across the country in which it is situated.

The managers of the individual TVW shops have little authority. Shop budgets are set centrally by the Finance Director and the senior management team, and shop managers are not consulted in the budget-setting process. Inventory purchasing is controlled by a central purchasing team, and brand marketing is controlled by a central marketing team. The head office also manages the rent agreements and other property costs for the shops. However, each shop has a small marketing budget of its own which it can use to run local promotions.

TVW produces a standard list of selling prices for all the products it sells, although shop managers do have some scope to change prices, and can vary prices by up to 5% from this standard list.

Shop managers also recruit and manage the staff within their shops. However, the wage rates they can offer their staff are fixed by head office, and are not negotiable.

The shop managers are paid a basic salary with bonuses of up to 25%. However, in order for a manager to qualify for a bonus, his or her shop's profit has to be above budget.

A number of the shop managers have recently complained about this, because they feel that the current remuneration scheme doesn't reflect the effort they are putting in.

The manager of one of TVW's largest stores commented: 'The budget that was set was totally unrealistic in the current economic conditions. Although I have run several promotions, which were well received by my customers, there was no way I could achieve the sales figure in the budget. The budgeted sales figure for my shop was the same as last year, but this year the industry as a whole has seen a 10% fall in revenues.'

The results for the manager's shop for the last year are as follows. These are the figures used as the basis for any bonus calculations:

	Actual	*Budget*	*Variance*
	CU	CU	CU
Sales	261,000	287,000	–26,000
Cost of sales	104,400	124,000	–26,600
Gross profit	156,600	172,200	–15,600
Marketing	12,500	13,000	500
Staff costs (manager)	27,500	27,500	0
Part-time staff	36,500	40,000	3,500
Other running costs (eg rent, heat & light)	26,000	25,000	–1,000
Shop profit	54,100	66,700	–12,600

Requirement

What are the problems with using this shop performance information as the basis for assessing the manager's performance?

See **Answer** at the end of the chapter.

5 Corporate social responsibility and performance

Section overview

- Since the 1990s, there has been a growing acceptance that good ethics is good business. To this end, there has been a large increase in the range of metrics that companies report in respect of their social responsibility. The increasing importance of social responsibility and sustainability has also been reinforced by legislation which requires companies to report on social and environmental matters in their annual reports.

Case example: BP

In 2001, the global energy company formerly known as British Petroleum, rebranded itself as BP, and adopted the tagline 'beyond petroleum.'

By the mid-1990s, in the aftermath of the Exxon Valdez oil disaster, and with global warming being recognised as a major environmental concern, 'green' issues were firmly on the agenda, and there was a perception it was profitable to be 'green.'

As part of its re-launch campaign, BP erected a massive billboard in Times Square, New York which read: 'Solar, Natural Gas, Wind, and Hydrogen. And, oh yes, Oil.' In doing so, BP was trying to highlight its promise to deliver energy that doesn't damage the environment.

But in reality, BP's alternative energy generation is miniscule. BP currently produces about 2 gigawatts of solar energy and 1.2 gigawatts of wind power annually, whereas, for context, total global electricity generation in 2008 was over 20 million gigawatts.

Despite the rhetoric, BP's activities are still primarily focused on the oil industry. The fact that it is trying to position itself as something more than this suggests there is a degree of 'greenwashing' involved.

One of BP's claims 'beyond petroleum', is that it is the largest producer of solar energy in the world. Yet BP achieved this position by spending $45m to acquire the Solarex solar energy corporation in 1999. However, the amount spent on that acquisition was a tiny fraction of the $26.5 billion spent to acquire ARCO, in order to increase oil production capacity. It was also significantly less than the $200m which BP spent between 2000-2 re-branding its facilities.

Ultimately, despite the rhetoric about social responsibility, profits still count in the corporate world. The 'Deepwater Horizon' oil rig disaster in the Gulf of Mexico (April, 2010), has called into question BP's sincerity in delivering on its brand promise. Critics have argued that cost-cutting and recklessness by BP contributed to the disaster. Yet, if BP chooses to stand for energy that 'does not damage the environment', then it must enforce environmental standards that support this (even though they may be more costly than the lower standards that may be legally required by relatively lax government regulations). Therefore, it appears that BP's actions have not matched the standards suggested by its brand promise, and BP has very visibly failed to produce energy that 'doesn't damage the environment'.

In 2010, BP suffered its first annual loss for nearly 20 years, following the catastrophic explosion at Deepwater Horizon, which will cost it at least £25 billion. Some analysts think the total cost to shareholders could exceed £40 billion over ten years (2010–2020). However, the financial cost was not the only reason that made 2010 one of the most damaging years in BP's history, because the devastating explosion also shattered the company's reputation.

Although we have highlighted the importance of looking at non-financial aspects of performance as well as financial aspects, the non-financial elements look mainly at customers, business processes, quality, and learning and development.

One potential criticism of the Balanced Scorecard we could make, however, is that it does not consider any aspects of social responsibility, sustainability and environmental matters.

However, these elements of social responsibility and sustainability are becoming increasingly important in shaping an organisation's long-term success. (We will discuss the ideas of social responsibility and sustainability in more detail in Chapter 11 (Section 5) of this Study Manual. Section 5 of Chapter 11 also addresses issues relating to the measurement and reporting of aspects of CSR and sustainability.)

The relevance here, though, is to remind us that when determining performance metrics, organisations should also consider social and environmental performance, as well as more conventional elements of 'business' performance.

Promoting socially responsible behaviour can have commercial benefits for an organisation. For example, companies that set standards for social responsibility could be listed on the **FTSE4Good Index.** The Index is comprised of companies which sets standards for corporate social responsibility (CSR). Members are expected to meet its criteria, including those on environment, supply chain and anti-bribery. Fund managers are increasingly placing funds into responsible investments, including the FTSE4Good index.

Similarly, Elkington, who developed the idea of the 'Triple Bottom Line', believes that environmental and social accounting will also develop our ability to see whether or not a particular company or industry is 'moving in the right direction.' However, the development of environmental management accounting, for example, will encourage the introduction of more environmental performance measures.

There could also be a direct link between 'environmental' behaviour and performance. There are potentially a number of ways poor environmental behaviour can affect a firm: it could result in fines (for pollution or damage), increased liability to environmental taxes, loss in value of land, destruction of brand values, loss of sales, consumer boycotts, inability to secure finance, loss of insurance cover, contingent liabilities, law suits, and damage to corporate image.

Moreover, although health and safety measures do not necessarily add value to a company on their own, they can help to protect a company against the cost of accidents which might otherwise occur. If a company has poor health and safety controls, this might result in, amongst other things, increased sick leave amongst staff and possible compensation claims for any work-related injuries, as well as higher insurance costs to reflect the higher perceived risks within the company.

Triple bottom line and performance management

In this respect, the idea of the triple bottom line has important implications for performance measurement and performance management. Instead of concentrating on financial performance, and particularly on short-term financial performance, companies should also pay greater attention to the **longer-term** social, environmental and economic impact that they have on society.

In turn, this means that they need to develop performance measures that address these factors, as well as measures focusing on short term financial performance.

Case example: Hyundai Engineering & Construction

In its Sustainability and CSR Report (2012), the Korean company Hyundai Engineering & Construction appears to apply the ideas of the triple bottom line directly to its plans for business sustainability and sustainable management.

Hyundai summarises the elements of its 'sustainable management' activities in a grid as below:

	Management Policy ⇨	Business Management ⇨	Achievement & Evaluation ⇨	Future Growth
Green Value	Carbon Management strategy Enforcing Green purchasing process	Energy reduction design; energy reduction projects	Responses to climate change R&D achievements in relation to reductions in energy use and emissions; and increased use of renewable energy	Expansion of R&D budget Development of eco-friendly technology
Social Value	'Win win' Co-operation with suppliers	Selection of suppliers Safety awareness and prevention of accidents	Economic value distribution among stakeholders	Securing human resources Training to develop future leaders
Economic Value	Ethical management and anti-corruption policies Fair Trade compliance programme	Job creation and production through infrastructure investment	Ranking of company's business management skill and performance	Reinforce expansion by marketing to developing countries Reinforce entry into eco-friendly markets

5.1 Measures of CSR performance

Although corporate social responsibility initiatives and measures can be extremely broad, and will vary from industry to industry, some prevailing themes are likely to emerge.

The following table includes some examples from Tesco plc's CSR review in 2012:

CSR Promises	KPIs
Buying and selling our products responsibly	Suppliers treated with respect – % responses % of suppliers who respond to survey question above
Caring for the environment	Reduce CO_2 emitted from stores and warehouses built before 2006 Reduce CO_2 emitted from stores and warehouses built from 2006 Reduce the $C0_2$ emitted in the delivery distribution network
Providing customers with healthy choices	Number of customers and staff involved in 'Active' events programme
Actively supporting local communities	Staff and customer fundraising Donate at least 1% of pre-tax profits to charities and good causes
Creating good jobs and careers	Staff being trained for their next job

5.2 Legal requirements and corporate reporting implications

While some of the pressure on organisations to become more socially responsible has come from stakeholder expectations, (including investors and the media who are paying closer attention to companies' social and environmental performance), perhaps more importantly many businesses now also face a **legal requirement** to report on social and environmental matters in their annual reports.

5.2.1 Business review

In the UK, the Companies Act 2006 requires company directors to report on environmental issues in a 'Business review' as part of their directors' report. (From October 2013, quoted companies have to produce a 'Strategic report' which replaces the 'Business review.')

The Companies Act states that companies, in particular, quoted companies, will have to ensure that 'to the extent necessary for an understanding of the development, performance of position of the company's business', the business review should include:

- The main trends and factors likely to affect the future development, performance and position of the company's business
- Information about:
  - (i) **Environmental matters** (including the impact of the company's business on the environment);
  - (ii) The **company's employees**;
  - (iii) **Social and community issues**, including information about any company policies in relation to those matters and the effectiveness of those policies; and
  - (iv) Persons with whom the company has contractual or other arrangements which are essential to the business of the company.'

Category (iv) could be very broad, and could include key suppliers and customers, as well as any partners in a joint venture or other contractual agreement (eg license holders or agents). The aim of category (iv) is not to require companies to list all their suppliers (or customers) but to highlight any key relationships which are critical to the business and so could influence the performance of the business and its value (for example, reliance on a key supplier which is particular important to the company's business).

For a large quoted company, there are three aspects to the environmental disclosures required in the business review:

- Risks and uncertainties
- Policies and their effectiveness
- Key performance indicators

5.2.2 Company's employees

UK Companies Act 2006 (Strategic Report and Directors' Report) Regulations 2013 require that, in additional to general reporting on their employees, quoted companies report specifically on the number of men and women on their board, in executive committees and the organisation as a whole.

These regulations also expand the requirements surrounding social and community issues to include specific consideration of human rights.

5.2.3 Greenhouse Gas emissions

In conjunction with the general requirement for companies to include information about environmental matters in their business reviews, UK Companies Act 2006 (Strategic Report and Directors' Reports) Regulations 2013, require that quoted companies have to report their annual greenhouse gas emissions in the directors' report.

Mandatory reporting is seen as a vital first step in getting companies to reduce their greenhouse gas emissions. By measuring and reporting greenhouse gas emissions, companies can begin to set targets and put in place management initiatives to reduce emissions in the future. (The requirement covers all greenhouse gases, not just carbon dioxide emissions.)

Commentators have suggested that by helping businesses to understand their carbon emissions, carbon reporting will help them identify opportunities to reduce costs, improve their reputation and potentially manage longer term business risks.

However, the legislation also has important performance measurement and performance management implications for companies:

The Companies Act Regulations apply to all emissions sources for which the reporting company is responsible, not just those sources in the UK. This means that multinational companies will have to have data collection systems for gathering information from global operations, as well as a set of global emissions factors to measure performance against.

Perhaps equally importantly, the legislation could encourage companies to make energy efficiency part of their business strategy and, for example, when evaluating a new strategic option, to consider the energy implications of that option rather than focusing solely on financial or commercial factors.

5.2.4 Implications of the increased importance of environmental issues

The increased focus on environmental issues and environmental performance also means that companies should introduce procedures to try to prevent non-compliance with environmental laws and regulations, and to avoid the fines or penalties which accompany such non-compliance.

In this respect, companies should consider the following procedures:

- Monitoring legal requirements and ensuring that operating procedures are designed to comply with these requirements.
- Implementing an appropriate system of internal controls and regularly reviewing the controls over environmental risks.
- Developing and operating a code of practice for environmental issues, such as accidental spills and the disposal of waste, especially hazardous waste.

Environmental information

A company's internal reporting system also needs to record information about environmental issues, and should be capable of providing sufficient information to enable the financial impact of any environmental issues to be estimated with a reasonable degree of reliability.

In addition, it will be important to maintain regular communication between those responsible for environmental issues in a company and the accounting staff, so that the financial implications of any environmental issues are understood, and any necessary action can be taken promptly.

Environmental issues and the supply chain

Environmental issues are not confined within the normal financial reporting boundaries of an organisation. For example, supermarkets' concerns over **supply chain issues** are driving significant changes in supplier companies. To avoid a supplier's reputation being seriously damaged by sourcing products in a way which harms the environment, suppliers are manufacturing products sustainably and from sustainable sources.

5.3 Integrated reporting

The increased importance of reporting about social and environmental aspects of performance, and of sustainability, could also be seen to support the need for **integrated reporting**.

An integrated report (as proposed by the International Integrated Reporting Council[1] (IIRC)) is a concise communication about how an organisation's strategy, governance, performance and prospects, in the context of its **commercial, social and environmental context**, lead to the creation of value over the short, medium and long term.

We will look at Integrated Reporting in more detail in Chapter 11 of this Study Manual, but it is worth noting here that a key aim of integrated reporting is to reflect the **longer-term consequences** of the decisions organisations make, in order that they take more sustainable decisions and create value over time.

An integrated report should answer the following questions:

[1] The IIRC is a global coalition of regulators, investors, companies, standard setters, the accounting profession and non-government organisations.

- What does the organisation do, and what are the circumstances under which it operates?
- **Governance** – How does the organisation's governance structure support its ability to create value in the short, medium and long term?
- **Opportunities and risk** – What are the specific opportunities and risks which affect the organisation's ability to create value over the short, medium and long term; and how is the organisation dealing with them?
- **Strategy and resource allocation** – Where does the organisation want to go, and how does it intend to get there?
- **Business model** – What is the organisation's business model, and to what extent is it resilient?
- **Performance** – To what extent has the organisation achieved its strategic objectives and what are the outcomes in terms of effects on the capitals?

  (The integrated reporting framework refers to six categories of 'capital': financial; manufactured; intellectual; human; social and relationship; and natural. (See Chapter 11 for more details.))
- **Future outlook** – What challenges and uncertainties is the organisation likely to encounter in pursuing its strategy, and what are the potential implications for its business model and its future performance?

An organisation's business model draws on various capitals as inputs and, through its business activities, converts them into outputs (product, services, by-products and waste). The outcomes of an organisation's activities and outputs also have an effect on the capitals. Some of the capitals belong to the organisation, but others belong to stakeholders or society more generally. The organisation and society therefore share both the cost of the capitals used as inputs and the value created by the organisation.

In the context of this chapter on strategic performance management, one of the important implications of recognising these different 'capitals' is that when measuring and managing performance, an organisation needs to look beyond short-term financial performance, and to consider the wider consequences of its strategies and activities.

Summary and Self-test

Summary

The first stage in a performance measurement and control process is to set goals and targets. Then actual performance can be measured and compared with target, and, if necessary, measures taken to correct any adverse variances.

Budgets are used by many organisations as a means to compel planning and co-ordinate activities, as well as to evaluate performance (eg through variance analysis).

The Beyond Budgeting management model argues that traditional budgets are too static for today's dynamic and complex in which organisations need to be flexible to allocate their resources in the way which creates most value for customers and shareholders.

Information is essential for performance measurement, and for strategic planning, decision-making and control more generally.

An organisation's information requirements vary at each level of the performance hierarchy: strategic, tactical/management and operational. The organisation's information systems need to be capable of providing appropriate information at of the three levels.

Traditional management accounting information can be criticised as being backward-looking (historical) and for concentrating solely on internal performance. However, strategic decision-making is forward-looking and outward-looking process. Therefore, strategic management accounting information (which provides an external orientation and a future orientation) is likely to be more useful in supporting strategic planning and control.

Traditionally, performance measurement has concentrated on financial performance. However, there is a danger that this will be lead to a focus on short-term performance (eg maximising short-term profit) at the expense of longer-term performance. Financial indicators also tend to be 'lagging' indicators rather than 'leading' indicators.

In response to these concerns, modern multi-dimensional performance measurement systems (such as the balanced scorecard) include a range of non-financial performance indicators as well as financial ones. However, the ultimate goal of commercial organisations is likely to remain the maximisation of profit, so the financial aspects of performance cannot be ignored.

When selecting performance indicators, an organisation should choose measures which indicate how well it is performing in relation to its critical success factors.

The performance of their staff is likely to have a major impact on an organisation's performance, and therefore an important aspect of performance management is to consider how remuneration and reward packages will influence directors' and employees' performance.

Increasingly, organisations are recognising that 'good ethics' is also good business. As a result, companies are publishing more information about their performance in relation to social responsibility and sustainability.

Self-test

Self-test question 1

AB Co manufactures, markets and distributes a large range of electronic components, and it has established a significant market share across Europe and the United States of America.

AB has three different divisions: the Domestic Electronic Components division (DEC), the Industrial Electronic Components division (IEC), and the Specialist Components (SC) division. The DEC division and the IEC division supply standard electronic components for domestic and industrial use, while the SC division supplies specialist components which are often unique and made to specific customer requirements. Each division has its own factory, with DEC and IEC's factories based in the same Eastern European country, and SC's factory based in a Western European country.

All three divisions have been profitable over the past five years, although the board has traditionally taken a relatively cautious approach to providing strategic direction for the company. However, AB's institutional shareholders are now looking for increased growth and profitability. In the past, the institutional shareholders have been critical of AB's board for being overly cautious in their attitude to risk.

In AB's most recent annual report, published in March 20Y0, the board stated that AB's overall strategic aim is to: 'Achieve growth and increase shareholder returns by continuing to produce and distribute high quality electronic components, and develop our international presence through expansion into new overseas markets.'

Two years earlier, in 20X8, AB established a separate trading company with a local partner in Asia to sell the IEC division's products. The ownership of the company is shared: 50% by AB and 50% with a local entrepreneur. AB chose this structure because of local legal requirements. A further legal requirement is that, in the case of the company ceasing to trade, AB will be required to reimburse the local entrepreneur the full amount of his original investment (which was $500,000).

This expansion was initially very successful, with good levels of demand being experienced for IEC's products. Recently, however, a number of environmental factors have rapidly changed. These include a forecast of declining demand for IEC's products in Asia, due to adverse world economic factors (which have slowed the growth in demand for electronic components in total) and a move towards protectionism in some Asian countries. The trading company had originally been forecast to make a profit of $2 million in 20Y1, but this figure has now been re-forecast to $1.6 million.

IEC has also been unfortunate in that its direct labour costs in Asia have increased by more than the planned level. Economic intelligence suggests that this inflation will continue increasing for the next two years.

However, analysis by AB's management accountant shows that the trading company's costs (and in particular, its wage costs) are proportionally much higher than its competitors.

Requirements

(a) Advise the Board of AB how strategic management accounting could help it manage the performance of the trading company in Asia.

(b) Discuss the factors which AB should consider before withdrawing from the trading company it has established with its partner in Asia.

Self-test question 2

Pamper Products Ltd

Pamper Products Ltd was purchased as part of a management buy-out in 1996 by two brothers, Peter and David Sample. The company buys nail care and cosmetic products from a variety of suppliers in order to supply chemists and other retailers. Peter Sample was the sales director of the business before the buy-out and David was an accountant working in practice at the time.

David organised the finance by re-mortgaging both of their houses and borrowing further from the bank. He has continued to deal with the financial and administrative areas of the company, whereas Peter is totally involved with suppliers and customers.

Peter was always an excellent salesman and his commitment to customer service is second to none. He deals personally with all of the major customers and has an excellent relationship with them.

Peter has a similar commitment to his suppliers. He has tried to limit the number of suppliers, but as the company has grown, he has been forced to deal with a growing supplier base. Most of the purchases are from either the Far East or Europe. Initial concentration on a few major suppliers has ensured that Pamper Products has been able to have exclusive access to some products.

The company buys its products from a variety of manufacturers but markets them under its own brand name; it is able to charge premium prices for these products as a result of having created a trusted brand.

The company has gone from strength to strength in the years since the management buy-out, with revenue increasing on average by over 20% per annum. This has led to an increased number of suppliers and an increase in staff from seven in 1996 to 22 currently. The company has also expanded physically and has recently rented a new warehouse, investing in a state of the art inventory control system and a new computer system.

The initial bank loan was paid off according to its terms by 2001 but recently, a further loan has had to be taken out in order to finance the expansion.

Peter is committed to even further expansion but David is concerned that the company's systems and finances cannot keep up with the rate of sales growth and would prefer a period of consolidation. As an accountant, David is happy with the financial controls and performance measures that he has built into the system, but is concerned that possibly other non-financial measures might be just as important, particularly as the company continues to expand.

Requirements

(a) Explain to David the most common reasons why companies may fail and suggest ways in which Pamper Products Ltd could avoid them.

(b) Using the balanced scorecard approach, suggest other non-financial performance indicators that Pamper Products Ltd could use to monitor its overall performance as it continues to expand.

Self-test question 3

Yacht manufacturer

YCT is a family-owned company employing 40 people, which builds and sells medium sized yachts. On average, YCT's yacht normally retail for around £110,000 each.

YCT operates in a very competitive market. Its yachts are usually bought by amateur sailors with high disposable incomes who value quality, reliability and performance. In 20Y1, YCT plans to sell 30 yachts. YCT's managing director has a vision for the company to be 'regarded as the best yacht builder for the private owner'.

YCT has always emphasised the high quality of its yachts and knows that its customers are very knowledgeable about yacht design and performance. Each yacht is built to a specific order and there is usually a period of at least one year between an order being placed and the yacht being delivered to the customer. YCT's construction processes are very traditional: most of its designs are at least 20 years old and much of the construction work on its yachts is done by hand. YCT regards its workforce as 'craftspeople' who have learned their skills through their work experience. YCT employs school-leavers and provides apprenticeships lasting seven years. However, most of its competitors employ university graduates who have studied yacht design and construction.

YCT designs all its yachts manually, which is very time consuming, although most of its competitors now use CAD/CAM* suites for their designs. YCT does not have any staff with CAD/CAM experience. YCT uses natural materials in the construction of its yachts: for example, cotton for the sails. However, recently some natural materials have become difficult to obtain and the prices of these have risen by as much as 35% in the last two years. Many of YCT's competitors have replaced natural materials with synthetic ones, as these are easier to obtain, cheaper and give enhanced performance.

YCT uses a standard costing system for its manufacturing operations. YCT employed a consultant to design the system twenty years ago, and the company still uses this system today. The managing director (MD) relies on the standard costing system which is his only control system for the company. The MD knows that the manufacturing cost of a yacht amounts to 60% of its total cost and believes that if he is in control of 60%, he is in control of the majority of cost. However, recently the MD has experienced some frustrations with the control system because it only reports financial results. The MD would like a system that gives him integrated control over all aspects of the business, and has been considering the use of a balanced scorecard.

YCT's business comes from repeat orders and recommendations. However, it has experienced criticism in the last year because it failed to meet the promised delivery time for 25% of its orders and has lost business because the potential customers said that YCT's yachts looked 'old-fashioned' and were 'too slow'.

Cash flow is particularly important for YCT, because of the long lead times for each yacht, and has been under pressure recently. YCT has had to increase its overdraft facility by $75,000 to $175,000 and this is nearly fully used. Every year since its inception, YCT has reported a profit but in 20Y0, its Return on Capital Employed was 3% which the MD has stated is unacceptable. He has asked senior members of staff for suggestions about how to increase YCT's profitability.

One such suggestion was that YCT should look to reduce its costs, while another was that the company should look to increase its revenues by developing and marketing a new range of yachts.

*[*CAD/CAM: Computer-Aided Design, Computer-Aided Manufacturing]*

Requirements

(a) Briefly discuss the weaknesses of YCT's current control system.

(b) Advise the MD on how the balanced scorecard could be applied and used with YCT. You should also suggest and justify ONE measure for each of the balanced scorecard's perspectives.

(c) In relation to the growth and survival of YCT, evaluate the two suggestions for increasing the company's profitability.

Self-test question 4

KLP Group

KLP has been growing its business successfully for a number of years, and the business has now grown to a size where the board considers it necessary to establish four divisions as investment centres and delegate more decision-making authority to the management of these divisions.

The authority delegated to the divisional managers will include decision-making responsibility for new capital investment projects for their divisions, within overall budget guidelines. The board has also decided that a reward system should be introduced, and that divisional managers should receive annual bonuses based on the profitability and return on investment of their division. The board considers that an incentive system of this kind will be necessary to provide the motivation for divisional managers to work for the long-term growth and development of the company.

At the moment, the board receives performance reports for the company as a whole. The most recent annual report is summarised below.

	CUm	CUm
Revenue		620.2
Manufacturing costs		
Direct manufacturing costs	142.6	
Manufacturing overhead costs	186.3	
		328.9
Gross profit		291.3
Administration costs	69.8	
Selling and distribution costs	105.3	
Finance costs	11.5	
		186.6
Net profit before taxation		104.7

The four divisions are largely independent operating units, although there are transfers of components and services between some divisions. As there is no external market price for most of the services and components transferred, the board has decided that transfers will be priced at cost plus a suitable margin for profit, although the divisional managers should have the freedom to negotiate the transfer prices between themselves.

The group management accountant has been asked to design a performance reporting system that will be appropriate for the new divisional structure and the requirements for responsibility accounting. Several issues have not yet been fully considered.

(1) One of the divisions produces high-technology components. The rate of innovation for new components is rapid, and it has been estimated that an 80% learning curve applies to the manufacturing work in this division.

(2) The group management accountant is concerned about giving too much emphasis to profit and return on investment within the performance reporting system.

(3) The problems of controllability within a responsibility accounting system have not yet been properly addressed.

(4) It is already clear that the managers of the new investment centres will respond to the bonus incentives on offer and that the performance reporting system that is introduced will need to encourage them to take decisions that are in the long-term interests of KLP.

Requirement

(a) Assess how the requirements for responsibility accounting should affect the design of the new performance reporting system.

(b) Assess how the expected behaviour of the divisional managers should affect the design of the new performance reporting system.

BFRS 2, Share based payments

- Requires an entity to recognise share-based payment transactions (such as shares granted, or share options) in its financial statements. This includes transactions with employees or other parties to be settled in cash, other assets, or equity instruments of the entity. **Overview**

BAS 19, Employee Benefits

- Outlines the accounting requirements for employee benefits, including short-term benefits (eg wages and salary, annual leave); post-employment benefits (eg retirement benefits); and termination benefits. The standard requires that the cost of providing employee benefits should be recognised in the period in which the benefit is earned by the employee, rather than when it is paid or payable. The standard also outlines how each category of employee benefits are measured, and it provides detailed guidance about post-employment benefits. **Overview**

Answers to Interactive questions

Answer to Interactive question 1

Strategic criticisms – The criticisms are strategic if they relate to aspects of STU which are fundamental to the University and its objectives as a whole, and to its long-term ability to achieve those objectives.

The criticism that **the overall quality of education** is 'Poor' appears to be a strategic criticism, given that one of STU's main purposes will be to provide the highest quality of education that it can to its students.

Operational criticisms – By contrast, operational criticisms will relate to weaknesses or problems in the specific, day-to-day activities which STU carries out in order to achieve its financial or operating objectives.

In this respect, the fact that STU could not produce a **head-count of the number of students enrolled**, and the fact that there were **discrepancies in cash counts** both seem to be operational criticisms.

Tactical (or managerial) criticisms – However, a number of the criticisms seem to relate to issues between these two extremes, meaning they are best viewed as tactical or management issues. In other words, they relate to the way that resources are obtained or used to try to achieve STU's objectives as effectively and efficiently as possible.

For example, the high numbers of students dropping out of their courses, or complaining, suggests that STU is not achieving its educational objectives as well as it could be. Equally, the fact that it is operating at a deficit, and it is not managing its debtors effectively suggests it is unlikely to be performing as well as it could be financially.

Computing facilities – The reference to computing facilities, and the management team's response to it, also gives an indication of the importance **of strategic objectives being linked to the tactical and operational level**. It is not clear whether STU's intention has simply been to provide more computing facilities or whether it has intended to use computer technologies to enable particular types of learning. However, if there was a particular educational strategy, it seems this has not been communicated clearly to those responsible for implementing it throughout the university (in the different academic departments, or the libraries for example) so consequently STU is not making the best use of the computing facilities it now has.

Answer to Interactive question 2

Invoices per employee per week: 10,000/4 = 2,500 (activity)
Staff cost per invoice: CU0.12 (cost/profitability) 16,000/ (2,500 × 52)
Invoices per hour: 2,500/ (7 × 5) = 71.4 (productivity). (Assume employee works 5 days a week, 7 hours per day.)
Cost of idle time: CU32 + CU4.28 = CU36.28 (cost/profitability). (Cost of phone call + ½ hour lost productivity (½ × CU0.12 × 71.4)

You may have thought of other measures and probably have slight rounding differences.

Answer to Interactive question 3

Financial performance: Profit and loss per department, variance analysis (eg expenditure on wages, power, catering, bedrooms and so on); revenue per available room.

Competitive performance: Market share (room occupied on a total percentage of rooms available locally); competitor occupancy; competitor prices; bookings; vacant rooms as a proportion of the total attitudes of particular market segments.

Resource utilisation: Occupancy rate (rooms occupied/rooms available)

Quality of service*:* Complaints, results of room checks, results of questionnaires

Answer to Interactive question 4

Part (a)

Four critical success factors which would be appropriate to use at SC are:

- **Students' satisfaction** with courses and learning materials
- **Staff satisfaction**
- **Quality** of teaching and materials
- **Reputation** and brand image

Part (b)

KPIs for each of the CSFs could be:

Student satisfaction

Student satisfaction rating – At the end of a course, or at the end of a module within a course, students could be asked to complete a questionnaire rating their satisfaction with various aspects of the course (for example, the knowledge levels of the staff, the quality of the supporting materials, and the approachability/availability of staff to ask them questions).

If students are happy with the level of tuition they receive, they are more likely to book on subsequent courses with SC than if they are dissatisfied with the courses or the materials. Similarly, they may share their experiences with their peers, in turn influencing their decision about where to book courses. Consequently, SC needs to ensure that student satisfaction levels are maintained as high as possible, particularly with the increasing number of competitors entering the professional qualifications market. In this respect, it is important that TDM knows how its students (its customers) feel about the services it offers so that it can improve any areas where it is not performing well.

Percentage of modules with online tutorials available – The online tutorials being offered by SC's competitors appear to be very popular, and may lead students, who would otherwise have studied with SC, to choose one of its competitors instead. If SC cannot offer the online tutorials, it may lead students to think that the level of tuition and service they will receive from SC may be inferior to that offered by the competitors, even though this may not actually be case.

Staff satisfaction

Staff turnover – The quality of SC's teaching staff is vital in maintaining customer satisfaction, so it is important for SC to retain its best staff. SC has been experiencing an increasing rate of employee turnover, and this could be indicative of dissatisfaction amongst the staff. The management at SC should be keen to prevent this upward trend in staff turnover from increasing, particularly if SC's best staff are leaving to join competitor organisations. The increase in staff turnover is a problem in itself, but even more so if staff are joining direct competitors – making this a crucial measure to look at.

Staff absenteeism – High levels of absence are likely to also indicate dissatisfaction among the staff. If absenteeism is rising, in conjunction with employee turnover, then there is a danger that the quality of service provided to students will suffer. For example, if an experienced lecturer phones in 'sick' at short notice, their classes may have to be taken by an inexperienced lecturer who is not such an expert in a subject, meaning the students could receive lower quality tuition.

Quality of teaching and materials

Market share – SC currently has the largest market share in its sector, despite carrying out relatively little marketing activity, and despite the number of new entrants joining the professional qualifications market in recent years. It will important for SC to monitor its market share, because the share of the market it can capture will have a direct impact on its revenues and consequently, on the wealth of its shareholders.

Customers will only continue to use SC if they feel it is providing courses and materials that are high quality, and also which offer value for money. If its market share starts to fall, it may be an indication that the students feel SC's competitors are offering courses that are better value for money.

Accreditations – SC's courses are accredited by a number of qualification-awarding bodies. SC has always concentrated on the quality of its courses and the accompanying study materials, so external accreditations will provide an independent corroboration of this quality. The quality of course tuition and study materials, in turn, is likely to feed back into the level of customer satisfaction with SC's courses, and the pass rates.

The scenario does not indicate what the accrediting bodies think about the use of online tutorials. However, it is possible that, in time, providing some kind of online tutorial support may become one of the conditions for accreditation.

Reputation and brand image

Brand reputation – SC's management team have never seen the need for market and customer research, given that SC has managed to establish a good reputation and a market-leading position without doing so. However, given the entrance of new competitors into the market, SC will need to ensure that its brand reputation is maintained. This will be very important if SC is to ensure potential customers will choose to come on its courses rather than going to one of its competitors. Equally, SC will need to ensure that the lack of online tutorials does not damage its reputation; for example, if students think that SC is out of touch with current practices and the new developments in the industry.

Pass rates – SC's students consistently achieve pass rates that are higher than the national average for the qualifications they are sitting. The level of pass rates achieved could be a key factor in students deciding where to study (or for employers deciding where to send their employees to study). If students, or their employers, think that selecting one college in preference to another can affect their chances of passing their exam, they are likely to select the college with the highest pass rate.

Equally, if some of SC's rivals regularly achieve pass rates which are even further above the national average than SC's, the competitors could use this as a marketing message to try to gain market share from SC. Conversely, if SC continues to deliver higher pass rates than its competitors (despite not offering tutorials), this could be an equally powerful marketing message in SC's favour.

Answer to Interactive question 5

The main focus of the managers' reward scheme is on room occupancy rates. Therefore, the managers are concerned with simply filling rooms, rather than looking at other aspects of performance.

They are using a variety of ways to fill rooms, but these are proving damaging to the hotel:

Broker sales

Elegant, one of the hotels in the Stayzee chain, advertises on online brokerage sites such as lastsecondhotels.com. These sites allow customers to compare prices, so in order to attract guests, Elegant has to offer low prices. The quote on the website, stating that it is a 'value for money hotel', indicates they are doing this. This suggests Elegant will now be making a lower profit margin than it historically did as a mid-market hotel.

Customer comments on the lastsecondhotels.com website are also likely to encourage potential guests to wait until the last minute to book, in order to get bargains. If occupancy looks like it will be low, managers will reduce rates as illustrated by the quote, 'very easy to get rooms at half the advertised rate.' Again, this puts downward pressure on the hotels' profit margin.

In addition to the lowering of prices, Elegant will also have to pay a commission for guests who have come to them via the brokerage website. This further reduces the profit margin it earns.

Group sales

Another way Elegant has been increasing occupancy rates is through offering packages for school groups. However, again the profit margins on these will be lower than those earned when the hotel catered for mid-market guests.

The use of the hotels by school parties, along with the fact that a large percentage of its bookings are now received through lastsecondhotels.com, has led to a shift in customer perceptions. Elegant are now viewed as a budget hotel rather than a mid-market hotel, which has historically been its market position. The presence of school groups may deter mid-market, higher value customers.

Manipulation of rates

As the bonus is based on a percentage occupancy rate, the managers have an incentive to reduce the number of beds available for use, as well as get bookings for the rooms. Some managers are declaring rooms unfit for use. If the rooms are not unfit for use, this means the managers are artificially increasing their bonus while not generating any revenue by having guests staying in the room.

Cutting costs

As a result of room rates being offered at a discount, managers need to cut costs even more to make a profit on them. There is evidence that costs are being cut in a number of areas:

- **Cheap ingredients**: Customer feedback on the website noted that the restaurant food was poor quality, suggesting managers are trying to reduce costs by using cheaper ingredients in the restaurant.
- **Repairs and maintenance**: Customer feedback on the website also noted that, 'The bath was cracked and the windows were dirty.' So it appears that managers are saving money but not arranging repairs when they are needed and by reducing how often the hotels are cleaned.
- **Low capital investment**: Guests have commented that there were no internet connections in the rooms or public areas. This suggests that managers have preferred to save money rather than investing in their hotels. This illustrates a short term focus because it will deter guests in the future.
- **No investment in staff**: Guests have also commented that the staff were not very helpful and were uncommunicative. Again, this suggests that either costs have been cut by hiring cheap, less competent staff, or by not giving staff proper training when they join the hotel. Either way, measures that have been designed to save costs, are leading to a decline in the service being offered to customers.
- **High prices on ancillary services**: The scheme is also leading to inconsistencies in the hotel's strategic approach. Whilst managers are trying to cut costs in a number of areas, they are trying to boost profit by charging high prices on food. This has led to a reduction in demand as guests on cheap, last minute deals are less likely to want to dine in the restaurant, than the guest Elegant traditionally catered for. This is evidenced by the quote 'Cheap, but don't eat there. The price for breakfast was extortionate.'

The conflict between the high prices charged for meals and the poor quality food offered is indicative of a confused strategy.

Ultimately, measures to cut cost have led to a decline in levels of customer service and perception of the hotel. However, this is unlikely to change as there is no incentive in the bonus scheme to improve customer service.

The management reward scheme has entirely the wrong focus and has led to a severe decline in the reputation and performance of the hotels. Rather than rewarding occupancy rates, the scheme should focus on customer service, quality and providing a good experience for its customers.

Answer to Interactive question 6

Problems with using shop performance indicators as the basis for assessing shop manager's performance:

Accountability – The shop manager should only be held responsible for those aspects of performance he or she can control. However, the branch information used does not appear to distinguish between the factors that the shop managers can control and those which they can't.

Controllable and non-controllable costs – A number of non-controllable costs are currently included in the manager's performance assessment. In particular, the shop manager will have very little scope to control property costs, because the rental contract and other contracted costs (such as heat and light) are managed by the head office. The shop managers may have some control over the amount of heat and light that are used in their shops, but not over the unit prices paid for these utilities.

Similarly the managers can't control their own wages. However, it is reasonable to classify the **part-time staff costs as controllable**. The managers manage the staffing for their shops, and so they could save on part-time staff costs by working longer hours themselves.

Consequently, a fairer way of assessing the shop managers' performance would be to distinguish costs into two groups: controllable (marketing; part-time staff) and non-controllable (managers' wages; property costs).

Budgets – Another problem with TVW's current performance management process is its budgeting process. If the manager's performance is assessed by comparing actual performance to budget, then it is important that the budgets are realistic and achievable.

However, the original sales budgeted (which showed the same figure as the previous year) seems unrealistic, given that there has been a 10% fall in sales across the industry as a whole.

Consequently, it would be useful to break down the overall profit variance (£15,600) into a planning variance (which adjusts for the 10% drop in industry sales) and an operational variance (showing the variance in the shop's own performance after adjusting for the 10%):

Planning variance		CU	
Original sales	(1)	287,000	
Revenue variance due to economic conditions (10%)	(2)	28,700	(A)
Planning variance (Gross margin 60%)		**17,220**	(A)
Operational variance			
Actual sales		261,000	
Revised budgeted sales	(1) – (2)	258,300	
		2,700	(F)
Operational variance (Gross margin 60%)		**1,620**	(A)

The operational variance more accurately reflects the shop manager's work in promoting sales, and here we can see that the manager's efforts have actually reduced the fall in gross profit by CU1,620. The overall gross profit variance (of CU15,600, adverse) reflects an adverse planning variance of CU17,220 partially offset by a favourable operational variance of CU1,620.

Controllable profit – Following on from this, we could suggest that TVW should show a controllable profit for each shop, as well as the overall shop profit.

The shop manager's performance (and hence their eligibility for any bonuses payments) should then be assessed on the controllable profit performance of their shop only.

If we apply this logic to the manager's shop, then instead of the manager facing an adverse variance of CU12,600, they would have achieved a positive variance of CU5,620, and would therefore have been entitled to a bonus. This helps explain why the manager is so unhappy about the current way performance is being measured:

Original variance (CU)	–12,600
Add back:	
Gross profit planning variance (CU)	17,220
Manager's wages (CU)	–
Property costs (CU)	1,000
	5,620

Discounting – One area where the managers do have a degree of autonomy is in setting prices, because they can vary prices by up to 5% from the standard price list; for example, to reduce prices of a particular product to boost sales of it. Therefore, this is an area of the manager's performance which TVW could justifiably measure; for example, by looking at the sales price and volume for individual product lines, and then looking at the impact of any promotions on gross profit.

However, in this case, it appears that the manager has not made any significant use of this authority because the actual gross margin percentage achieved for the year (60%) has remained constant with the budgeted margin of 60%. If the manager had applied any price discounts, this would have led to a reduction in the margin percentage.

Answers to Self-test

Answer to Self-test question 1

Part (a)

Strategic management accounting – Unlike 'traditional' management accounting which looks primarily at internally generated financial information, strategic management accounting looks at information that relates to **external factors**, and it looks at **non-financial** as well as financial information.

Competitors' costs – For example, as well as looking at the trading company's own operating costs and margins, strategic management accounting would also encourage AB to look at competitors' costs. This will help focus attention on the need to control the trading company's costs if it is going to compete successfully. For example, why are the trading company's wage costs proportionally so much higher than its competitors' costs?

Given the nature of IEC's product (standardised electrical components) cost efficiency is likely to be an important factor in the trading company's competitiveness. There is likely to be little scope for differentiation as a competitive strategy.

Market growth – Strategic management accounting will also encourage AB to look at market size and growth, and the trading company's share of the market. The scenario highlights that the downturn in economic conditions has slowed the growth demand for electronic components as a whole, which could intensify competition in the market. Instead of market growth being a source of increased sales, the trading company will now have to increase its market share in order to increase its sales.

Although the scenario mentions the presence of competitors, it does not give any indication of the number of competitors or their size relative to the trading company. However, these factors could both affect the trading company's ability to compete successfully in the market.

In this respect, strategic management accounting's **external focus** is very important: AB needs to understand the market environment in Asia in order to analyse the trading company's current performance, and then to evaluate future strategies for the company.

Analysis of current performance – Strategic management accounting can contribute to the trading company's success by **monitoring its performance** and results compared to its competitors, and then assessing whether its current strategy appears to be working successfully or not.

For example, the trading company's revised forecast suggests that its profit for 20X1 is now expected to be 20% lower than had originally been expected. Some of this shortfall may be due to an over-optimistic budget, since the trading company is still a relatively new entrant to the Asian market. However, it could also be an indication that the trading company has not been able to sustain its initial success and break into the market as well as it had hoped. Therefore, it will be useful to compare the company's performance against its competitors, for example, to see the extent to which their revenues and profits are growing or falling.

If it appears the trading company is performing relatively worse than its competitors, then AB should consider how it could revise its strategy to help improve the company's performance.

Forecasting – Strategic management accounting can also be used to help forecast performance.

AB's forecasts should not look solely at the trading company's own performance but should also look at competitors' performance and market trends in general. For example, how realistic is the level of forecast sales growth in the context of a slowdown in the market?

Equally, economic intelligence suggests that wage inflation is going to continue increasing over the next two years. However, the reason the trading company's wage costs are currently much higher than its competitors' may be that it is paying above the market rates. In which case, it may be able to offer lower annual wage increases than many of its competitors who are currently paying lower wage rates. If not, the trading company will need to review its staffing model and its labour productivity, and try to reduce its wage costs relative to its competitors.

Part (b)

Sales potential – Despite the trading company not seeming to be as profitable as had hoped, it is still generating a profit for AB (with its 50% share of the company's profit expected to be around $800,000 in 20Y1). It is not clear how much AB has invested in the company is, or what its target rate of return is on any investments.

Although the local entrepreneur has invested $500,000, it is likely that AB has invested more, given the level of profit the company is generating.

Therefore, before deciding whether to withdraw, AB needs to consider how profitable it expects the trading company to be in the future, and equally whether it feels it could invest its capital more profitably elsewhere.

Impact of environmental factors – The trading company's performance appears to have been adversely affected by **economic factors** (economic slowdown) and **political factors** (protectionism) in the external environment. However, it is not clear the respective impact that these two factors have had on the trading company's performance, nor the impact that other factors have had on its performance.

Long term or short term impact – Although economic conditions have worsened at the moment, they should improve again in the future, at which point AB might expect demand to increase again. Therefore, the protectionist policies introduced by some of the Asian countries may be a more significant factor, if they are expected to remain in place for the longer term.

Alternative business structures – Although AB is considering withdrawing from the trading company, this need not mean it withdraws from Asia completely. Although the trading company does not seem to have been as profitable as it had hoped, AB should consider whether it stops selling its products in Asia altogether or whether it needs to find an alternative channel. For example, if there is still a market for IEC's products in Asia, it could consider using Asian sales agents to act on its behalf.

Strength of competition – However, AB should also consider the strength of **competitive rivalry** within the Asian markets, because this will affect its profitability, both in the short term and the longer term. Alongside this, AB could also consider factors such as the **threat of new entrants**, and the **bargaining power of customers**, which could also affect its profitability.

Exit barriers – AB and the local entrepreneur both have 50% shares in the trading company. If AB withdraws, the local entrepreneur will have to decide whether he wants to acquire AB's share and try to maintain the trading company himself, or whether the company should cease trading. If the company ceases trading, AB will be liable to pay the entrepreneur $500,000. This exit payment could affect AB's decision of whether to withdraw or not.

Wider implications – The trading company seems to have been AB's first significant venture into Asia. If AB withdraws from the venture within about three years of establishing it, this could be damaging for its reputation. This could be problematic, either if AB wants to continue selling its products through sales agents, or if, in future, it wants to re-establish a joint venture company.

(As we have noted earlier, although market conditions have worsened at the moment, they should improve again in future, at which point AB might look to expand into Asia again. But if AB has a poor reputation in Asia, local businesses will be reluctant to become venture partners with it.)

Business portfolio – Moreover, before withdrawing from the Asian company, AB should critically assess the growth prospects of its current European and American markets. If there are limited growth opportunities in these markets (for example, because they are **more mature** than the overseas markets), the board might be advised to persevere with looking at expansion into new overseas markets.

Fit with strategic aims – AB has stated in its annual report that it wants to develop its international presence by expanding into overseas markets. Establishing the trading company in Asia is a way of helping to achieve this aim. By contrast, withdrawing from the Asian market would seem contradictory to this aim, and to the shareholders' wishes for increased growth and profitability.

Answer to Self-test question 2

Pamper Production Ltd

Part (a)

There have been many attempts to find a methodology to predict corporate decline, or companies at risk of decline. This interest in the subject means that the main reasons for corporate decline are heavily documented. There are many reasons why companies fail and in most cases, it will be due to a combination of such reasons.

Sales and profitability

Declining profitability is a clear reason for the eventual failure of a company. A decline in profits is not always accompanied by a decrease in sales volume, but this is often the case. As sales fall, the same level of fixed costs must be paid from reduced revenue, inevitably reducing profits. Also, if a company expects increases in sales volume that do not materialise, this will also cut profits if the company has invested further, in staff, plant and inventories, for example. An important implication of this for Pamper Products is that a close eye must be kept on costs of all kinds. The need to seek out low cost suppliers may be of particular relevance, considering the past policy of only dealing with a few of those available.

Gearing and liquidity

As a company's borrowing increases, so do the costs of servicing loans. This can significantly increase the risk of the company and in extreme cases, if the loans or debentures are not serviced, they could be called in and the company put into liquidation. The Sample brothers have borrowed extensively, so they should take great care over this. Allied to this problem is that of a decrease in liquidity. A company can still be profitable but if it cannot pay its debts as they fall due, then eventually it will fail. One particular problem here is where seemingly growing companies fall foul of overtrading. This occurs when sales are increasing and therefore, so are inventory-holding costs and payments to suppliers but these costs are not being matched in cash terms by money received from customers. Pamper Products has expanded rapidly and has avoided this problem so far, but the brothers must continue to take care of their cashflow.

Suppliers and customers

A company can appear to be successful, but if it is over-reliant on a few suppliers or customers, then the failure of one of these parties can have a disastrous knock-on effect. If a principal supplier fails, this will have a major effect on the ability of the company to supply its own customers. The loss of a major customer means a significant fall in turnover and cashflow. This calls for close management attention.

Management

So far we have considered largely financial reasons for company failure. However, Argenti argues that many causes of corporate failure are due to poor management. For example, an autocratic chief executive, a passive board of directors and a weak finance director is a common scenario of corporate failure. Finally, there is always the issue of complacency. If a company is seemingly successful, then senior management may become complacent about performance, growth and innovation, which will eventually lead to a loss of market share and declining revenues. The implications for Pamper Products are obvious.

Part (b)

Note: The balanced scorecard is a useful and popular model, both in an examination context and in the real world. Make sure you have learned and understood the nature of the four perspectives and expect to have to suggest relevant possible measures for each one.

A **balanced scorecard** considers performance indicators for a business within four **perspectives**:

- The financial perspective
- The customer perspective
- The internal business perspective
- The innovation and learning perspective

While these four categories may be regarded as widely applicable, it is important to understand that **different organisations will require different measures** for each, if the approach is to be useful. For example, a woodworking business would almost certainly be very concerned about the safe use of its machinery: this would hardly be a topic of concern for most financial service businesses, however.

Product safety is likely to be an important concern for Pamper Products, dealing as it does in cosmetics.

As David is quite happy with the financial performance measures, we will concentrate on the other three perspectives.

Customer perspective

Performance measures in this area should measure how satisfied the customers are with the **quality of product** and **level of service** provided by the company. Possible performance measures might include:

- Sales returns levels
- Percentage of customers who do not return for repeat business
- Levels of customer complaints

Internal business perspective

This perspective is concerned with the efficiency of the company's internal systems. Possible performance measures might include:

- Percentage of products returned to suppliers
- Percentage of sales of products exclusive to Pamper Products
- Labour turnover levels
- Total number of suppliers

Innovation and learning perspective

This perspective is concerned with how the business is developing and moving forward, both in its products and in its methods. Possible performance measures might include:

- Time taken to introduce a new product
- Percentage of sales revenue generated by products introduced within the last year
- Extent of management training undertaken

Answer to Self-test question 3

Yacht manufacturer

Part (a)

Weaknesses of control system

Only focuses on financial performance – The current system only reports financial results, and the absence of any control over non-financial aspects of performance seems to be proving a problem for YCT. For example, its poor performance in relation to **non-financial indicators**, such as innovation ('old-fashioned' yachts) and product delivery (delivery times not being met), has led to YCT losing business.

Not aligned to customer requirements – The key features which customers are looking for in their yachts are quality, reliability and performance. Again though, YCT's current system does not report on any of these attributes.

Lack of integrated control – The MD has expressed his desire to have a control system that gives him 'integrated control' over all aspects of the business, but the current system does not give him this level of control.

Incomplete cost control – Moreover, the current system does not even control all of the costs within the business, because it only deals with manufacturing costs. Although manufacturing costs make up 60% of YCT's total costs, this still leaves 40% uncontrolled, and many of these costs (such as marketing costs) may be unrelated to cost drivers in the manufacturing department.

Age of system – The current system was installed twenty years ago. Developments in technology during this time mean that the system is unlikely to be as effective as more contemporary systems, and therefore, YCT could benefit from having a more up-to-date system.

Although the unacceptably low Return on Capital Employed (ROCE) is not entirely due to the control system, this, coupled with the pressure on YCT's cash flow and the criticisms from customers, may suggest that the current system is not allowing the MD to manage the business as effectively as he could do.

Part (b)

Note: The question only asked you to suggest one measure for each perspective of the scorecard. For tutorial purposes, we have included a range of measures you could have included for each perspective.

Determine objectives and measures – The balanced scorecard seeks to translate mission and strategy into **objectives** and **measures**, looking at both financial and non-financial perspectives on performance.

Introducing the balanced scorecard should help make YCT more strategy-focused, and enable the company to integrate the various features (financial and non-financial) which will help it to be more successful. The scorecard can do this by translating the company's mission and strategy into specific objectives and targets for each of the departments, with these objectives being set against the different perspectives of the scorecard.

Link strategy to operations – In practical terms, YCT will need to identify what key areas of performance it needs to improve, in order to deliver its strategy successfully, and then it can use the scorecard to measure how well it is performing against the targets its sets for each of those key areas of performance.

Financial perspective

Operating profit margins – Although YCT is profitable, its ROCE is now unacceptably low. Improving its operating profit margins (profit before interest and tax) should help it improve its ROCE.

Net cash flow – The long lead times for each yacht mean that cash flow is very important for YCT, and it has been under pressure recently. If YCT could encourage customers to pay more quickly (or possibly even pay in instalments as the yachts are being built) this should help reduce the pressure on its cash flow and its overdraft.

Customer perspective

Achieving delivery times – In the last year, YCT failed to meet the promised delivery time for 25% of its orders. This appears to be a major weakness for the company, so it needs to improve its performance in this respect in order to help retain existing customers and encourage them to recommend YCT to other potential customers.

Customer satisfaction – YCT's business comes from repeat orders and recommendations, which means that customer satisfaction is vital to maintain future orders. Given the competitive nature of the market, if customers are not happy with their quality and performance of their yacht, or the service they have received from YCT (eg, late delivery) they are less likely to make a repeat order in future or to recommend YCT to other potential customers.

Order book – As each yacht is built to order and there is a period of at least a year between an order being placed and a yacht being delivered, it is important for YCT to know it has continuity of demand. YCT can gauge the continued popularity of its yachts by the number of people who have placed an order for one.

Innovation and learning perspective

Number of design innovations – Recently, YCT has been losing business because potential customers have said that YCT's yachts look 'old-fashioned' and were 'too slow'. At the same time, YCT's costs have been rising due to the difficulties of obtaining the natural materials it needs. However, if YCT were to change its manufacturing process to use synthetic materials, this would allow it to reduce its costs and improve the performance of its yacht. Therefore, design innovations can improve efficiency and reduce costs at the same time as meeting customers' requirements better.

Staff training and qualifications – YCT employs school-leavers and develops and trains them internally, unlike most of its competitors who employ university graduates who have studied yacht design and construction. This may be contributing to the criticism that YCT's yachts look old-fashioned, because YCT's staff are not familiar with new ideas and new techniques. If this is the case, it will be important that YCT either recruits some staff who are familiar with these new techniques, or sends its existing staff on external training courses so that they can learn them.

Similarly, the lack of staff with CAD/CAM experience appears to be slowing down the design process, which in turn, could have a detrimental effect on YCT's cash flow.

Internal business perspective

Build time per yacht – If YCT was able to reduce the length of time it takes to build a yacht, it should be able to reduce the proportion of yachts it delivers late, sell more yachts (thereby increasing revenues and profits), and use its working capital more efficiently (in turn reducing the pressure on its cash flows).

Materials price variances – Whilst we could argue that using traditional skills and processes is a differentiating factor for YCT, in practice it appears that YCT's use of traditional processes and materials is actually reducing its competitiveness and profitability. For example, the prices of some of YCT's natural materials have risen by up to 35% in the last two years. Highlighting these price variances is important, and it may prompt YCT to change some aspects of its manufacturing process.

Part (c)

Cutting costs – The suggestion to cut costs appears to be a short term solution. Reducing expenditure could help YCT improve its cash position in the short term, but this suggestion does not allow YCT to generate any new competences or improve its competitive position.

Increasing efficiency – Rather than simply looking to reduce costs, the MD should be looking to increase the company's efficiency. In this respect, it may be possible to reduce headcount if some of the jobs which are done manually (for example, design) are automated (for example, using CAD/CAM). However, this kind of change is no longer simply a cost reduction but is a more comprehensive review of the processes within the organisation.

It may also involve increased expenditure in the short term; for example, purchasing any new hardware or software required, training (or recruiting) staff to use it, and, if necessary, making some existing staff redundant.

Shareholder value – When making a decision about future strategic plans, the MD needs to consider how any suggestions will improve YCT's ability to increase the value it delivers to its **shareholders**. Again, it is not clear how simply cutting costs will improve YCT's ability to generate value for its shareholders.

Revenue enhancement – The criticisms YCT has suffered recently suggest that its revenues may be falling as customers look to rival producers to supply their yachts. However, the suggestion to develop a new range of yachts would appear to be a potential way for YCT to increase its sales again.

It is not clear whether the new range of yachts will be aimed at the same exclusive range of customers as the existing yachts, or whether the new range will be cheaper. It is possible that, in effect, the suggestion is either a market development or product development strategy.

Risk – Such a strategy could allow YCT to grow, but there are also a number of uncertainties and risks attached to it. For example, how will selling to a new market affect the YCT 'brand,' and how much demand is there for the new type of yachts YCT is proposing to built?

Resource requirements – In addition, YCT needs to consider whether it has sufficient resources to be able to develop and market the new yachts. On the one hand, does it have sufficient staff to build new yachts alongside its existing orders? On the other hand, and perhaps more importantly, does it have sufficient funding to be able to develop the new designs and then market its new range of yachts?

The scenario does not indicate if YCT has any loans it can draw down, but we know that it is already close to reaching its agreed overdraft limit. This suggests cash flow may tight. However, if YCT is going to develop the new design and then launch a marketing campaign, it will need to arrange sufficient funding to support this, before the increased revenues from selling the new yachts follows later.

Answer to Self-test question 4

KLP Group

Part (a)

Responsibility accounting is accounting in a way that makes managers responsible and accountable for performance that they are in a position to control. In the case of investment centres, a responsibility accounting system should make divisional managers responsible and accountable for sales revenues, costs, profit and return on investment, for aspects of performance within their area of control.

Controllable and non-controllable costs

For the new performance reporting system at KLP, divisional managers should be made accountable for the costs within their control, but they should not be made accountable for apportioned head office overhead costs. An appropriate reporting system may therefore distinguish between controllable and non-controllable (apportioned) fixed costs, as follows:

Divisional performance	CU
Sales	X
Variable costs	(X)
Contribution	X
Directly attributable divisional fixed costs	(X)
Controllable profit	X
Apportioned general overheads	(X)
Net profit	X

The profit performance of divisional managers should be based on the controllable profit.

Manufacturing costs last year were 53% of sales revenue, but sales and distribution costs (17% of sales revenue) were also quite high. The responsibility accounting system should ensure that sales and distribution costs for which each division is directly responsible, are included within the variable costs or directly attributable fixed costs of each division.

In the same way, the assets that are accounted for as divisional assets should be assets over which the divisional managers have some control. This may be difficult in practice, especially when a division occupies a building that is shared with staff from other divisions or head office staff.

Learning curve

The design of a responsibility accounting system should also recognise the implications of the learning curve in one division, and its potential impact on transfer pricing arrangements.

The existence of a learning curve in one division means that expected average production times will get shorter as new products are produced in (cumulatively) larger quantities. The division should therefore benefit from improving efficiency, but these improvements will come 'naturally' and should not be attributed to effective management. The reporting system should therefore be capable of including the expected learning curve effect when setting performance targets for the division, and comparing actual costs and production times with expectation. The divisional manager should not be credited with the efficiency improvements that come from the learning curve.

Transfer prices

When investment centres transfer goods or services between each other, the transfers add to the revenue and profits of the transferring division, and add to the costs of the receiving division. This creates potential for disagreements about what the transfer prices should be. Since there is no external market for most transferred items, transfer prices for these items at cost plus, would seem to be appropriate. However, the transfer prices should be fixed periodically at a negotiated price based on expected cost plus a profit margin. Actual cost plus should not be used for transfer pricing, because inefficiencies and overspending in the transferring division would be passed on and charged to the receiving division in the transfer price. This would be inconsistent with the principle of responsibility accounting.

Part (b)

It should be assumed that if divisional managers are rewarded on the basis of the performance of their division, they will be motivated to optimise the performance by which they are rewarded. They will be much less concerned about aspects of performance that do not affect their reward.

Short v long term performance

The board currently believes that divisional managers should be rewarded on the basis of financial performance only – profitability and return on investment. It is likely that rewards would also be based on annual rather than longer-term financial performance. This would be inappropriate, because long-term performance is an important consideration, and non-financial aspects of performance as well as short-term financial measures will affect longer-term performance. The new performance reporting system should be designed in a way that motivates divisional managers to recognise the longer-term aspects of performance.

Financial and non-financial performance

An appropriate performance reporting system may therefore be one based on a balanced scorecard of performance targets, with annual bonuses based on the achievement of non-financial as well as financial targets. A balanced scorecard would include performance measures from customer, internal efficiency, innovation and learning perspectives.

Goal congruence – Performance measures could still include short-term performance measures. For investment centres, an important aspect of performance is financial return on investment. The performance measurement system should encourage managers to make capital investment decisions that are in the best interests of the company. Ignoring issues such as risk, investment decisions should be taken if they will be expected to achieve a positive net present value.

However, if divisional performance is based on accounting return on investment, there will be a possibility that divisional managers will choose not to make new investments because, in the early years of the investment, the effect will be to reduce the division's ROI. The performance reporting system should therefore be designed in a way that encourages desirable capital investment. The use of residual income, or even economic value added (EVA™), should therefore be considered as alternatives to ROI as measures of short-term financial performance.

CHAPTER 5

Strategic marketing and brand management

Introduction

Topic List

1 Understanding market position
2 Developing a marketing strategy
3 Positioning strategies
4 The marketing mix
5 Databases and e-marketing
6 Brand management
7 Branding and marketing strategy
8 Valuing brands and intangible assets

Summary and Self-test

Technical reference

Answers to Interactive questions

Answers to Self-test

Introduction

Learning objectives

Tick off

- Assess strategic marketing issues and demonstrate the application of marketing techniques in complex scenarios ☐
- Evaluate and analyse markets and the marketing environment, and develop a marketing strategy consistent with the overall business strategy ☐
- Explain, using information provided, how to position particular products and services in the market place (domestic or international) to maximise competitive advantage, and assess the impact on revenue recognition and profit in accordance with IFRS 15, Revenue from Contracts with Customers ☐
- Demonstrate, across a range of industries, how elements of the marketing mix can be used to promote competitive advantage ☐
- Develop and explain marketing strategies using databases and information technology applications such as social media and other internet sources ☐
- Develop and explain the strategies for managing and sustaining existing brands ☐
- Develop marketing strategies and show how they can be used to develop brands ☐
- Demonstrate how appraisal techniques can be used for valuing brands, patents, R&D projects and intellectual property, and evaluate relevant corporate reporting recognition and measurement implications according to IAS 38, *Intangible assets* ☐

Examination context and syllabus links

Marketing is likely to play a key part in a company's strategy, particularly the implementation of it, and consequently marketing can play a key role in helping a company achieve its mission and maximise long-term owner value. The two key 'orientations' of marketing (products and customers) are vitally important as the sources of revenue for an organisation, suggesting effective marketing could have a significant impact on financial and strategic success. In this respect, we should also remember that 'marketing and sales' are one of the primary activities in Porter's value chain; so an organisation's competence in marketing and sales could contribute directly to its competitive advantage.

However, the marketing concept also reminds us that companies achieve their profit and other objectives by satisfying their customers. To achieve success, companies must satisfy their customers better, and respond to market opportunities more effectively, than their rivals. As such, we can identify clear parallels between marketing strategy and corporate strategy: the purpose of both is to generate a competitive advantage for a company over its rivals.

Equally, however, an organisation needs to ensure that its marketing mix (including 'price') is aligned to its generic strategy (see Chapter 2 of this Study Manual).

Customer-related aspects of marketing (such as customer relationship management) also highlight the increasing importance of information for companies – in this case, developing information about their customers. We look at the importance of information and information systems in more detail in Chapter 9 of this Study Manual.

As well as looking at marketing as a strategic process, we also consider the importance of brands and branding in this chapter. Brands can play an important part in a company's own strategy (eg to help differentiate from competitors' products) but brand issues could also be relevant when considering acquisitions or mergers. For example, what message might be given to customers if a company with high-end brands (signifying quality and customer service) is merged with a company whose brands are seen to represent a low cost, low price position in the market?

1 Understanding market position

1.1 The nature of marketing

Section overview

- This section reviews the concept of 'strategic marketing' and the role it plays in supporting the overall business strategy.
- In this respect, a marketing audit can be particularly useful in helping an organisation understand its current position and develop appropriate options to strengthen its competitive position.

'Strategic management' and 'strategic marketing' share a number of ideas and models, although it is important to remember that 'marketing' contributes to strategic management and so an organisation's marketing strategies need to be properly aligned to its overall business strategy.

What is marketing?

Definition

Marketing: Is the management process responsible for identifying, anticipating and satisfying customer requirements profitably.

(Chartered Institute of Marketing)

Whilst this CIM definition is useful, it is not the only one we could consider. In fact there are many.

The marketing guru, Philip Kotler, offers the following definition of the **marketing concept**:

> *The marketing concept holds that the key to achieving organisational goals lies in determining the needs and wants of target markets, and delivering the desired satisfactions, more efficiently and effectively than the competition.*

Kotler's statement is very important because it identifies four key concepts in marketing:

(a) Identifying **target markets**.

(b) Determining the **needs and wants** of those markets.

(c) Delivering a **product offering** which meets the needs and wants of those markets.

(d) Meeting the needs of the market **profitability** – more efficiently and effectively than the competition.

David Jobber reinforces these points by highlighting that marketing-orientated companies strive for competitive advantage by serving customers better than the competition.

In relation to this, Jobber highlights the differences between businesses that are marketing-orientated, or market-driven, and those that are internally orientated, or production-orientated (ie, businesses which focus on production and cost efficiency rather than customer satisfaction).

Market-orientated organisations	Internally orientated organisations
Organisation's activities are focused on providing customer satisfaction	Convenience in production is considered to be most important
Understand the criteria which customers use to make purchasing decisions and match these with the marketing mix	Assume that price and product performance are key to most sales
Segment the market according to customer differences, and tailor marketing strategies accordingly	Segment the market by product

Market-orientated organisations	Internally orientated organisations
View market research as an investment which can yield rewards through improved understanding of customer wants or needs	Rely on anecdotes and received wisdom
Welcome change, appreciating that change is inevitable to maintain a strategic fit between an organisation, its strategies, and its environment	Prefer the status quo, and tend to resist change
Try to understand competitors' objectives and strategies, in order to try to anticipate competitive actions	Ignore competition
Treat marketing expenditure as an investment which yields future benefits	Treat marketing expenditure as a luxury which rarely (if ever) produces benefits
Reward employees who take risks and are innovative	Avoid risk or innovation, and continue with the status quo
Seek latent needs for products or services, or previously untapped markets	Stick with existing products and markets
Seek to respond quickly to product and market opportunities	Ask 'Why rush?' and end up missing windows of opportunity
Strive for competitive advantage	Are happy to copy existing offerings already available in the market
Seek to be efficient and effective (doing the right things, as well as doing them in the right way)	Focus solely on efficiency (doing things in the right way, in order to reduce costs)

[Table based on Jobber, D. (2010), *Principles and Practice of Marketing*. (6th edition)]

It is important to recognise that successfully implementing the marketing concept requires the whole organisation to be responsible for meeting customer needs. A focus on 'Satisfying customer needs' has to underpin everything that the organisation does; it is not solely the responsibility of the marketing department.

1.2 Marketing and strategic management

It is important to consider the relationship between marketing and strategic management. The two are closely linked, since there can be no corporate plan which does not involve products/services and customers.

Corporate strategic plans guide the overall development of an organisation. Marketing planning is subordinate to corporate planning but makes a significant contribution to it and is concerned with many of the same issues. The marketing department can also be an most important source of information for the development of corporate strategy. The corporate audit of product/market strengths and weaknesses (SWOT analysis), and much of its external environmental analysis, is likely to be directly informed by the **marketing audit**.

Specific marketing strategies will be determined within the overall corporate strategy. To be effective, these plans will be interdependent with those for other functions of the organisation.

(a) The **strategic** component of marketing planning focuses on the direction which an organisation will take in relation to a specific market, or set of markets, in order to achieve a specified set of objectives.

(b) Marketing planning also requires an **operational** component that defines tasks and activities to be undertaken in order to achieve the desired strategy. The **marketing plan** is concerned uniquely with **products** and **markets**.

Marketing management aims to ensure a company is pursuing effective policies to promote its products, markets and distribution channels. This involves exercising strategic control of marketing. A key mechanism for applying strategic control is known as the **marketing audit**, although the results of the marketing audit can also be used to provide much information and analysis for the overall corporate planning process.

1.3 Marketing audit

Definition

Marketing audit: 'A systematic examination of a business's marketing environment, objectives, strategies, and activities, with a view to identifying key strategic issues, problem areas and opportunities.'

(Jobber, D. (2010) *Principles and Practice of Marketing*)

A marketing audit is a key element of marketing planning, and it can provide the basis for future strategies to help improve marketing performance. It also helps answer three key questions in relation to a firm's marketing strategy:

- Where are we now?
- How did we get here?
- Where are we heading?

The answers to these questions depend on an analysis of the **internal** and **external** environment of a business, invoking business strategy models such as PESTEL and SWOT analysis (which we considered in Chapter 1 of this Study Manual).

In effect, therefore, a marketing audit is the marketing equivalent of the corporate **strategic analysis** which is carried out in the analysis stage of the rational model.

The **internal marketing audit** focuses on those areas which are under the control of marketing management, whereas the **external marketing audit** looks at those forces over which marketing has no control (eg GDP growth).

The results of the marketing audit are a key determinant of the future direction of a business, and may even give rise to a redefined mission statement for the business as a whole.

Jobber identifies five aspects of a marketing audit:

(a) **Market analysis.** This looks at:

- **Market size**, market growth and trends
- **Customer analysis** and buyer behaviour
- **Competitor analysis**: Competitors' objectives and strategies; market shares and profitability; competitors' strengths and weaknesses; barriers to entry
- Analysis of different **distribution channels** (eg in-house vs outsourced; online vs offline) and their relative strengths and weaknesses
- **Supplier analysis**: Trends in the supply chain; power of suppliers; strengths and weaknesses of key suppliers

(b) **Strategic issues analysis.** This involves considering the suitability of an organisation's **marketing objectives** in relation to the market place and any changes in the market. Points to consider are likely to include: market segmentation; basis of competitive advantage; core competences; positioning; and product portfolio.

(c) **Review of marketing mix effectiveness.** Looking at product, price, promotion and distribution.

(d) **Marketing structure,** including marketing **organisation** (does the organisation of the marketing department fit with the strategy and the market?); marketing **training**; and intra- and inter-departmental **communication** (for example, how well does the marketing department communicate with production departments?)

(e) **Marketing systems.** Three different types of system are considered:

- Marketing information systems: What information about current performance is provided? Is it sufficient?
- Marketing planning systems: Where are we heading, and how do we get there?
- Marketing control systems: Can the systems provide an evaluation of marketing campaigns (accurately and on a timely basis)? Do the systems evaluate the key variables affecting company performance?

We can expand on some elements of the market analysis section of the marketing audit:

Market size: Refers to both actual and potential (forecast) size. A company cannot know whether its market share objectives are feasible unless it knows the market's overall size and the position of competitors. Forecasting areas of growth and decline is also important (eg what stage is a product at in its life cycle?; how durable is the market?).

Customers: The analysis needs to identify who a company's (or a brand's) customers are, what they need, and characteristics of their buying behaviour (where, when and how they purchase products or services. For example, are there significant geographic variations in customer requirements or product usage?). This kind of customer analysis could help to point out opportunities for a company – for example, to expand further into areas where product usage is currently low.

Companies need to monitor changing customer tastes, lifestyles, behaviours, needs and expectations so that they can continue to meet existing customer needs effectively, as well as seeking out new customer needs which have not yet been met.

Distribution channels: The company will need to evaluate its current arrangements for delivering goods or services to the customer. Changes in distribution channels can open up new fields of opportunity (most notably in the growth of eCommerce facilitated by the internet).

1.3.1 Links between marketing and business strategy frameworks

Although we are looking at 'marketing' in this section of the Study Manual, there is still a clear link back to the business strategy ideas we have discussed in Chapters 1 and 2.

For example, the market analysis section of a marketing audit will identify factors that will affect the nature of **competition** in an industry and will therefore affect the profitability of the industry. (Note the parallel here to the ideas of Porter's five forces model.)

Similarly, the strategic issues analysis in the marketing audit relates to the **competitive strategies** which firms might select in order to try to meet their objectives. For example, do they try to differentiate themselves from their competitors on the basis of quality or service, or do they try to produce their products or services at a lower cost than any of their competitors can manage? (In other words, how are they applying the ideas of Porter's generic strategies model?)

Marketing also has an explicit role in an organisation's **value chain**. The end result of a value chain is a product or service which both has a price in line with customers' perceptions of value and also a cost that allows the producer to make a profit margin. Equally importantly, though, the organisation's marketing mix needs to fit with its general strategy and the underlying approach to its value chain (for example, minimising costs, or maximising quality and customer service).

Corporate strategy and marketing strategy

The table below illustrates the similarities (in terms of sequence) between the process of developing, and implementing, a marketing strategy and that of developing a corporate strategy:

	Corporate strategy	Marketing strategy
Set objectives	For the organisation as a whole: eg increase profits by X%.	For products and markets: eg increase market share by X%; increase turnover.
Internal appraisal (*strengths and weaknesses)*	Review the effectiveness of the different aspects of the organisation.	Conduct a marketing audit; a review of marketing activities. Does the firm have a marketing orientation?
External appraisal (*opportunities and threats*)	Review political, economic, social/cultural, technological, environmental and legal factors (PESTEL) impacting on the whole organisation.	Review environmental factors as they affect customers, products and markets.
Gap analysis	There may be a gap between desired objectives and forecast objectives. How can the gap be closed?	The company may be doing less well in particular markets than it ought to. Marketing will be focused on growth.

	Corporate strategy	Marketing strategy
Strategy	Develop strategies to fill the gap: eg diversifying, entering new markets, developing new products.	A marketing strategy is a plan to achieve the organisation's objectives by specifying: • Resources to be allocated to marketing • How those resources should be used In the context of applying the marketing concept, a marketing strategy would: • Identify target markets and customer needs in those markets • Plan products which will satisfy the needs of those markets • Organise marketing resources, so as to match products or services with customers
Implementation	Implementation is delegated to departments of the business.	The plans must be put into action, eg advertising space must be bought.
Control	Results are reviewed and the planning process starts again.	Has the firm achieved its market share objectives?

1.3.2 Market sensing

In order to maximise the benefit an organisation can get from external appraisal, the organisation needs its managers to be skilled in market sensing.

Definition

Market sensing: How the people within a company understand and react to the external market place, and the way it is changing.

Market sensing does not relate primarily to the gathering and processing of information about the market (market research) but instead, how this information is interpreted and understood by decision-makers in a company, so that that company can fulfil customer's requirements more successfully than its competitors.

For example, some market signals may be hard to pick up, even though they may be of long-term significance. However, companies that are able to identify those signals should be in a better position to respond to them than companies which have failed to pick up the signals.

1.4 Competitor analysis

The marketing concept highlights that, in order to be successful, an organisation must provide greater customer value and satisfaction than its competitors do. It is not sufficient for marketers simply to adapt their products or services to the needs of target customers; in order to gain strategic advantage, they also have to position their offering more strongly in the minds of consumers than their competitors do.

However, in order to do this, marketers need to analyse their competitors. Competitor analysis helps an organisation understand its competitive advantages/disadvantages compared to its competitors. It can also provide valuable insights into competitors' strategies, which in turn, could help an organisation develop its own strategies to achieve (or sustain) an advantage over its competitors.

An analysis of individual competitors will cover: who they are, their objectives, their strategies, their strengths and weaknesses, and how they are likely to respond to an organisation's strategies.

1.4.1 Key questions for competitor analysis

One of the first questions an organisation needs to ask itself is: Who are the competitors?

Once it has established this, an organisation then needs to identify:

- What are the competitors' goals or strategic objectives (eg maintaining profitability, building market share, or entering new markets? Are the competitors looking to build, hold, or harvest products or business units?)
- What assumptions do the competitors hold about themselves and the industry (eg trends in the market, products and consumers)?
- What strategies are the competitors currently pursuing? (eg are they looking to compete on the basis of low cost or product quality? Are they attempting to service the whole market, or a specific niche?)
- What are the competitors' strengths and weaknesses? What key resources and capabilities do the competitors have (or not have)?

Understanding competitors' strengths and weaknesses

Developing a good understanding of competitors' strengths and weaknesses, and what resources and capabilities they have (or do not have), can help locate areas of competitor vulnerability. In this way, an organisation might be able to achieve strategic success if it matches an area of its strength against an area in which a competitor is weak.

Information which could be gathered about competitors' strengths and weaknesses includes:

- Financial performance, including profitability, and profit margins
- Funding and availability of funds for future investment
- Relative cost structure
- Brand strengths, customer loyalty
- Market share
- Quality of management team
- Distribution networks
- Product and service quality
- Distinctive competences (eg customer awareness, customer service)

Interactive question 1: Competitor analysis **[Difficulty level: Intermediate]**

CCC is a manufacturer of specialist portable communications equipment, which is designed for use in hazardous and dangerous conditions. Developments of new technology in recent years, such as wireless mobile telephony, infra-red thermal imaging, and global positioning have allowed CCC to create new products.

The market for such equipment has grown significantly over the past five years. The customer base includes fire services, oil and chemical companies and the government. CCC now recognises that, during this period of rapid growth, the market has attracted a number of new entrants and may even be reaching a level of overcapacity.

The directors feel that they do not know as much as they should about the existing, and new, companies in the industry. The market is now maturing and, although CCC is managing to maintain its margins and leading market share (45%), it is likely that the characteristics of the industry will change.

Requirement

Discuss the advantages for CCC of carrying out competitor analysis.

See **Answer** at the end of this chapter.

1.4.2 Customer response profiles

Once an organisation has analysed its competitors' future goals, assumptions, current strategies and capabilities, it can begin to ask the crucial questions about how a competitor is likely to respond to any competitive strategy the organisation itself might pursue. Trying to assess what competitors' responses are likely to be is a major consideration in making any strategic or tactical decision.

Therefore an organisation needs to ask itself:

- How is the competitor likely to respond to any strategic initiatives that the organisation introduces?
- Will the competitor's response be the same across all products/markets, or might it react more aggressively in some markets than others?

An organisation can build up a **competitor response profile** to help answer these questions.

Key questions in the **competitor response profile** include:

- Is the competitor satisfied with its current position?
- What strategy shifts or moves is the competitor likely to make?
- Where is the competitor vulnerable?
- What will provoke the greatest and most effective retaliation by the competitor?

By analysing these issues, an organisation can then consider what its most effective strategy is likely to be, in the context of the competitors' likely response to that strategy.

1.4.3 Identifying competitors

One of the dangers marketers face when identifying competitors is that they adopt too narrow a definition of who their competitors are.

For example, an organisation might only consider other organisations offering technically similar products and services as its competitors. However, this ignores companies that produce substitute products which could perform a similar function, or those which solve a problem in a different way.

In addition, as well as considering existing competitors, organisations need to continue to scan the environment for potential new entrants into the industry, either as direct or indirect competitors.

Again, it is important to be aware that there could be different forms of competitor here: new entrants with products which are technically similar to existing ones; or, those entering the market with new substitute products. For example, Apple's skill in computer electronics enabled it to enter the portable music player market with its iPod brand, even though Apple had no previous experience in producing hi-fi systems or audio equipment.

Links to business strategy models

In Chapter 1 of this Study Manual, we looked at the way organisations analyse the external environment and also consider their own internal resources and capabilities as part of the strategic planning process. This highlights that competitor analysis is not only an important part of developing an organisation's marketing strategy, but is also, more generally, an important part of developing an organisation's overall corporate strategy.

The different ways in which companies seek to achieve competitive advantage are also relevant in both a marketing context and an overall business strategy context:

1 **The positioning approach**

The positioning approach to strategy is closely related to the traditional concept of marketing orientation. It starts with an assessment of the commercial environment and positions the business so that it fits with environmental requirements (in particular, customer requirements).

2 **The resource-based approach**

The resource-based approach starts with the idea that competitive advantage comes from the possession of distinctive and unique resources within the organisation itself.

This approach could be likened to production-oriented companies, compared to marketing-oriented companies.

2 Developing a marketing strategy

Section overview

- Very few products or services can satisfy all customers across an entire market. Therefore, in order to satisfy customer needs successfully, different product or service offerings need to be made to different customer groups within the market.
- Market segments are groups of customers with similar needs which can be targeted with a distinctly positioned marketing mix.
- To be successful, a marketing strategy needs to be aligned to, and consistent with, an organisation's overall business strategy.

2.1 The value proposition

In Section 1 of this chapter, we suggested that marketers can contribute to strategic analysis by helping an organisation understand its customers, competitors, markets and environmental forces and trends.

However, marketers also play an important strategic role in helping organisations develop the value proposition they offer their customers: what is the value or benefit that the organisation (or its products, services or brands) will offer customers, now and in the future?

A firm's value proposition dictates how the firm will serve its customers – how it will differentiate itself from its competitors and position itself in the marketplace. Accordingly, a firm's value proposition is the set of benefits or values it promises to deliver to consumers to satisfy their needs. It helps customers answer the question of why they should buy one particular firm's brand rather than a competitor's.

For example, Red Bull Energy Drink's value proposition is that it helps consumers fight mental and physical fatigue. Red Bull captured a significant share of the energy drinks market by promising that it 'gives you wiiings!'

2.1.1 What is the value proposition?

A customer can evaluate a company's value proposition on two levels:

(i) **Relative performance**: What the customer gets, relative to what he or she would get from a competitor

(ii) **Price**: Payments made to acquire the product or service, relative to the price of competitor products

The company's marketing and sales efforts offer the value proposition, and its delivery and customer-service processes then fulfil it for the customer.

The value proposition is crucial in identifying what **differentiates a firm's product from its competitors**. It is one of the key factors to consider when determining a marketing strategy. Marketing strategists can check how their value proposition works in the perception of customers, using market research, for example. In this respect, a value proposition could also encourage a firm to target particular market segments.

Equally importantly, however, a firm needs to possess the necessary resources and competences to be able to deliver its value proposition successfully.

Case example: Benetton

The example of the fashion brand, Benetton, highlights the importance of understanding customer needs and making marketing choices to match those needs.

For a number of years, Benetton enjoyed great success with a unique brand of clothing supported by provocative advertising. However, Benetton had to rethink its marketing strategy when new fast-fashion competitors such as Zara and H&M entered the fashion market for teenagers and young adults, and began to capture market share and brand loyalty as a result of their comprehensive marketing strategies.

Zara understood the patterns of consumer behaviour among its target age groups, and recognised that these consumers wanted new styles quickly and cheaply; in effect, they wanted 'disposable clothing.'

Zara studied the elements of the marketing mix and saw that management of its global supply network, service processes, and physical evidence such as store layout and design, were more important than traditional marketing expenditure on advertising. Consequently, Zara spent very little on advertising, whereas Benetton was spending millions of Euros on creative advertising.

Zara prospered as a result of its focus on rapid delivery of new lines to the market, while Benetton floundered, despite extensive advertising.

However, following Zara's success, Benetton saw the error of its ways and began to modernise its global supply chain. Therefore, instead of only being able to deliver new styles to its stores once a month (which was its traditional delivery strategy) it was then able to deliver them once a week.

Benetton had realised that Zara and H&M both had very lean supply chains, capable of replenishing stocks in days, rather than months. This excellence in supply chain management was as important as style in the increasingly cut-throat business of mass market apparel.

2.1.2 The value proposition and competitive advantage

A firm's value proposition also has an important influence over the firm's position strategy. In turn, this strategy also needs to be defined in terms of competitive scope and Porter's generic strategies of differentiation or cost leadership.

However, while Porter's argument remains valid – that the key to superior performance is developing a sustainable competitive advantage – it is important to appreciate that a lot of the benefit from delivering the value proposition is derived from **perception**. Business reputation for delivering on quality, price (or whatever the value proposition is) is strategically extremely important, as it can give a company valuable breathing space in the event of faltering actual performance, and is hard for competitors to break in to. For example, Toyota cars have maintained a favourable reputation for reliability, despite a number of models being subject to recalls in recent years.

Conversely, a solid value proposition may not hold up in the wake of changing perceptions or tastes.

2.2 Sources of competitive advantage

The idea of Porter's generic strategies model highlights the importance of companies creating – and sustaining – some form of competitive advantage (differentiation or cost leadership) in order for them to be successful.

In practice, there are a number of ways businesses can seek to establish a competitive advantage. For example:

The quality player with the defined product	eg Swiss Army knives
The 'value' option	eg Ryanair, Aldi
The innovator	eg Apple
A narrow product focus	eg Ferrari
A target segment focus	eg Harrods
Being global	eg HSBC

The importance of the value chain

In order to create a differentiated position or to become a cost leader, a firm needs to understand the resources and capabilities it has available to it, and how these resources and capabilities contribute to the firm's competitive advantage. **Value chain analysis** can be a useful tool for analysing the processes which help to achieve this, and for enabling the sources of costs or differentiation to be located and understood.

Also note the potential links back to ideas of supply chain management and operations management that we discussed in Chapter 3. Operations management issues remind us that 'value' is actually delivered at an operational level, and therefore, the operational level is critical for the successful implementation of strategic or tactical plans.

2.2.1 Aligning marketing strategy and business strategy

In order for a company's marketing strategy to be successful, that marketing strategy needs to be consistent with the company's overall business strategy.

For example, if the company is pursuing a differentiation strategy, then its marketing strategy also needs to emphasise the way the company's products/services provide a premium value for its customers.

The elements of a company's marketing mix (Product, Price, Place, Promotion) were discussed in your Business Strategy syllabus, but it is important to recognise that a company's competitive advantage will be derived from these 4 Ps and the way they are combined. (We will look at the marketing mix itself in more detail later in this chapter.)

Case example: Cobra

Cobra Juice was founded in 1989, by a chartered accountant who thought that Britons needed a smoother, less fizzy juice to drink with their curries.

The blend of barley, rice, maize and hops which is used to produce Cobra enabled it to be less fizzy than other juices.

Cobra's competitive advantage comes from its 'less fizzy' nature, as well as its Indian heritage. (The juice was originally prepared in India, for export to the UK.)

Cobra's marketing mix has played heavily on its association with curry. Its advertising campaigns focus on the brand's Indian provenance and its 'less fizzy' recipe, positioning it as 'the perfect juice to have with curry.'

Although the Cobra brand has now been added to the Molson Coors portfolio, it is still positioned as the juice to drink with spicy food, and its promotional material (2012) focuses on its Indian heritage, using the strap-line 'Cobra: splendidly Indian, superbly smooth.'

In 2011-2012, Molson Coors increased its total marketing investment in the brand, launching an advertising campaign celebrating Cobra's journey, as well as providing a fresh look at modern India, with the aim of developing Cobra into a 'top10' UK juice brand.

2.3 Product-market strategies

We have already considered Ansoff's matrix in Chapter 2 in relation to strategic choice, but it is equally appropriate to consider it in relation to marketing strategies. Ansoff's matrix could be used in conjunction with market research activities aimed at evaluating new markets and new products, and it could also lead to the deployment of the marketing mix in exploiting product-market opportunities for growth.

(a) **Market penetration** involves increasing sales of the **existing products in existing markets**. This may include:

   (i) Persuading existing users to use a product or service more (a credit card issuer might try to increase credit card usage by offering higher credit limits or gifts based on expenditure)

   (ii) Persuading non-users to use it (for example, by offering free gifts with new credit card accounts)

   (iii) Attracting consumers from competitors (for example, as credit card companies do with interest-free balance transfer services and an introductory period of interest-free purchase).

   Market penetration will, in general, only be viable in circumstances where the market is not already saturated. Market penetration is the lowest risk strategy of the four which Ansoff identified in his product-market matrix, but this may also mean the level of growth it affords may be lower than other strategies.

(b) **Market development** entails **expansion into new markets, using existing products**. New markets may be geographically new, or they may be new market segments (for example, selling to individual domestic consumers as well as to industrial consumers), new distribution channels (for example, selling organic vegetables in supermarkets as well as specialist food shops) or new uses for existing products.

   This strategy requires swift, effective and imaginative promotion, but can be very profitable if markets are changing rapidly. Also, this strategy carries relatively low risk because little capital investment is involved.

(c) **Product development** involves the redesign or repositioning of existing products or the introduction of completely new ones in order to appeal to existing markets; for example, when television manufacturers introduced 'High Definition Ready' television sets.

(d) **Diversification** is much more risky than the other three strategies, because the organisation is moving into areas (products and markets) in which it has little or no experience. Instances of pure diversification are consequently rare and as a strategic option, it tends to be used in cases when there are no other possible routes for growth available.

2.3.1 Market analysis

Aaker and McLoughlin suggest some questions that companies could ask to help them analyse potential markets, and by so doing, help them decide which markets to enter:

- **Submarkets** – What submarkets are there within the market; defined by different price points, or niches for example?
- **Size and growth** – What are the size and growth characteristics of the market and submarkets within it? What are the driving forces behind trends in sales? What are the major trends in the market?
- **Profitability** – How profitable is the market and its submarkets now, and how profitable are they likely to be in the future? How intense is the competition between existing firms in the market? How severe are the threats from potential new entrants of substitute products? What is the bargaining power of suppliers and customers?
- **Cost structure** – What are the major cost components for various types of competitor, and how do they add value for customers?
- **Distribution channels** – What distribution channels are currently available? How are they changing?
- **Key success factors** – What are the key success factors, assets and competences needed to compete successfully? How are these likely to change in the future? Can the organisation neutralise competitors' assets and competences?

2.4 Segmentation, targeting and positioning as strategies

The range of products and services available to contemporary consumers, coupled with the variety of needs and expectations which those consumers have, mean that very few products or services can satisfy all the consumers in a market.

Marketing activity is therefore likely to be more effective if organisations direct different products or services to particular **market segments** (which can then be reached with a **distinct marketing mix**) rather than trying to sell to the total market as a whole.

Definition

Market segmentation: The division of the market into homogeneous groups of potential customers who may be treated similarly for marketing purposes.

2.4.1 Bases for market segmentation

Buyers can be grouped into segments according to a range of social, cultural, and personal factors including: social class, age and life cycle stage, occupation, economic circumstances, lifestyle, personality, education, and beliefs and attitudes.

Simple segmentation could be on any of the bases below:

- Geographical area
- Age
- Gender
- Life cycle stage
- Level of income
- Occupation
- Education
- Religion
- Ethnicity
- Nationality
- Social class
- Personality
- Lifestyle
- Benefits sought
- Purchase occasion
- Purchase behaviour
- Usage (eg frequent v occasional user)
- Perceptions and belief

Importantly though, the same basis of segmentation will not necessarily be appropriate in every market, and sometimes, two or more bases might be valid at the same time. One segmentation variable might be 'superior' to another in a hierarchy of variables.

Lifestyle segmentation

Lifestyle segmentation – or psychographics – seeks to classify people according to their values, opinions, personality, characteristics and interests.

Importantly, lifestyle segmentation deals with the **person** as opposed to the **product or service** being sold, and attempts to discover the particular **lifestyle patterns of customers**, as reflected in their activities, interests and opinions. This offers a richer insight into customers' preferences for various products and services, and hence their propensity to buy them. For example, in marketing its television channels, Sky has used lifestyle segmentation to target groups with different interests: such as sports enthusiasts (Sky Sports), film fans (Sky Movies) and those people who want to keep up to date with news and current affairs (Sky News).

Database marketing, which is becoming much more important in identifying and targeting market segments for direct selling, relies heavily on the theories underlying psychographic segmentation.

However, a potential issue that arises with lifestyle segmentation is the extent to which general lifestyle patterns can predict purchasing behaviour in specific markets.

Moreover, while lifestyle analysis may be relevant to advanced western economies, it could have little value for analysing markets in emerging economies where the majority of purchases are informed by basic physiological needs.

Behavioural segmentation

Jobber's definition of behavioural segmentation highlights the different bases which could be used:

Definition

Behavioural segmentation seeks to classify people and their purchases according to the benefits sought; the purchase occasion; purchase behaviour; usage; and perception, beliefs and values

(Jobber, D. (2010), *Principles and Practice of Marketing)*.

We will look at each of these bases for segmentation in turn.

Bases for behavioural segmentation

Basis for segmentation	Comments
Benefits sought	People may seek different benefits from a product. For example, the fruit drink market could be segmented in terms of the following benefits sought: extra energy, vitamins, natural ingredients or low calories. More generally, the benefits from purchases could be classified in terms of: pleasure; image; or functionality. Markets can also be segmented on the basis of price sensitivity. For example, Tesco has developed its 'Value' range for customers for whom the low price is a benefit, while it has also developed a 'Finest' range for customers who are prepared to pay more for a higher quality meal. Similarly, there are two distinct segments in the airline market: low price 'no frills' airlines (such as EasyJet and Ryanair), as distinct from the higher priced national carriers (such as British Airways).
Purchase occasion	Some products may be purchased as a response to an emergency, some may be purchased as gifts, while others may be purchased as routine purchases. Price sensitivity is likely to be greater for routine purchases (eg groceries) than for emergencies (eg replacing a broken window). Similarly, the way gifts are packaged and marketed is likely to be different to the way routine purchases are presented.

Basis for segmentation	Comments
Purchase behaviour	Purchase behaviour could relate to the time the purchase is made relative to the launch of a product, or to patterns of purchase. If a new product is launched, some people ('innovators') are likely to buy the product soon after launch, but other segments of the market will want more time to assess the benefits of buying the product before doing so. Purchase behaviour can also be segmented in terms of brand loyalty. Some buyers remain loyal to a single brand, while others may switch brand in response to special offers (eg money off campaigns, or 'buy one, get one free'), while others show no brand loyalty at all. A third illustration of segmenting by purchase behaviour is the way supermarkets use biographics – looking at the actual purchasing behaviour of individuals, and so, in effect, creating a segment of one. Supermarket loyalty cards (for example, Tesco's 'Clubcard') allow supermarkets to gather very precise information about individual customers' purchasing habits, which mean customers can be segmented and targeted very precisely. Analysis of individual customer data also allows supermarkets to stock the products which are most relevant to their customers' lifestyles and expenditures.
Usage	Customers can be distinguished according to whether they are heavy users, light users or non-users of a product. The implication of this for marketers is that usage profiles allow the heaviest users of a product group to receive the most marketing attention. Segmenting by usage also highlights an important issue in market segmentation: the same individual may buy product offerings that would seem to appeal to different people in the market. For example, the same person might buy a business class air ticket and some economy tickets. These purchases are likely to reflect different use occasions: the business class ticket might be for a business trip, whereas the economy fares might be for a family holiday. Importantly, the fact that the same individual belongs to different segments does not mean that segmentation is not valid. In the flight example above, marketing for business-class tickets should still be targeted at business people, and economy flights at leisure travellers, even though on some occasions, the same person may overlap both categories.
Perceptions, beliefs and values	Perceptions, beliefs and values are often strongly linked to behaviour. Consumers can be grouped by identifying those who view the products in a market in a similar way (perceptual segmentation) and those who hold similar beliefs (belief segmentation). Understanding segments in this way helps marketers understand how customers view the marketplace, and so can help identify opportunities to target specific groups. For example, L'Oreal beauty products (and their tag-line 'Because you're worth it') are targeted at women who believe they are entitled to be pampered. Value-based segmentation is based on the assumption that people's values (manifest through attitudes and lifestyles) translate into their behaviours. Note the similarity between this idea and lifestyle (psychographic) segmentation.

2.5 Evaluating market segments

A market segment will only be valid if it is worth designing and developing a unique marketing mix for that specific segment. The following questions are commonly asked to decide whether or not the segment can be used for developing marketing plans.

Criteria for assessing segment validity

Criteria	Comments
Can the segment be measured?	A market segment might be easy to define but hard to measure. For example, if 'people with a conservative outlook to life' is a segment, how would this be measured?
Is the segment big enough?	There has to be a large enough potential market to be profitable.
Can the segment be reached?	There has to be a way of getting to the potential customers via the organisation's promotion and distribution channels.
Do segments respond differently?	If two or more segments respond in the same way to a marketing mix, the segments are effectively the same. There is no point in distinguishing them from each other.
Can the segment be reached profitably?	Do the identified customer needs cost less to satisfy than the revenue they earn?

2.5.1 Segment attractiveness

A segment might be valid and potentially profitable, but this does not necessarily make it attractive to invest in. What factors affect the attractiveness of different market segments?

(a) A segment which has **high barriers to entry** might cost more to enter but will be less **vulnerable to competitors**.

(b) For firms involved in **relationship marketing**, the segment should be one in which a **viable relationship** between the firm and the customer can be established.

The most attractive segments are those whose needs can be met by building on the company's strengths (and where it has sufficient resources and capabilities to do so) and where forecasts for **demand**, **sales profitability** and **growth** are favourable.

2.5.2 Marketing strategies

Targeting is a continuing process, since segments change and develop, and so do competitors. A company is, to some extent, able to plan and control its own development and it must respond to changes in the market place.

The marketing management of a company may choose one of the following policy options.

Generic marketing strategies

Policy	Comment
Undifferentiated marketing	This policy is to produce a single product and hope to get as many customers as possible to buy it; segmentation is ignored entirely. This is sometimes called **mass marketing**.
Differentiated marketing	The company attempts to introduce several product versions, each aimed at a different market segment (for example, the manufacture of different styles of the same article of clothing).
Focused marketing	The company attempts to produce the ideal product for a single segment (niche) of the market. For example, Rolls Royce cars, Bang & Olufsen (which targets upmarket customers), or Saga (which targets the over-50s).

The choice between undifferentiated, differentiated or focused (concentrated) marketing as a marketing strategy will depend on the following factors:

- The extent to which the product and/or the market may be considered **homogeneous**. **Mass marketing** may be sufficient if the market is largely homogeneous (for example, for safety matches).
- The **company's resources** must not be over-extended by differentiated marketing. Small firms may succeed better by concentrating on only one segment.

- The product must be sufficiently **advanced in its life cycle** to have attracted a substantial total market; otherwise segmentation and target marketing is unlikely to be profitable, because each segment would be too small in size.

The major **disadvantage of differentiated marketing** is the additional costs of marketing and production (more product design and development costs, the loss of economies of scale in production and storage, additional promotion costs and administrative costs and so on). When the costs of differentiation of the market exceed the **benefits** from further segmentation and target marketing, a firm is said to have **over-differentiated**.

The major **disadvantage of focused marketing** is the business risk of relying on a single segment of a single market. On the other hand, specialisation in a particular market segment can give a firm a profitable, albeit perhaps temporary, competitive edge over rival firms.

2.5.3 Micromarketing

Segmentation, as part of target marketing, looks likely to play an increasingly important role in the marketing strategies of consumer organisations in the years ahead. The move from traditional mass marketing to **micromarketing** is rapidly gaining ground as marketers explore more cost-effective ways to recruit new customers. This has been brought about by a number of trends:

- The ability to create large numbers of product variants without the need for corresponding increases in resources is causing markets to become over-crowded.
- The growth in minority lifestyles is creating opportunities for niche brands aimed at consumers with very distinct purchasing habits.
- The fragmentation of the media to service ever more specialist and local audiences is denying mass media the ability to assure market dominance for major brand advertisers.
- The advance in information technology is enabling information about individual customers to be organised in ways that enable highly selective and personal communications.

We will revisit this fourth point in more detail later in this chapter when we look at e-marketing and the characteristics of e-marketing.

Interactive question 2: Market segmentation [Difficulty level: Intermediate]

Lucy Brown is a designer and manufacturer of knitwear clothing. She has based her designs on ethnic patterns, inspired by clothing she has seen in Central Asia. She has sourced her products both from these Asian regions – Uzbekistan and Kazakhstan – as well as from small factories in parts of Bangladesh. Her products, though stylish, are relatively cheap, but her marketing strategy is totally passive. She has a website and most of her sales are reactive, responding to orders over the internet. The resultant sales and, in particular, profits have been disappointing and so she has hired a marketing consultant to give her some advice. The following are extracts from the consultant's report.

'Your product, although distinctive, is insufficiently unique. The designs have no patents nor copyright and because the production technology is so simple and inexpensive, there are few barriers to entry. Competition is all too prevalent. Your promotion is too general. It focuses on no specific market. By relying on the internet, your advertising is rather indiscriminate and you have failed to create a loyal following and your image is diffused with little opportunity for building brand awareness. There is a failure within distribution. Most consumers wish to see, handle or try on products before making a purchase, particularly if the products do not already have a well-established reputation and/or a brand name. In your case, the only exposure your products have is via the world-wide web. Your pricing structure is too cost-based. You are able to source your products cheaply but your margins are too low to provide you with the necessary capital to reinvest if the business is to develop profitably in the future.

'You have failed to establish yourself in the market place as a dominant player. Too many of your business decisions are reactive and often too late to have adequate impact. You are following market trends and not attempting to lead them.'

Lucy is naturally disturbed by the criticisms which this report has levelled at her company's operations and has decided that she must be more positive in her actions. In particular, she has decided that her marketing efforts must be more focused and she must pursue more proactively her competitive activities.

Requirement

In order to focus her company's marketing efforts more precisely, Lucy has decided to segment the market for knitwear products.

Suggest potential bases for segmenting this knitwear market and discuss the benefits which a more focused segmentation could bring to the company.

See **Answer** at the end of this chapter.

3 Positioning strategies

3.1 Positioning and positioning strategies

Section overview

- Once a company has identified the different segments in a market, and selected its target market, it then has to position its product or service in the market place. The objective of positioning is to create, and maintain, a distinctive place for a company and its products/services in its target market.
- On occasions it will be necessary to reposition products or brands to improve their performance or to increase market share.
- Price is a key element of positioning. When considering any promotions or discounts, as well as assessing the impact a promotion could have on revenue, marketing managers also need to consider the impact that any price changes in the promotion could have a brand's positioning.
- Ultimately, the aim of marketing strategy and promotions is to boost revenue, and in this context, revenue can be viewed as the culmination of all of an entity's marketing activities.

3.1.1 Positioning

So far we have looked at market segmentation and target market selection. However, in order to develop an effective marketing strategy, a firm also has to decide how to position its product or service in the marketplace.

Definition

Positioning: The 'act of designing the company's offer and image so that it occupies a distinct and valued place in the target customers' mind.'

(Kotler & Keller*, Marketing Management*)

Positioning strategies are based on the results of two key sets of choices:

(a) **Target markets** – *Where* a firm or brand wants to compete

(b) **Differential advantage** – *How* a firm or brand wants to compete. (What advantages can it offer its customers that competitors cannot replicate?)

Link between marketing strategy and business strategy

Notice how the bases of these positioning strategies reflect the same key sets of choices as we looked at in Chapter 2 in the context of the business strategies, which firms should choose to achieve their objectives: how to compete (eg cost leadership vs differentiation), and where to compete (eg Ansoff's product-market matrix).

3.1.2 Positioning and strategy

Once an organisation has decided which customer groups within which market segments to target, it has to determine how to present the product to this target audience. This allows it to address the needs and requirements of the target groups exactly, with a marketing mix that consists of product characteristics, price, promotional activities and distribution channels.

Case example: InterContinental Hotels

The InterContinental Hotels Group is the world's largest hotel group, with approximately 3,650 hotels in nearly 100 countries. The group has adopted a multi-segment strategy in order to serve a variety of segments. The group's marketers have considered a range of customer characteristics, requirements and behaviours in developing the brands and their respective brand positionings.

Characteristics which the group's marketers have considered include: the duration of guests' stay; hotel location and proximity to other addresses; amenities and services sought or expected; the level of luxury desired; value for money; hotel ambience and 'feel'; hotel usage and usage characteristics; size of guest room; and customer profiles.

We can illustrate the way the group has segmented the market by looking at the different target markets of some of its brands:

- InterContinental Hotels and Resorts – Aimed at well-travelled, affluent guests who want to be connected to what's special about a destination.
- Crowne Plaza – The 2011 Annual Report comments that Crowne Plaza's 'core guests are best described as "Strivers." These individuals are aspiring business people who choose hotels that understand their ambitions. We are currently repositioning this market more precisely. New products and services are being developed to give guests the space and technology they need to be highly productive and to feel restored and re-energised for the day ahead.'
- Hotel Indigo – Hotel Indigo aims to combine the individuality of a boutique hotel with the reliability of a big brand company. It aims to appeal to the upscale, well-travelled guest who has an eye for design and is looking for something different.
- Staybridge Suites – These are aimed at upscale business and leisure travellers who want to move in for longer, extended stays and enjoy the best of home and hotel. Guests have their own spacious living areas, fully-equipped kitchens and separate work areas.
- Holiday Inn Express – By contrast to the brands aimed at high end customers, Holiday Inn Express is a mid-priced chain with the IHG Group. As an 'express' hotel, its focus is on offering limited services at reasonable prices. Standard amenities lean towards convenience and practicality, which cater to business travellers and short-term stay.

www.ihgplc.com

Positioning should be used to help a company or brand develop a strong and distinctive image which differentiates it from its competitors, in the minds of its **target customers**. Factors which could be used to help position a product include: price, quality, reliability, supporting services/after-sales service, and value for money.

However, because position is ultimately based on customers' **perceptions**, it is important that marketers focus most on the factors which are **most important to the customers**. For example, there are a range of product characteristics that car manufacturers could focus on, such as: speed, fuel efficiency, security, luxury interiors, and image. The factors which a manufacturer chooses to emphasise should be those that are most important to its target market, such that the positioning image of their car matches the aspirations of its target customers.

However, another consequence of 'position' being ultimately based on customers' perceptions is that it is only partly within marketers' control. External developments could change the way customers think about a product: for example, as result of a change in the price of a competitor product, or the launch of a new rival product or substitute product, or test results by a consumer magazine or research institution which call into question some of the claims made about a product.

3.1.3 Steps in positioning

We can identify three key steps in the positioning process:

- **Identify differentiating factors** in products or services which provide an organisation with competitive advantage in relation to competitors.
- **Select the most important differences**, and select an overall positioning strategy based on them.
- **Communicate, and deliver**, the position to the target market.

The value of positioning is that it enables **tactical marketing mix decisions to be made**.

Case example: FedEx

In the early 1970s, in the US, the founder of FedEx (formerly Federal Express) identified that the delivery speeds required by consumers in modern society could only be achieved by using air transport. However, he believed that the US air cargo system at the time was too inflexible and bureaucratic to be able to make sufficiently fast deliveries to satisfy customer requirements.

Therefore he founded FedEx, which became the US pioneer in the overnight delivery service category. Within this category, FedEx created strong, favourable and unique associations with the consumer benefits of being the fastest and most dependable delivery service. The company's slogan at the time – 'When it absolutely, positively has to be there overnight' – reinforced these benefits and highlighted the company's key points of difference from competitors. The traditional postal service typically took two or more days to deliver post, while other overnight carriers initially found it difficult to match FedEx's high level of service quality.

Initially, FedEx built its success from delivering important documents between companies and individuals. However, with the development of email these issues of 'speed and reliability' become obsolete in relation to many document transfers, meaning FedEx's market opportunities in this respect were greatly reduced. However, the rise of e-commerce – where goods were purchased online and then needed to be delivered to the purchasers' address – provided an increased demand for the fast delivery of packages. So too did increasing globalization and the economic boom in Asia in the first decade of the 21st century.

Nonetheless, the rival logistics and delivery company UPS has proved a tough competitor to FedEx, due to its aggressive pricing and good ground delivery capabilities. In order to compete successfully, FedEx had to improve its ground delivery offers, as well as marketing its own packaged delivery offer more heavily.

However, FedEx's underlying points of difference – speed and reliability – continue to be valued by customers, both for individuals buying products online or for a company running a business internationally and needing deliveries quickly.

Consequently, FedEx Express remains the express distribution industry's global leader, providing rapid, reliable, time-defined delivery to more than 220 countries, and making more than 3.6 million shipments each business day.

www.fedex.com

Based on case study in Keller *et al*, *Strategic Brand Management*

3.1.4 Issues with positioning

Although positioning can help an organisation determine its marketing mix, Jobber suggests that a positioning strategy must have four key elements if it is to be successful:

(a) **Clarity** – The positioning idea must be clear in terms of both its target market and the differential advantage. Simple positioning messages (such as Stella Artois' classic tagline 'Reassuringly expensive') are often the clearest and most memorable.

(b) **Consistency** – A consistent message must be presented. Customers will become confused if the basis of positioning changes from 'quality of service' one year to 'superior product performance' the following year.

(c) **Credibility** – The differential advantage that is chosen as a basis for positioning must be credible in the minds of the customer. For example, the brand image of some types of car would make it difficult for them to be marketed as 'luxury.'

(d) **Competitiveness** – The differential advantage must offer something of value to the customer which competitors cannot supply or cannot match.

If a product or brand is not positioned carefully, then instead of contributing to a successful marketing strategy, the positioning process can be damaging:

Mistake	Consequence
Under-positioning	The brand does not have a clear identity in the eyes of the customer
Over-positioning	Buyers may have too narrow an image of a brand
Confused positioning	Too many claims might be made for a brand
Doubtful positioning	The positioning may not be credible in the eyes of the buyer

3.1.5 Perceptual maps

A useful way of assessing the market positioning of a product or brand is through the use of perceptual maps (or positioning maps). These can be used to plot brands or competing products in terms of two key characteristics, such as price and quality.

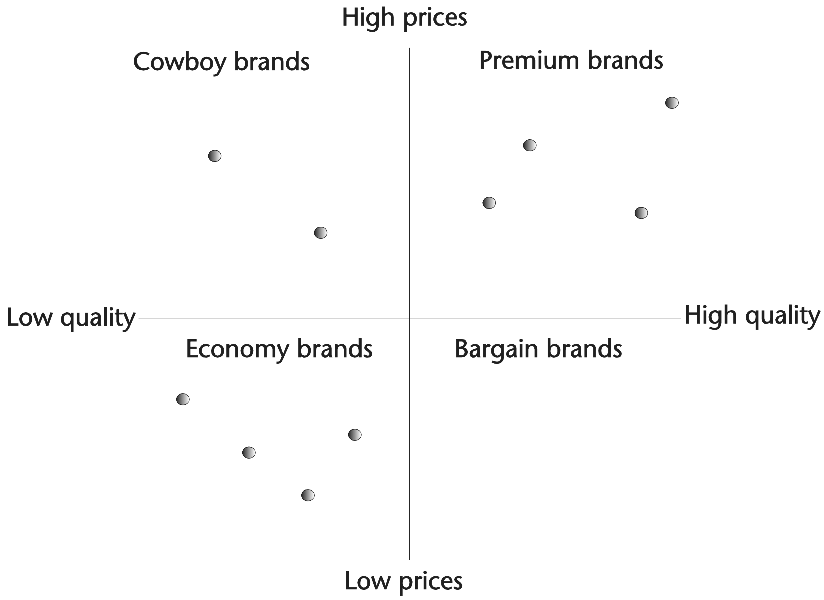


Figure 5.1: Perceptual (or positioning) map

A perceptual map of market positioning can also be used to **identify gaps in the market**. The example above might suggest that there could be potential in the market for a low-price high-quality **'bargain brand'**. A company that carries out such an analysis might decide to conduct further research to find out whether there is scope in the market for a new product which would be targeted at a market position where there are few or no rivals.

3.1.6 Mapping positions

We can look at the different competitive positioning strategies an organisation can use by looking at a 3 × 3 matrix of nine different competitive positioning strategies.

Product quality	Product price		
	High price	*Medium price*	*Low price*
High	Premium strategy	High-value strategy	Super-value strategy
Medium	Over-charging strategy	Medium-value	Good-value strategy
Low	'Rip off' strategy	Fake company strategy	Economy strategy

The 'natural' combinations of price and quality will be to sell a high quality product at a high price, an average quality product at a medium price, or a low quality product at a cheap price.

However, a company might want to offer a product at a comparatively low price if it is trying to increase its market share (ie, it is pursuing a market penetration strategy). For example, a company trying to increase its market share could offer a high quality product at a medium price.

By contrast, such a positioning exercise might indicate that some companies are charging a higher price for their products than the quality justifies. Such a strategy is unlikely to be successful in the longer term, so a company in this position will either need to increase the quality of their product, or reduce its price.

Positioning and strategy

Once an organisation has selected its target segment in a market, the needs of the targeted segment can be identified, and the marketing mix strategy developed to provide the benefits package needed to satisfy them. Positioning the product offering then becomes a matter of matching and communicating appropriate benefits.

Positioning map (sports shoes)

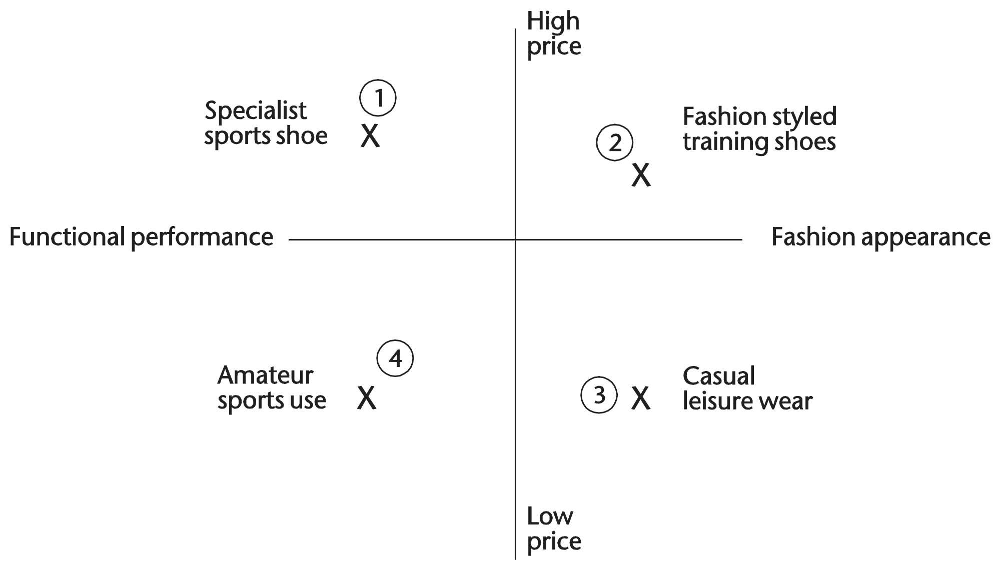


Figure 5.2: Positioning map for sport shoes

The figure above indicates that there are a variety of sports shoe products offering distinct positions on the price vs fashion/functionality spectrum. A firm entering this market could try to establish a unique position, for example, it could offer a high price, ultra-high fashion shoe (at the outer extreme of the top right-hand quadrant). Possible implications of this might be that the existing product '2' becomes less profitable as fashion-conscious customers switch to the new product; or alternatively, customers may not value the price/fashion mix of the new product, and so sales of product '2' will remain largely unaffected.

3.2 Repositioning

Strategic managers must be prepared to deal with under-performance and failure. One possible response is repositioning of the market offering.

Definition

Repositioning: A competitive strategy aimed at changing position in order to increase market share.

Repositioning is a difficult and expensive process, though, since it requires the extensive remoulding of customer perceptions. The danger is that the outcome will be confusion in the mind of the customer and failure to impress the selected new market segments.

Bases for repositioning

Type of position	Comment
Real	Relates to actual product features and design
Psychological	Change the buyer's beliefs about the brand
Competitive	Alter beliefs about competing brands
Change emphasis	The emphasis in the advertising can change over time

An important implication of positioning is the potential impact that sales and discounts have on customers' perception of price and value. For example, if a retailer regularly offers money-off deals, will customers treat the discounted price as being a better indicator of the brand's position than the 'full' price, which is rarely used?

Retailers need to be aware of the negative consequences of setting artificial 'sales' prices. The use of persistent 'sales' by retail outlets can lead to increasing scepticism about the integrity of the sales – especially sales which 'must end soon' but rarely do!

The use of sales and discounts also has an impact on the profit margins that a company can achieve. Nonetheless, if a company is trying to break into a new market, or to increase market share, then setting a low price initially ('penetration pricing') may be an appropriate strategy. Although the low price may mean that the product generates a low profit at first (or even makes a loss), once consumers are locked in to using the product, then the price can be increased, allowing the product to generate higher profits in the longer term.

Case example: Repositioning Argos

In October 2012, Home Retail Group (which owns Argos) announced that it was committed to reinventing Argos as a digital retail leader. In 2012, the online 'Check & Reserve' option was the fastest growing channel at Argos, and by the end of the year it was contributing over 50% of the company's total sales.

The Chief Executive of Home Retail group, Terry Duddy, said 'We have… concluded a comprehensive business review of Argos which highlighted a clear opportunity to transform the business through increased investment in digital technologies.'

The transformation plan aims to deliver growth by repositioning Argos from a catalogue-led business to a digitally-led one, and by focusing on online, mobile and tablet transactions to attract more shoppers and reverse declining profits.

Home Retail group has targeted a 15 percent rise in sales between 2012 and 2018 (from CU3.9 billion to CU4.5 billion), as a result of reinventing Argos as a digital retailer. To support this growth, Home Retail group plans to invest CU100 million per year in Argos between 2012–2015; mainly on IT infrastructure.

However, the company's reinvention as a digital retailer means reduced circulation for the 'Argos catalogue' which has been printed twice a year since 1973. Instead of being a core part of Argos' marketing strategy, the catalogue will now move into a supporting role, although it will not be discontinued entirely. Nevertheless, Mr Duddy claimed 'In the last ten years, this is the biggest thing we have done.'

As part of the transformation programme, at least 75 Argos stores are expected to close or relocated by 2018 as their leases expire. Moreover, the focus of stores will change: towards product pick-up and customer service for transactions that are increasingly managed online or through mobile devices.

The 'new' Argos will also offer a bigger range of products, intended to appeal to a wider range of socio-economic groups, and which are made available faster to customers.

Based on: Davey, J, (2012) Home Retail to reinvent Argos as profit slumps, 24 October, uk.reuters.com

3.3 Pricing and revenue

The axis of positioning maps (discussed in Section 3.1 above) highlight the importance of firms matching the price of their goods or services with the perceived quality of them; since many customers view price as an indicator of quality.

Equally, however, the price which a firm charges for a product is likely to be strongly influenced by its positioning strategy as well as the firm's overall strategic objectives. For example, a firm pursuing a low cost strategy (eg *Lidl*) also sells its products at low prices (ie using a low price strategy).

However, a low price strategy can also be used initially with a view to making money later. This is the logic behind penetration pricing: initially using a low price to break into a new market, and then increasing the price in the longer term.

These points highlight that price is a key element of the marketing mix, and therefore it is vital for an organisation to consider how 'price' information aligns with the other elements of its marketing mix. (You should have already covered the fundamentals of pricing and pricing issues in the *Business Strategy* syllabus, although we revisit them briefly in Chapter 9 of this Study Manual.)

Initiating price changes

When analysing price in a competitive environment, it is important to remember that prices are dynamic. Managers need to know when to raise or lower prices, and whether or not to react to competitors' price moves.

The following factors could all be reflected in rising prices:

- Excess demand for a product
- Rising costs incurred in producing a product

- Market research which reveals that customers place a higher value on a product than is reflected in its price

Conversely, prices may be reduced is there is excess supply of a product; if costs are falling; or if the current price is deemed to be high compared to the value customers give to a product.

The idea of changing prices in relation to the relative levels of demand and supply has been particularly important in the transportation and hospitality industries, where prices are adjusted seasonally or after initial demand has been observed. For example, the price of tickets on a flight often varies according to the number of unsold seats remaining on the fight.

Additionally, and similar to the idea of penetration pricing noted above, price cutting may be used to build sales and increase market share when customers are thought to be sensitive to price. (However, price cutting in this context may not be successful if competitors follow suit and a price war ensues.)

As well as changing prices directly, there are other tactics companies can use which effectively change the price customers pay for products or services; for example, price bundling or unbundling, and applying discounts to the list price.

3.3.1 Bundling and unbundling

Bundling

Where a number of products and services that tend to be bought together are price separately, price bundling can be used to effectively lower the price. For example, a new car could be sold with 'free insurance for the first year' or a new television could be sold with a 'free two-year repair warranty'.

In practice, the price of the car or the television may already include some allowance to cover the cost of the insurance or the warranty, but the bundled price is still likely to be lower than the cost of buying the car plus insurance separately.

Unbundling

By contrast, price unbundling is a tactic which could be used to effectively raise prices. Many product offerings actually consist of a set of products for which an overall price is set (for example, computer hardware and software). Price unbundling allows each element of the product to be priced separately, in such a way that the total price is raised.

In a similar way, companies could charge separately for services that were previously included in a product's price. For example, suppliers of office IT systems have the option of unbundling installation and training services, and charging for them separately.

Exposure draft – *Revenue from contacts with customers*

The idea of bundling is discussed in a 2011 Exposure Draft *Revenue from contracts with customers*.

The rationale behind the Exposure Draft is that IFRS 15 provides limited guidance on revenue recognition for multiple-element arrangements (bundles): for example, when a consumer buying a new car also receives a year's motor insurance cover as part of the purchase price; or when a consumer books a holiday online, bundling together an air fare, hotel accommodation and travel insurance.

The core principle of the Draft is that 'an entity should recognise revenue to depict the transfer of promised goods or services to customers in an amount that reflects the consideration to which the entity expects to be entitled in exchange for those goods or services.'

To achieve this, the entity would have to identify the separate elements of their contract with a customer, and then allocate the transaction price to the separate performance obligations in the contract (for example, allocating the price the customer has paid for the car between the cost of the car itself and the cost of the year's insurance).

To allocate an appropriate amount to each separate performance obligation, an entity should determine the stand-alone selling price of each obligation at the time when the contract with the customer is signed, and then allocate the transaction price in proportion to the stand-alone selling prices of each obligation.

The Exposure Draft also highlights that an entity should only recognise revenue when it satisfies a performance obligation. So, for example, the 'revenue' from the two-year warranty sold with a new television should be spread over the two years, rather than all being recognised at the point the television was sold.

3.3.2 Discounts

Another way companies can change the price of an item is through the use of discounts.

A commonly used way of offering discounts is as a percentage of the list price of an item. For example, the list price of an item could be CU50, but if a 20% discount is applied, the price to the customer will only be CU40.

Whilst this kind of discount is often used by retailers in relation to the goods they are selling to individual consumers, a similar idea can be applied to the volume discounts companies given to trade customers; where the actual price they pay for goods is discounted in recognition of the volume of purchases they make.

This idea of volume discounting could equally be applied directly to purchases of individual products by individual customers: for example, the price of one bottle of juice might be CU8, but customers could also buy two bottles for CU15.

For many products, a manufacturer will identify a recommended retail price (RRP). However, in practice a retailer may choose to sell the product at a lower price; highlighting the difference between its price and the RRP.

Another way of applying discounts is to offer customers a monetary reduction in cost of their purchases if they spend a given amount; for example, CU5 off if they spend CU50.

Discounts and positioning

Whilst offering special promotions and discounts can boost sales by encouraging additional customers to buy a product, it is also important to think about their potential implications for positioning and the perceived value of a product. For example, if the price of a product is reduced from $50 to $40, will customers perceive the value of the item now also to be $40 or will they still be prepared to pay the full price once the discount period comes to an end?

In this context, it is important to highlight the distinction between discounts and promotions and the notion of **everyday low prices**. This distinction again has important implications in the context of positioning.

Promotions and discounts can be used to attract consumer to buy specific items at a specific time, but they are not usually designed to reposition the item or brand. However, an alternative to using specific promotions is to set lower prices on a regular basis; in effect, to introduce everyday low prices. This is the approach taken by Wal-Mart (Asda) supermarkets. Rather than focusing on specific promotional prices, they aim to attract customers on the basis of everyday low prices. As such, Asda (Wal-Mart's UK arm) has positioned itself differently to the majority of other supermarkets in the UK.

Discounts and revenues

An important issue for companies to consider in relation to any possible discounts and promotions will be the potential impact on revenues (and profits) which could arise from any changes in price or position.

The logic of price promotion is that it enables companies to sell higher volumes of a product by temporarily decreasing the price. Nonetheless it is important to achieve a balance between volume growth and profitability; for example, to avoid offering too many discounts such that profits fall despite volume increasing.

Discounts can also be used when a company's products are sold in the form of long-term commitments, such as phone or internet contracts. Promotional offers (for example, reduced prices for the first three months of a contract) help attract customers who then commit to contracts and produce revenue over a long term horizon.

However, alongside this, companies also have to decide when to begin increasing contract fees and by how much fees can be raised in order to avoid losing customers. In effect, companies have to analyse how to maximise revenue while minimising churn (the rate of losing customers).

3.3.3 Markdowns

One specific use of price reductions is in the fashion industry. Fashion clothes have very short life cycles: typically one season. Therefore, as the end of the season approaches the prices of clothes are marked down, and eventually the clothes are replaced by the new season's ranges.

Whereas discounts and promotions only involve temporary price reductions, markdowns affect the price of an item permanently. After a markdown, the price of the item marked down will not typically increase again.

3.4 Revenue recognition and profit (IFRS 15, Revenue from Contracts with Customers)

The use of price discounts and promotions (eg money off coupons) is one of the main techniques a company can use to try to boost sales (particularly in the short term). Ultimately the aim of marketing strategy as a whole is to boost revenue; meaning that revenue could also be viewed as the culmination of all an entity's marketing activities.

IFRS 15, Revenue from Contracts with Customers

Revenue recognition in the financial statements is a measure of the success of the marketing strategy. Revenue recognition also considers accounting for some marketing initiatives such as discounts and other sales incentives. It may not, however, take full account of the success of longer-term marketing initiatives, such as building a brand.

Some companies have adopted questionable practices concerning the reporting of revenue as part of aggressive earnings management policies. This has led to different companies, operating within the same business sector, adopting varying accounting policies on revenue. In turn, these variations in accounting policy have resulted in marked variations in the timing and measurement of revenue, and hence, profit.

Some of the high profile accounting scandals have involved manipulation of revenue, such that revenue has been recognised in an inappropriate manner, resulting in reported profits also being hugely inflated.

An effective and credible accounting standard on revenue is therefore essential to ensure that a company's success in selling into its markets is measured and reported appropriately. This is the purpose of IFRS 15, Revenue from Contracts with Customers.

Revenue recognition

A significant issue in accounting for revenue is determining *when* to recognise revenue (ie it is largely a timing issue). IFRS 15, Revenue from Contracts with Customers, states that revenue is recognised once it is probable that future economic benefits will flow to the entity, and these benefits can be measured reliably. Revenue is therefore generally recognised as being earned at the point of sale for goods. For services, revenue is, in general, recognised over the period that the service is delivered.

The recognition criteria in IFRS 15 are usually applied separately to each transaction. However, in certain circumstances, it is necessary to apply the recognition criteria to the separately identifiable components of a single transaction in order to reflect the substance of the transaction. For example, when the selling price of a product includes an identifiable amount for subsequent servicing, that amount is deferred and recognised as revenue over the period during which the service is performed.

Fair value

IFRS 15 states that revenue shall be measured at the fair value of the consideration received or receivable. Fair value is the price that would be received to sell an asset, or paid to transfer a liability, in an orderly transaction between market participants at the measurement date.

Discounts

IFRS 15 identifies that the fair value of the consideration received or receivable, should take into account the amount of any trade discounts and volume rebates allowed by the entity.

Therefore, an organisation which offers trade discounts would be expected to show a lower profit margin on its revenue than an organisation which did not offer similar discounts.

Worked example: discounts and sales incentives

Caravans Deluxe is a retailer of caravans, dormer vans and mobile homes, with a year end of 30 June 20X8. It is having trouble selling one model – the CU30,000 Mini-Lux, and so is offering incentives for customers who buy this model before 31 May 20X7:

(a) Customers buying this model before 31 May 20X7 will receive a period of interest free credit, provided they pay a non-refundable deposit of CU3,000, an instalment of CU15,000 on 1 August 20X7 and the balance of CU12,000 on 1 August 20X9.

(b) A three-year service plan, normally worth CU1,500, is included free in the price of the caravan.

On 1 May 20X7, a customer agrees to buy a Mini-Lux caravan, paying the deposit of CU3,000. Delivery is arranged for 1 August 20X7.

As the sale has now been made, the director of Caravans Deluxe wishes to recognise the full sale price of the caravan, CU30,000, in the accounts for the year ended 30 June 20X7.

Required

Advise the director of the correct accounting treatment for this transaction. Assume a 10% discount rate.

Solution

The director wishes to recognise the sale as early as possible. However, following IFRS 15, Revenue from Contracts with Customers , he cannot recognise revenue from this sale because the risks and rewards of ownership of the caravan have not been transferred. This happens on the date of delivery, which is 1 August 20X7. Accordingly, no revenue can be recognised in the current period.

The receipt of cash in the form of the CU3,000 deposit must be recognised. However, while the deposit is termed 'non-refundable', it does create an obligation to complete the contract. Therefore, the cash should be treated as deferred income in the statement of financial position.

DEBIT	Cash	CU3,000	
CREDIT	Deferred income		CU3,000

On 1 August 20X7, when the sale is recognised, this deferred income account will be cleared. In addition:

The revenue from the sale of the caravan will be recognised. Of this, CU12,000 is receivable in two years' time, which, with a 10% discount rate, is: CU12,000/ 1.1^2 = CU9,917. CU15,000 is receivable on 1 August 20X7.

The service plan is not really 'free' – nothing is. It is merely a deduction from the cost of the caravan. The CU1,500 must be recognised separately. It is deferred income and will be recognised over the three year period.

The sales revenue recognised in respect of the caravan will be a balancing figure.

The journal entries are as follows:

DEBIT	Deferred income	CU3,000	
DEBIT	Cash (1^{st} instalment)	CU15,000	
DEBIT	Receivable (balance discounted)	CU9,917	
CREDIT	Deferred income (service plan monies received in advance)		CU1,500
CREDIT	Sales (balancing figure)		CU26,417

Customer retention and loyalty

An important issue in marketing is customer retention, and one way that organisations try to encourage loyalty is through the use of loyalty schemes. However, these schemes create a potential issue around the recognition and measurement of obligations when companies have to provide customers with free or discounted goods or services, if and when they choose to redeem the credit they have accrued on their loyalty awards.

IFRS 15 requires that separately identifiable components of sales transactions are accounted for separately, if necessary, to reflect the substance of transactions. This suggests that when a loyalty card customer buys a product or service, the proceeds of the sale are split into two components: an amount reflecting the value of the goods or services delivered in the sale, and an amount that reflects the value of the loyalty award credits.

Proceeds allocated to the first component are recognised as revenue at the time of the first sale. However, proceeds allocated to the award credits are deferred as a liability until the entity fulfils its obligations in respect of the award, either by supplying free or discounted goods when a customer redeems the credit, or engaging (and paying) a third party to do so.

Accounting for customer loyalty programmes – IFRIC 13

The rationale behind IFR13 is that existing accounting standards lack any detailed guidance about how to account for customer loyalty programmes, and consequently current treatment varies in this respect. Some companies measure their obligation based on the value of the loyalty award credits to the customer (loyalty points); others measure their obligation as the cost to the entity of supplying the free or discounted goods or service when a customer redeems their points.

IFRIC 13 is based on the view that customers are implicitly paying for the points they receive when they buy other goods or services, and therefore some of that revenue should be allocated to the points.

Consequently, IFRIC 13 requires companies to estimate the value of the points to the customer, and defer that amount of revenue as a liability until they have fulfilled their obligation to supply the free or discounted goods or other awards.

4 The marketing mix

4.1 The marketing mix and competitive advantage

Section overview

- The marketing mix consists of four core elements: product, price, place and promotion; supplemented by an additional three for the marketing of services: people, processes and physical evidence.
- The elements of the marketing mix are the key decision areas which marketers have to manage so ensure that their product or service satisfies customers' needs better than competitor offerings do.
- The internet has had a major impact on the elements of the marketing mix, and companies need to recognise this when developing their marketing strategies.

Our definition of 'positioning' in the previous section highlights the importance of creating a distinctive position for a product or brand within a target market.

The way a firm looks to achieve this is through the marketing mix being applied to that product or brand. The role of the marketing mix is to develop a unique identity for a product or brand within the market place.

4.1.1 Elements of the marketing mix

One of the learning objectives from the ICAB *Business Strategy* syllabus at Professional Level is that candidates should 'Understand the marketing mix, its roles and limitations.'

At Advanced Level, however, rather than simply 'understanding' the marketing mix, you will be expected to be able to demonstrate how a firm could use the different elements of the mix (product, price, place and promotion – the 4Ps; plus, people, process, and physical evidence – the 7Ps) to help generate competitive advantage.

An important point to note here is that applying a unique (and appropriate) mix of the elements of the marketing mix within a given market allows a firm to compete more effectively, thereby helping it to generate a sustainable profit.

The elements of the mix are summarised briefly here:

Mix element	Comment
Product	The product (or service) is best considered as a collection of benefits, offered by the features that it provides. What features of the product or service are most critical to satisfying the customer's needs?
Price	The only element of the mix to bring in revenue, price is not solely determined by the cost of producing a good or service, but the value that the customer is prepared to pay for it. Price can be highly variable, but must support the overall positioning of the product. Price also needs to reflect overall marketing objectives: for example, profit maximisation, or market share leadership; and needs to consider the strength of competition in the market and competitors' positions.

Mix element	Comment
Place	'Place' covers distribution channels, intermediaries and logistics between the producer and the end consumer. Logistics deals with transportation and storage. Distribution channels and intermediaries are other organisations that determine where a customer can acquire the product. Companies need to decide how much of their marketing function they are prepared to delegate to intermediaries. For example, will they outsource the logistics function, or use wholesalers rather than selling to retailers or end users? Also, companies need to decide whether to sell online or offline, or through a combination of both.
Promotion	This covers advertising, public relations, personal selling and direct mail – in other words all aspects of marketing communications.
People	These include the people delivering a service. Inclusion of 'people' in the marketing mix reflects the fact that the consumer's perceived quality depends heavily on those providing the product/service. Staff selection, motivation of staff and customer care training are critically important for companies. People can also mean not just the employees providing the product/service, but other customers receiving the same service at the same time, eg in a restaurant, at a sports match or in public transport.
Processes	This is the process by which a product/service is provided. The process is sometimes referred to as the 'whole customer experience'. A customer of a top class restaurant, for example, experiences the food, the atmosphere, the surroundings, the service, and so on. Process can also refer to the efficiency of the service. For example, the ease with which a well-designed loan application form can be completed could be an important element in a bank's loan service.
Physical evidence	A service is intangible: physical evidence suggests that there is something to show for it. Examples of physical evidence include: • Evidence that the service has been performed. When people go on rollercoaster rides, the service provider arranges for photographs to be taken as people undergo the experience. For financial services, you may receive a certificate notifying you that you have joined a scheme – a legal document entitling you to the service but not, usually, the service itself. • The environment of the service encounter (eg restaurant ambience, staff uniforms): Disney theme parks are a good example. Layout and cleanliness are important physical aspects of the service, and reinforce the family-friendly image.

Distribution (place) is often seen (wrongly) as the least important aspect of the traditional marketing mix, and therefore can tend to get over-looked. In companies where distribution involves the physical transport of goods and stores, undervaluing the importance of 'place' can be very costly as a lack of co-ordination often results in inadequate control over the distribution function, and inefficient inventory management.

However, as we saw in Chapter 3, the increased importance of supply chain management, accompanied by the introduction of Just in Time (JIT) production and purchasing, should help to increase the profile of the 'place' element within the marketing mix.

4.1.2 Critical moments of truth

One of the characteristics which distinguish service transactions from product sales or purchases are the 'moments of truth' between the customer and the firm (when the consumer comes into direct contact with the service provider).

When consumers and service providers meet, the encounter between them might permanently shape the consumer's view of the firm.

Moments of truth can be:

- Before the service is purchased, for example, enquiries and reservations
- Before the service is actually consumed (eg check-in procedures at airports)
- While the service is consumed (encounter with waiter at restaurant, quality of service on a train, assistance and information)

- After the service has been consumed, (queries, staff saying 'goodbye', paying the bill if payment is made after the service is consumed). The rise of eCommerce is leading to an increase in on-line credit card fraud. Card fraud could be seen as a moment of truth after the service has been consumed.

Ultimately, customers decide what a moment of truth is. Some will be put off using a service provider by poor procedures in one aspect of the service, which could lead to any competitive advantage generated by other aspects of the marketing mix being undermined.

4.1.3 The marketing mix and value to the customer

In his text, *Principles and Practice of Marketing*, David Jobber reinforces the importance of the marketing mix in creating competitive advantage for an organisation by illustrating how elements of the basic marketing mix (4 Ps) also create value to customers.

Marketing mix	Basis of differentiation	Value to customer
Product	Performance	Functionality; pleasure from using it; status; safety
	Durability	Longer life; lower costs (maintenance costs, or replacements)
	Reliability	Fewer problems; lower maintenance/repair costs
	Style	Status; good looks
	Technical assistance	Support; close supplier-buyer relationships
Distribution (Place)	Location	Convenience, time savings
	Quick/reliable delivery	Fewer problems; ease of planning. Reduced costs (eg inventory levels; production downtime for B2B customers)
	Delivery guarantees	Peace of mind
	Computerised reordering	Time savings, less effort required by customer
Promotion	Creative/more advertising	Superior brand personality
	Sales incentives	Direct added value to customers
	Co-operative promotions with distributors	Lower prices
	Well-trained salesforce	Superior problem solving; assurance over product/service being purchased
	Fast, accurate quotes	Improve efficiency/reduce hassle in purchasing process
	Free demonstrations; free trials	Reduce risk of purchase
	Fast complaint handling	Minimise cost and inconvenience resulting from any problems
Price	Lower price	Reduce purchase costs
	Credit facilities; low-interest loans	Lower costs of purchase; ease cash flow
	Higher price	Support brand image and status (for premium products)

(Adapted from Jobber, D. (2010), *Principles and Practice of Marketing*; (6th edition), pg. 720).

4.2 Co-ordinating the marketing mix

Although we can look at how individual elements of the marketing mix can be used to differentiate a firm's products from a rival's, we also need to remember that the different elements in the mix need to be co-ordinated such that they portray a consistent message to customers.

Each element of the marketing mix contributes to the total value proposition being offered to the customer. Therefore, all the elements of the mix need to be coherent and consistent, rather than conflicting with, or undermining, each other.

For example, if an organisation wants to position a product as a luxury or high-quality 'premium' brand, it should price the product accordingly (on the grounds that consumers assume they 'get what they pay for'). It should also ensure a matching quality image in its intermediaries or dealerships, and should select promotional media and messages along the same lines (advertising in up-market media, and avoiding 'buy one, get one free' sales promotions).

Moreover, the way the firm relates to all its stakeholders also needs to be coherent and consistent. For example, there is little merit in a firm marketing its products to customers on the basis of corporate social responsibility and ethics, if conflicting messages are given out by the firm's treatment of its suppliers, distributors or employees. The charity Oxfam, for example, had its credibility undermined when it was discovered that suppliers of its 'Make Poverty History' wristbands were themselves guilty of exploiting workers with minimal pay and poor working conditions.

The marketing mix and market segments

Marketing mix decisions must be taken with the needs of a range of market segments in mind. The product mix or product portfolio, for example, can be adapted to cover a range of stakeholder and customer needs. For example, Nestlé's range of coffee brands covers luxury, economy, fair-trade and health-conscious (de-caffeinated) brands.

The distribution mix can similarly cover the needs of different regions, urban and rural lifestyles, isolated or less mobile consumers (eg internet buying and/or home delivery).

4.3 Global or local marketing mix

In Chapter 2, we discussed international growth and strategies for firms to expand globally.

However, the decision to enter foreign markets also requires companies to decide whether or not to adapt the marketing mix to local conditions. The choice is between **standardising** the product in all markets to reap the advantages of scale economies in manufacture and, on the other hand, **adaptation** which gives the advantages of flexible response to local market conditions.

Complete global standardisation could greatly increase the profitability of a company's products (through economies of scale) and simplify the task of the international marketing manager.

However, the extent to which standardisation is possible is controversial in marketing. Much of the decision-making in an international marketing manager's role is concerned with assessing the need, or not, to adapt the product, price and communications to individual markets.

Case example: Haier

Haier is a leading Chinese manufacturer of 'white goods' (fridges, washing machines etc).

It was founded in Qingdao in 1984, and first became established in China. By 1991, it had become the market leader there. From a strong domestic base, it then expanded internationally. It is now the world's fourth largest 'white goods' manufacturer, and the world's No 1 major appliances brand. By 2011, it had a market share of 7.8% of the 'major appliances' market.

Haier now views itself as 'a global brand with local operations'.

Haier has established 29 manufacturing bases and 16 industrial parks in Europe, North America, Asia, the Middle East and Africa to enable it to localise its production within various markets. And with eight research and development centres in the US, Germany, China, Japan and Korea, Haier aims to bring its products in line with the wide variety of consumer needs, in different regions of the world.

In China, Haier's four leading product categories – refrigerators, refrigerating cabinets, air conditioners, and washing machines – have over 30% market share each. In international markets, Haier products are available in 12 of the top 15 chain stores in Europe and in 10 leading chain stores in the USA. Haier is approaching its goal of being 'local' in American and European markets via localised design, manufacturing and sales processes.

Haier, Japan

In February 2012, Haier announced that it planned to establish its Asian headquarters in Osaka, along with two R&D centres in Tokyo and Kyoto, a development which establishes Japan as an overseas market that combines all of the three key elements for the business – R&D, manufacturing and marketing.

At the same time, Haier officially unveiled its second brand in Japan – AQUA. In 2011, Haier purchased SANYO's washing machine and refrigerator businesses in Japan, as well as its washing machine, refrigerator and consumer electrical appliance businesses in Indonesia, Malaysia, the Philippines and Vietnam.

Haier expects its sales in Japan to reach 50 billion yen in 2012, including an estimated 35 million yen from AQUA. However, the company emphasised that its move into Japan is not based only on a desire to increase market share. Its Executive Vice President, Liang Haishan said, 'What is the most important for us is to better understand Japanese consumers, and provide high-quality appliances to meet the demands of their lives through our localized operations, technology innovation, and resource consideration.'

www.haier.com

4.3.1 Standardisation or adaptation in international marketing mix

The following factors encourage **standardisation**:

- Economies of scale
  - Production
  - Marketing/communications
  - Research and development
  - Inventory holding
- Easier management and control.
- Homogeneity of markets; that is, world markets available without adaptation (eg denim jeans).
- Cultural insensitivity, eg industrial components and agricultural products.
- Consumer mobility means that standardisation is expected in certain products (eg hotel chains; memory cards for cameras).
- Where 'made in' image is important to a product's perceived value (eg France for perfume, Sheffield for stainless steel).
- For a firm selling a small proportion of its output overseas, the incremental adaptation costs may exceed the incremental sales value.
- Products that are positioned at the high end of the spectrum in terms of price, prestige and scarcity are more likely to have a standardised mix.

Adaptation

Adaptation may be mandatory or discretionary.

Mandatory product modification normally involves either adaptation to comply with government requirements or unavoidable technical changes. An example of the former would be enhanced safety requirements, while the requirements imposed by different climatic conditions would be an example of the latter.

Discretionary modification is called for only to make the product more appealing in different markets. It results from differing customer needs, preferences and tastes. These differences become apparent from market research and analysis; and intermediary and customer feedback.

- Levels of customer purchasing power. Low incomes may make a cheap version of the product more attractive in some less developed economies.
- Levels of education and technical sophistication. Ease of use may be a crucial factor in decision-making.
- Standards of maintenance and repair facilities. Simpler, more robust versions may be needed.
- 'Culture-bound' products such as clothing, food and home decoration are more likely to have an adapted marketing mix.

These strategies can be exercised at global and national level, depending on the type of product. Not all products are suitable for standardisation.

For example, although McDonald's is often seen as a global brand, the menus in its restaurants are adapted to fit with local tastes and cultures. For example, in India, McDonald's menu is typically 50% vegetarian because the Hindu majority cannot eat beef dishes, and Muslims avoid pork.

Case example: Cadbury's chocolate

Before Cadbury was acquired by Kraft (in 2010) the UK company was also having talks with fellow confectioner Hershey.

However, the prospect of Cadbury – the UK's chocolate-maker – being taken over by an American company was causing concern among some chocolate lovers.

Whilst there is a degree of patriotism behind this response, for many loyal British chocoholics, the word 'Herschey' sets alarm bells ringing.

To many people, Herschey's chocolate has a more bitter, less creamy taste than its British equivalent, and seems to have a grittier texture.

But this all comes down to what 'chocolate' actually is.

In the UK, chocolate must contain at least 20% cocoa solids. In the US, however, cocoa solids need only make up 10%.

A Cadbury's Dairy Milk bar contains 23% cocoa solids, whereas a Hershey bar contains just 11%.

Interestingly, much of Europe would scoff at either definition. The preference in continental Europe is for richer, darker chocolate, with a significantly higher cocoa solid count. Many European chocolatiers make chocolate with over 40% cocoa solids, creating a product which is significantly different from the chocolate bars that British consumers buy from their local newsagents for a morning snack.

Abridged from: Purser, E. (2009), The great transatlantic chocolate divide, *BBC online*, 15 December, www.bbc.co.uk

4.4 The impact of the internet on the marketing mix

The internet has had a significant impact on the elements of the marketing mix, and companies need to recognise this when developing their marketing strategies, particularly strategies for online marketing.

4.4.1 Product

What does buying products online offer which offline purchasing cannot?

(a) The ability to deliver interactivity and more detailed information through the internet is the key to enhancing the augmented or extended product offering online.

(b) The buyer knows immediately about product features, the facts, not a sales person's interpretations.

(c) The buying process is customised for returning visitors, making repeat purchases easier. Organisations can also offer immediately ancillary products along with the main purchase. EasyJet for example, can readily bundle its flights, hotels and car hire through suitable design of its web site.

(d) The product can also be customised to consumers' needs. For example, Nike.com offer customised trainers to users online. Users can design and see their trainers online before they order.

4.4.2 Price

The internet has made **pricing very competitive**. Many costs such as store cost and staff salaries have disappeared completely for online stores, placing price pressures on traditional retailers.

(a) The internet increases customer knowledge through **increased price transparency,** since it becomes much quicker to shop around and compare quoted prices by visiting supplier web sites. In this respect, the use of **price comparison sites** by consumers is very important. Sites such as *Kelkoo.com (or*

Kelkoo.co.uk in the UK) give a single location that empowers the consumer to quickly find out the best price from a range of suppliers for a range of products. Such easy access to information is likely to increase price competition between retailers, and ultimately increase the bargaining power of customers.

(b) **Dynamic pricing** gives retailers the ability to test prices or to offer differential pricing for different segments or in response to variations in demand. For some product areas, such as ticketing, it may be possible to dynamically alter prices in line with demand. *Tickets.com* adjusts concert ticket prices according to demand and has been able to achieve 45% more revenue per event as a result. Dynamic pricing is used widely in airline and hotel industries, but it is also increasingly used in restaurants; for example, by offering people a discount to eat at quieter times of the day, rather than at peak lunch time or evening services.

(c) Different types of pricing may be possible on the internet, particularly for digital, downloadable products. Software and music has traditionally been sold for a continuous right to use. The internet offers new options such as payment per use; rental at a fixed cost per month, or a lease arrangement. Bundling options may also be more possible.

(d) The growth of **online auctions** also helps consumers to dictate price. The online auction company eBay has grown in popularity, with thousands of buyers and sellers bidding daily.

(e) ePricing can also easily reward loyal customers. Technology allows repeat visitors to be tracked, allowing loyalty incentives to be targeted towards them.

(f) Payment is also easy – PayPal or online credit cards allow for easy payments. However, the downside to this is internet fraud, which is growing rapidly around the world.

4.4.3 Place

The internet clearly has significant implications for '**place'** in the marketing mix, since it has a **global reach,** meaning that firms can now sell to a much wider geographical market that they have traditionally been able to.

As well as its global reach, the fact that it is 'open' 24 hours a day, 7 days a week (24/7) is also a major impact the internet has had on marketing. Customers can search for, and buy, products at their own convenience, rather than being constrained by the opening hours of a traditional shop, for example.

Channel structures

The internet has also created new marketplaces and channel structures which affect the 'place' where online transactions take place. In some cases, the internet means buyers and sellers interact directly, rather than going through an intermediary. For example, rather than booking a holiday through a travel agent, customers can now go directly to hotel websites or airline websites and book their accommodation and flights themselves. Alternatively, however, customers could use online travel websites (such as Expedia) to book their holidays from a range of options that the website has sourced from flight and hotel reservation systems.

For many companies, the notion of 'place' in the marketing mix is also linked to the supply chain (or value chain). For example, 'place' is closely related to the distribution and delivery of products or services.

The internet has had a major impact on this aspect of the marketing mix. As well as reducing the need for physical stores from which to sell their products, companies are also looking to differentiate themselves from their rivals on the basis of the speed and efficiency of their deliveries. Moreover, many companies no longer 'supply' the goods to their end customers; instead, the companies contract with third-party providers such as Fedex or UPS, which have superior logistical expertise and economies of scale in distribution.

4.4.4 Promotion

Marketing communications are used to inform customers and other stakeholders about an organisation and its products.

(a) There are new ways of applying each of the elements of the **communications mix** (advertising, sales promotions, PR and direct marketing), using the internet and email. Most organisations today have some form of webpage used in most, if not all advertisements.

(b) The internet can be used at different stages of the **buying process**. For instance, the main role of the web is often in providing further information, rather than completing the sale. Think of a new car purchase. Many consumers will now review models online, but most still buy in the real world.

(We will look at social media in more detail later in the chapter, but social media can be an important source for potential customers to gauge other customers' feedback on a product or service, not just the 'official' promotional material from the seller.)

(c) Promotional tools may be used to assist in different stages of **customer relationship management** from customer acquisition to retention. In a web context, this includes gaining initial visitors to the site and gaining repeat visits using, for example direct email reminders of site proposition and new offers.

One of the tactics which companies have used to manage, and build, brands effectively in the internet era, is to increase their links with customers and enter into dialogue with them about products and services. The benefit of this two-way relationship is that, as well as providing customers with information about their products, it also enables companies to collect information about their customers which can then be analysed – for example, through data mining.

In this way, the internet encourages marketing that is based on direct, personalised relationships with customers – 'relationship marketing.'

(d) Targeted marketing – The internet can enable companies to have direct access to individual customers, and in turn, this allows companies to collect more detailed information about their customers. This should help companies be able to target their marketing more precisely, and introduce products or services which better meet customers' needs.

(e) The internet can be integrated into **campaigns**. For example, we are currently seeing many direct response print and TV ad campaigns where the web is used to manage entry into a prize draw and to profile the entrant for future communications.

Promotion activity	Impact/opportunity	Examples of supporting technology
Advertising	Reach more customers worldwide	Websites and ads
	Target audiences more specifically	Specialist TV channels
	Increase response via interactivity	Direct Response TV, SMS text messaging
Sales promotion	Target segment/individual interests and preferences	Customer databases, EPOS data
	Facilitate/motivate response	Online entry/coupons
	Online discounts (lower admin costs)	Online transaction
Direct marketing	Personalised, one-to-one messages	Database
	Permission-based database/contacts to enhance response rate	Email, website, SMS requests for info
	Speed and interactivity of response	Email and website links
	Direct response/transaction	eCommerce sites
PR and publicity	Speed of information dissemination and response to crisis/issues	Email media releases and online information
Marketing/sales support	Publicising sponsorships	Website
	Publicising exhibition attendance	Website/email clients
	Up-to-date information for sales force and call centre staff	Access to product/inventory and customer database
Internal marketing	Staff access to information relevant to their jobs	Intranet newsletters, bulletins, policy info
	Co-ordination/identification of dispersed offices and off-site staff	Email, tele- and video-conferencing
Network marketing	Supplier/client access to information relevant to business relationship	Extranet: access to selected information

4.4.5 People

An important consideration for the people element of the mix is the consideration of the tactics by which people can be replaced or automated.

(a) **Autoresponders** automatically generate a response when a customer emails an organisation, or submits an online form.

(b) **Email notification** may be automatically generated by a company's systems to update customers on the progress of their orders. Such notifications might show, for example, three stages: order received; item now in stock; order dispatched.

(c) **Call-back facility** requires that customers fill in their phone number on a form and specify a convenient time to be contacted. Dialling from a representative in the call centre occurs automatically at the appointed time and the company pays.

(d) **Frequently Asked Questions (FAQ)** can pre-empt enquires. The art lies in compiling and categorising the questions so customers can easily find both the question, and a helpful answer.

(e) **On site search engines** help customers find what they are looking for quickly. Site maps are a related feature.

(f) **Virtual assistants** come in varying degrees of sophistication and usually help to guide the customer through a maze of choices.

4.4.6 Process

The **process** element of the marketing mix refers to the internal methods and procedures companies use to achieve all marketing functions such as new product development, promotion, sales and customer service. The restructuring of the organisation and channel structures described for product, price, place and promotion all require new **processes**.

4.4.7 Physical evidence

The physical evidence element of the marketing mix is the tangible expression of a product and how it is purchased and used. In an online context, physical evidence is **customers' experience of the company through the web site** and associated support. It includes issues such as ease of use, navigation, availability and performance. Responsiveness to email enquiries is a key aspect of performance. The process must be able to give an acceptable response within the notified service standards such as 24 hours.

4.5 Reinforcing the importance of the customer

Customer-centric process – At an overall level, the internet increases the amount of control customers have over the marketing process. In particular, as a result of the internet reducing search costs to almost zero, consumers will increasingly only buy products which precisely match their needs.

This increased importance of the customer reinforces the need to place the customer (rather than the supplier's product or service) at the centre of the marketing relationship.

As a result of this, in some text, the 4Ps of the traditional marketing mix have been renamed as the 4 Cs:

- Product becomes **customer value**
- Price becomes **customer cost**
- Place becomes **customer convenience**
- Promotion becomes **customer communication**

5 Databases and e-marketing

Section overview

- The availability of information and knowledge about customers can help organisations manage their marketing campaigns more effectively. Database marketing illustrates how organisations can use databases to assist with the direct marketing of products.
- The increasing importance of data means that organisations need to hold and manage ever-increasing amounts of data (about sales, revenues, customers, competitors etc). Data warehousing and data mining can help organisations manage and use this data.
- The way firms manage (and use) data about their customers, and how effectively firms manage their relationships with customers, is becoming increasingly important in the context of relationship marketing.
- Web 2.0 technologies and social media (such as blogs, Facebook and Twitter) provide new channels for companies to publish information about their products and services. Perhaps more importantly they also provide new ways for companies to interact with their customers, and hence develop their relationships with those customers.

Brought forward knowledge

The concept of relationship marketing has been discussed in the *Business Strategy* syllabus at Professional Level, along with the differences between relationship marketing and transactions marketing.

For many companies, approximately 80% of their sales come from 20% of their customers. This highlights how important it is for companies to retain their existing high-volume and highly profitable customers, as well as those with strong potential to become high-volume, high profit customers in the future.

This emphasis on **customer retention** has led to an increasing focus on customer relationship management. Sales and marketing staff should no longer be looking solely to make a one-off sale, but to create a long term relationship, which is mutually beneficial for the company and the customer.

Relationship marketing is the use of marketing resources to maintain and develop a firm's **existing customers**, rather than using marketing resources solely to attract new customers.

Firms can implement their relationship marketing strategy through effective **customer relationship management.**

At a tactical level, relationship marketing also needs to be supported by database marketing.

Definition

Database marketing: An interactive approach which builds a database of all communications and interactions with customers (and other stakeholders) and then uses individually addressable marketing media and channels to contact them further (for promotional messages, help and support, or any other relationship-building contacts). Customer data held in computerised databases can be interrogated and manipulated in various ways, through the process of data mining.

Definition

Data mining: The process of sorting through data to identify patterns and relationships between different items. Data mining software, using statistical algorithms to discover correlations and patterns, is frequently used on large databases. In essence, it is the process of turning raw data into useful information.

5.1 Database marketing

Database marketing techniques can be used for a range of relationship marketing projects, including:

- Identifying the most profitable customers, using RFM analysis (**R**ecency of the latest purchase, **F**requency of purchases and **M**onetary value of all purchases).

- Developing new customers (for example, by collecting data on prospects, leads and referrals).
- Tailoring messages and offerings, based on customers' purchase profiles. (Actual customer buying preferences and patterns are a much more reliable guide to their future behaviour than market research, which gathers their 'stated' preferences.)
- Personalising customer service, by providing service staff with relevant customer details.
- Eliminating conflicting or confusing communications: presenting a coherent image over time to individual customers. In this respect, it is important to differentiate the message to different customer groups. (For example, companies must avoid sending 'Dear first-time customer' messages to long-standing customers!)

5.2 Databases and new customers

An organisation's customer database (and database of potential customers) represents a major source of trade. The company can use it to generate repeat business, or to stimulate new business.

When advertising, companies don't only target new customers, but also the existing ones they already have listed in their databases. **Keeping contact with existing customers** is not only a crucial way to generate repeat business, but it also helps companies promote new products to the right people – the people who would be most interested in buying them.

Obtaining **names of potential new customers** is now quite easy, because there are companies who specialise in selling the information of individuals who wish to be contacted by relevant businesses.

However, there is a cost involved in this method, which is why it is also important for organisations to keep records of all the potential customers they come into contact with so that they can build up their own database.

Ultimately, the **aim of marketing databases is to generate revenues**, so the more information organisations can hold about customers and potential customers, the better. The more the organisation knows about potential customers, the greater the chance it should have of targeting the right people in a marketing campaign.

In an effort to **target potential customers more effectively**, organisations can use database marketing to build models of their target demographic group. These models then allow them to focus their advertising budgets on these target groups, in the hope that this will result in an improved return on investment (ROI) on their advertising spend.

Information gathering is therefore an important process, and organisations need to attract potential customers who are willing to divulge information about themselves. Offering prizes or promotional campaigns through newsletters or 'ezines' can help achieve this.

If **records are stored and organised effectively**, an organisation should be able to implement new marketing strategies and (targeted) campaigns more quickly and easily. For example, by grouping individuals together according to shared characteristics (age, income, gender etc) organisations can generate targeted mailing lists of potential customers who share a set of desired characteristics.

Moreover, having a comprehensive database can also **help with forecasting**. Future trends for sales and marketing can be modelled based on the results of previous projects. By studying the past purchases of consumers, analytical software allows data analysts to predict broad trends in purchasing habits, which can give an insight into customers' future purchasing behaviour.

However, it is important that organisations keep their database **up to date, and well-organised**. Having outdated or invalid entries could cause confusion and waste time. For example, there is no point in trying to contact business customers who have gone out of business.

There is also an **ethical/legal dimension** to consider when managing databases. Often, unsolicited calls do not generate any business and can be annoying for the recipient. But more importantly, companies need to ensure their databases comply with the law. In the UK, data must be kept up to date, be relevant, and must only be used for the purpose the customer intended or can reasonably expect it to be used for.

Data warehouses and data mining

We will look at the way organisations can store and manage data in more detail in Chapter 9.

5.3 Customer Relationship Management (CRM)

Definition

Customer relationship management (CRM): The use of database technology and ICT systems to help an organisation develop, maintain and optimise long-term, mutually valuable relationships between the organisation and its customers.

CRM is a more comprehensive approach to the use of database technology, designed to:

- Enable marketers to predict and manage customer behaviour, by allowing them to learn and analyse what customers value (eg about products, services, customer service and web experiences).
- Segment customers based on their relative profitability or lifetime value to the organisation.
- Enhance customer satisfaction and retention by facilitating seamless, coherent and consistent customer service across the full range of communication channels and multiple points of contact between the customer and the organisation.

A CRM system involves a comprehensive database that can be accessed from any of the points of contact with the customer, including website contacts, field sales teams, call centres and order processing functions. Information can be accessed and updated from any point, so that participants in customer-facing processes – sales, customer service, marketing, accounts receivable and so on – can co-ordinate their efforts and give consistent, coherent messages to the customer.

Information can also be analysed (through data-mining) to determine profitability, purchasing trends, web browsing patterns and so on.

5.3.1 Customer loyalty programmes

Customer loyalty or reward programmes are specifically designed to incentivise and reward loyal behaviour such as repeat purchases, escalating purchases and recommendations and referrals. They include schemes such as Air Miles, various retail discount/rebate/bonus/dividend cards (for example, Nectar cards and store loyalty cards) and voucher schemes.

Case example: Tesco Clubcard

By rewarding registered customers with 'points' when they make purchases using their Clubcard, Tesco rewards customers for their loyalty. However, at the same time, the Clubcard programme also provides Tesco with insights from millions of customer transactions.

From this, Tesco can develop tailored ranges, promotions and marketing by country or region. Perhaps even more valuably, Tesco can tailor its marketing, right down to individual customers, via its Clubcard mailings.

Loyalty card programmes (such as Tesco's Clubcard) are also linked to data warehouses, and the data stored in them can be analysed to provide retailers with valuable information about individual customers' spending patterns. This information enables retailers to send personalised marketing messages to customers with offers relating to products which they have bought previously or may be likely to buy in the future.

5.3.2 The need for customer relationship management

There are several reasons why CRM is an important consideration:

- Customers are now inherently more willing to switch suppliers and are less likely to be loyal to a specific company or brand than they have been in the past. (The internet has had an impact on customer loyalty. For example, price comparison websites may reduce customer loyalty if customers see that an alternative supplier offers a product or service more cheaply than their current provider. However, by developing a relationship with its customers, an organisation will move away from competition based on price alone.)
- It is cheaper to focus on retaining existing customers than to have to attract new ones. Attracting new customers is expensive, due to low initial prices or promotional expenses, for instance.

- In mature markets, existing customers provide the most likely source of future earnings because there is little scope to attract 'new' customers, given the low growth rate in the market overall.
- Strategies to widen the range of products available would make no sense if existing customers could not be retained.

5.3.3 Phases of CRM

Dave Chaffey outlines three phases of CRM (particularly in relation to eBusiness and eCommerce management):

- Customer **acquisition**
- Customer **retention**
- Customer **extension**

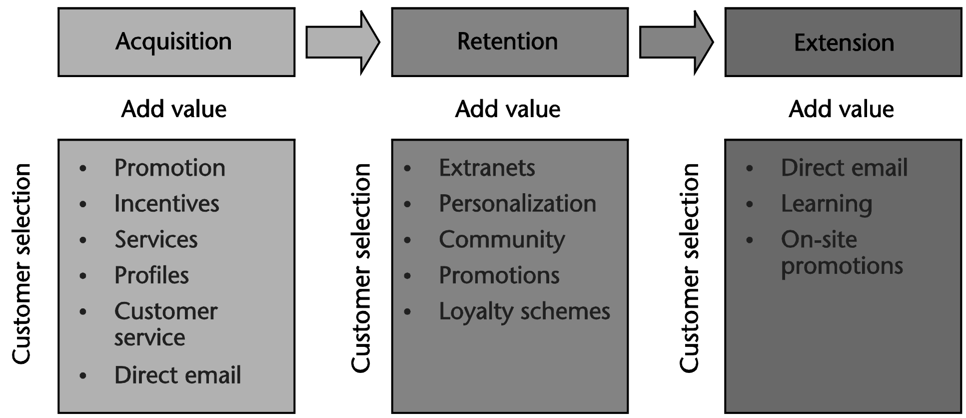


Figure 5.3: Chaffey's three phases of customer relationship management

Customer acquisition is the process of attracting customers for their first purchases.

Customer retention ensures that customers return and buy for a second time. The organisation keeps them as customers. The second phase is most likely to be the purchase of a similar product or service, or the next level of product or service.

Customer extension introduces products and services to loyal customers that may not wholly relate to their original purchases. These are additional, supplementary purchases.

Links to customer profitability analysis

As the definition of CRM earlier in this section highlights, the aim of CRM is to develop **mutually valuable relationships** between an organisation and its customers. From the organisation's perspective, the relative 'value' of different customers, or groups of customers, will depend on how profitable they are over their customer lifecycle.

Therefore, alongside CRM, organisations should also be monitoring customer profitability, because it will not be beneficial for an organisation to invest in, and develop, relationships with unprofitable customers.

Interactive question 3: Customer profitability [Difficulty level: Intermediate]

SportyTech (ST) is a company that supplies high specification parts that major international motor manufacturers use in the higher performance versions of their road cars. ST produces a standard range of high-performance parts, including brake sets, turbos and other engine components that can be customised to suit the requirements of a particular car, if required.

Total turnover for the coming financial year is forecast to be CU135m. The standard pricing policy of ST is based on a simple calculation that delivers a gross profit of 18% excluding any discounts awarded or refunds for faulty goods (ie a part which costs CU492 to make would be priced at CU600). Faulty goods returned have to be replaced, with the returns scrapped and no resale or scrap value achieved.

ST has a fairly stable business, underpinned by three major customers but has become increasingly concerned as it has seen its profitability decline.

In response to this, the company paid a management consultant CU150,000 for advice on how to arrest this decline in profitability. The main finding of the consultant's report was that the cost of servicing the major customers is much higher than ST had realised. The recommendation of the report was to either cease to supply these customers or preferably, to persuade them to reduce the incidence of cost generating activities (see below).

Extracts from the consultant's report:

Forecast for coming financial year

	FMC	*GMC*	*HMC*
Sales revenues CUm (before discounts/returns)	28	14	17
Average discount given	8%	7%	5%
Sales visits made	12	10	14
Purchase orders processed	48	57	46
Customisations requested	5	7	33
Faulty products returned (% of sales made)	2.1	1.8	3.3

Cost generating activities	*Cost* (CU)
Making a sales visit	750
Processing a purchase order	175
Design and tooling a customised part	26,175

Requirement

Calculate the forecast net customer account profitability of each of the three major customers of ST.

See **Answer** at the end of this chapter.

Customer lifecycle value

Customer lifecycle value (CLV) is the present value of the future cash flows attributed to the lifecycle of an organisation's relationship with a customer.

In theory, CLV shows how much each customer is worth to an organisation, and therefore indicates how much the organisation should be prepared to spend on acquiring and retaining that customer. For example, it is not worth an organisation offering promotions and incentives whose value is greater than the customer's lifecycle value to that organisation.

In practice, firms have to make two key assumptions in order to calculate CLV:

(a) **Churn rate**: The percentage of customers that end their relationship with the organisation in any given period. Organisations tend to assume that churn rate remains constant, but if, for example, churn rate turns out to be lower than this assumed level, CLV should be higher than anticipated.

(b) **Retention cost**. The amount of time and money the company has to spend in order to retain an existing customer, for example, through customer service, special offers, and other promotional incentives.

Any attempt to estimate lifecycle costs and revenues also needs to consider existing and potential environmental impacts, however, including the likely actions of competitors and the potential for product and process innovation.

These external factors increase the degree of uncertainty in any customer value calculations over the longer term. For example, what is the probability of retaining customers in the future if competitors introduce new products? Or what is the probability that customers will buy additional products in the future if the company develops alternative new products which satisfy the same needs?

5.4 Customer relationship management strategies

A number of strategies can be implemented in relation to CRM, and to develop customer loyalty towards an organisation.

Strategy	CRM implications	Examples
Develop appropriate staff incentive schemes	Encourages staff to work harder to retain existing customers	Reward staff based on customer satisfaction and feedback, rather than number of new customers attracted
Provide consistent standards	Customers more likely to return if they receive consistently good service Familiarity with good staff encourages loyalty	Implement measures to reduce staff turnover
Obtain senior management buy-in	If senior management prioritise staff retention, staff will too	Build customer retention into the organisational strategy Develop a customer-focused approach at all levels in the organisation
Monitor customer relationships and act appropriately	By understanding the behaviour of customers, improvements to secure their loyalty can be made	Establish regular contact with customers Assess customer satisfaction and loyalty Determine reasons for loss of a customer Address reasons to prevent future loss of custom
Obtain detailed customer information	Allows the firm to: • Identify customer needs • Develop improved ways of meeting those needs • Specifically target customers and bring relevant new products or services to their attention	Customer loyalty/reward cards can provide invaluable information about the buying habits and patterns of customers
Develop specific loyalty focused strategies	Directly encourages the customer to return	Introduce loyalty cards Appoint dedicated account managers for key customers
Implement procedures to monitor and influence all aspects of the customer relationship	Provides the customers with a good experience of the company encouraging them to be loyal Monitors the success of the relationship allowing weak areas to be identified and improved	Total quality management (TQM)
Implement systems that can support Customer Relationship Management	Provides high level of information to the firm, allowing better understanding of the relationship. This in turn, helps understand how it can be improved.	Analytical customer databases Automated sales management systems Systems to track customer spending and profitability

5.5 E-marketing and the application of social media

Definition

E-marketing is 'the application of the internet and related digital technologies to achieve marketing objectives' (Dave Chaffey).

Marketing objectives include identifying, anticipating and satisfying customer requirements profitably. Digital technologies are relevant to these objectives as follows:

- **Identifying** – Using the internet to find out customers' needs and wants
- **Anticipating** – The demand for digital services
- **Satisfying** – Achieving customer satisfaction raises issues over whether the site is easy to use, whether it performs adequately and how the physical products are dispatched

Although the media used in e-marketing are different to 'traditional' marketing, the basic principles behind it remain the same – creating a strategy to deliver the right messages to the right people.

What has changed, however, are the number of media available to disseminate that message. These include: pay per click advertising, banner ads, email marketing and affiliate marketing, interactive advertising, search engine marketing (including search engine optimisation) and blog marketing.

Although businesses will continue to make use of traditional marketing methods (such as press and television advertising, or direct mail-outs), e-marketing offers a new dimension to the promotion element of the marketing mix and is an increasingly valuable component of that mix. It gives businesses of any size access to the mass market at an affordable price and, unlike TV or print advertising, it allows truly **personalised marketing**.

5.5.1 Key marketing functions the internet can perform

(a) **Creating company and product awareness** – Communicating essential information about the company and its brands. Such information may have a financial orientation to help attract potential investors, or it may focus on the unique features and benefits of its product lines.

(b) **Branding** – With the amount of advertising being devoted to the internet increasing each year, the frequency of visits to a site will also increase. Consequently, a company's web site will play a more prominent role in building its brand image. Online communications should therefore be similar in appearance and style to communications in the traditional media so as to present a consistent brand image. Similarly, any dealings a customer has with the online brand should be consistent in terms of positioning with the traditional (offline) brand.

(c) **Offering incentives** – Many sites offer discounts for purchasing online. Electronic coupons, bonus offers, and contests are now quite common. Such offers are intended to stimulate immediate purchase before a visitor leaves a web site, and also to encourage repeat visits.

(d) **Lead generation** – The internet is an interactive medium. Visitors to a site provide useful information about themselves when they fill in boxes requesting more information from a company (eg, name, address, telephone number, and email address). A site may also ask for demographic information that can be added to the company's database. This information is retained for future mailings about similar offers, or they can be turned over to a sales force for follow-up if it is a business-to-business marketing situation.

(e) **Customer service** – In any form of marketing, customer service is important. Satisfied customers hold positive attitudes about a company and are therefore more likely to return to buy more goods. Customer service is often perceived as a weak link in internet marketing. Customers are concerned about who they should call for technical assistance or what process to follow, should goods need to be returned.

Some customer service tactics commonly used include frequently asked questions (FAQs) and return email systems. However, if a potential customer registers interest on a company's website and asks to be contacted, if the company does not respond to that request, the potential customer may take their business elsewhere.

(f) **Email databases** – Organisations retain visitor information in a database. Emailing useful and relevant information to prospective and existing customers helps build stronger relationships. An organisation must be careful that it does not distribute spam (unsolicited/unwanted email) on the internet.

(g) **Online transactions** – Organisations are capable of selling online if the website is user friendly. The ability to sell online could potentially be the most important benefit the internet provides for a company. However, if a company website is hard to navigate, and it proves difficult for customers to make a purchase online, this will reduce the company's ability to generate online sales.

Websites and online ordering also enable organisations in the supply chain to link together to achieve efficiencies in business-to-business transactions. The ability to track and monitor orders via an extranet can also be valuable (particularly for B2B customers), so websites which provide this facility could play a part in customer retention.

Technology and website designs

Developments in technology mean that companies have to continuously monitor the media through which they interact with potential customers.

'User experience' is very important for customers. Since potential customers no longer only access websites from PCs, but also from tablet computers or smartphones, they are likely to expect a user experience built around these different devices. Therefore, a well-designed 'app' or a web page designed for the screen size of the device it is being accessed from, could help enhance a mobile user's impression of a company.

5.5.2 Specific benefits of e-marketing

(a) **Global reach** – A website can reach anyone in the world who has internet access. This allows organisations to find new markets and compete globally with only a small investment required.

(b) **Lower cost** – A properly planned and effectively targeted e-marketing campaign can reach the right customers at a much lower cost than traditional marketing methods.

(c) **The ability to track and measure results** – Marketing by email or banner advertising makes it easier for companies to establish how effective their campaigns have been. You can obtain detailed information about customers' responses to your advertising.

(d) **24-hour marketing** – With a website customers can find out about a company's products even if its physical shops or offices are closed.

(e) **Personalisation** – If the customer database is linked to the website, then whenever someone visits the site, they can be greeted with targeted offers. The more they buy from an organisation, the more the organisation can refine the customer profile and market effectively to them.

(f) **One-to-one marketing** – E-marketing helps to reach people who want to know about the products and services instantly. For example, many people take their mobile phones, tablets or *Blackberry* hand-held devices with them wherever they go. If the combine this instant communication with the personalised aspect of e-marketing, companies can create very powerful, targeted campaigns.

(g) **More interesting campaigns** – E-marketing helps to create interactive campaigns using music, graphics and videos. For example, sending customers a game or a quiz – whatever will interest them.

(h) **Better conversion rate** – Customers are only ever a few clicks away from completing a purchase. In contrast to other media which require people to get up and make a phone call, post a letter or go to a shop, e-marketing is seamless.

Together, all of these aspects of e-marketing have the potential to add up to more sales.

As a component of e-commerce it can include information management; public relations; customer service and sales.

5.5.3 Developing an effective e-marketing plan

It is important to recognise that planning for e-marketing does not mean starting from scratch. Any online e-communication must be **consistent with the overall marketing goals** and **current marketing efforts** of the organisation.

The key strategic decisions for e-marketing are common with strategic decisions for traditional marketing. They involve selecting target customer groups and specifying how to deliver value to these groups. Segmentation, targeting, differentiation and positioning all contribute to effective digital marketing.

The **SOSTAC® planning framework** developed by Paul Smith provides a structured and effective approach to marketing strategy. It can be used by managers in the private, public and non-profit sectors.

S = Situation Analysis	Where are we now? What is the external environment in which we are operating? What are our own strengths and weaknesses?
O = Objectives	Where do we want to get to? What is our goal?
S = Strategies	How do we get there? What do we need to do to be successful?
T = Tactics	What are the individual steps we need to take to achieve our objective?
A = Actions	What are the things we need to do? What is our 'to-do' list? Who will do what?
C = Control	What will we measure to know we are succeeding? How will we know when we have arrived?

The planning framework is expanded in the diagram below to show the techniques/actions that make up each stage:

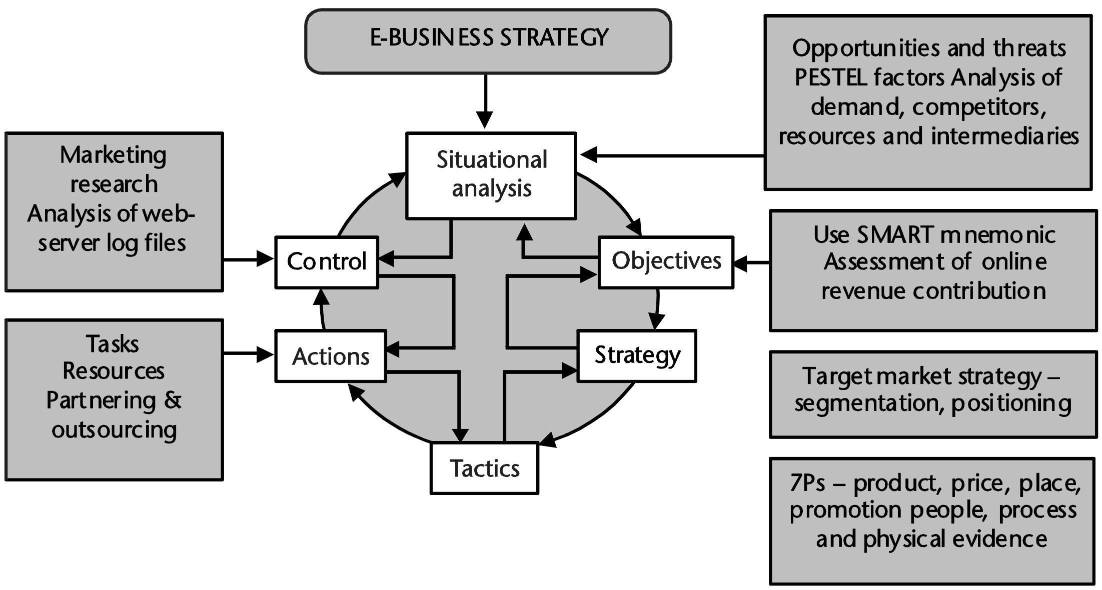


Figure 5.2: Framework for e-marketing planning

In developing an effective e-marketing plan, the media of e-marketing used at certain stages will include the following.

Competitor analysis	Scanning competitor internet sites Competitor benchmarking to compare e-commerce services within a market Competitive intelligence systems give a structured approach to monitoring and disseminating information on competitor activities
Intermediary analysis	Identify and compare intermediaries for a marketplace Search portals and look for new approaches for traffic building Research whether competitors are using disintermediation or re-intermediation

CHAPTER 5

Internal marketing audit	Focus on e-market measurement: Channel promotion → Channel behaviour → Channel satisfaction → Channel outcomes → Channel profitability Acquisition costs Referrers / Who? How? / Opinions? Attitudes? Brand impact? / Leads? Sales? / ROI? Profitability? Applying web analytics tools to measure the contribution of leads, sales and brand involvement currently delivered by online communications such as search engine marketing, online advertising and email marketing in conjunction with the website Create online CRM capabilities to understand customers' characteristics, needs and behaviours and to deliver targeted, personalised value
Objective setting	Online revenue contribution
Strategy	Identify target market by assessing size, segments, needs and competitive action Online value proposition (OVP)
Tactics	Use internet to vary the extended product Look at new channel structures Research people replacements: auto-responders, email notification, call-back facility, FAQs, on-site search engines and virtual assistants Branding Managing the continuous online marketing communications such as search engine marketing, partnerships, sponsorships and affiliate arrangements and campaign-based e-marketing communications such as online advertising, email marketing and microsites to encourage usage of the online service and to support customer acquisition and retention campaigns

5.6 Characteristics of e-marketing

The six 'I's of marketing developed by McDonald and Wilson summarise the ways in which the internet can add customer value and improve an organisation's marketing effectiveness:

- Independence of location
- Industry structure
- Integration
- Interactivity
- Individualisation
- Intelligence

By considering and questioning each of these aspects of e-marketing, marketing managers can develop plans to accommodate them.

Independence of location	Do you exploit any opportunities to deliver information-based products and services electronically? Electronic media gives the possibility of communicating globally – giving opportunities of selling into markets that may not have been previously accessible
Industry structure	Industry restructuring includes the following: Redesigning business processes (for example, distribution and logistics arrangements in the value system) Redrawing the market map in the form of new market segments or increasing the marketing boundaries Adopting IT enabled services (ITeS)

Integration	Do you have detailed knowledge of individual customers, influencers or consumers? Do you share this knowledge across all customer-facing parts of the business? Advertising products/services on the web is relatively easy. It is more difficult, but absolutely crucial, to gather vital customer information, obtain customer feedback, use existing knowledge about the customer and exploit the web's interactive nature to add value through product configuration, online pricing and so on
Interactivity	Do you use interactive media to allow your customers to communicate with you? Do you listen to what they say and respond appropriately in a continuing dialogue? Traditional media are mainly 'push' media – the marketing message is broadcast from company to customer – with limited interaction. On the internet it is usually a customer who seeks information on a web – it is a 'pull' mechanism. The growing use of carefully targeted direct mail as a means of communicating with individual customers has led some to call this 'the age of addressability'
Individualisation	Do you use your customer knowledge to tailor products and services to the needs of particular individuals or segments? Do you tailor all your communications to the characteristics of the recipients? Communications can be tailored to the individual, unlike traditional media where the same message is broadcast to everyone
Intelligence	Do you inform your marketing strategy with intelligence gleaned from your operational systems at the customer interface, for example through analysis of customer needs, segmentation, prioritising segments according to customer lifetime value etc? The internet can be used as a low-cost method of collecting marketing information about customer perceptions of products and services. The web site also records information every time a user clicks on a link. Log file analysers will identify the type of promotions or products customers are responding to, and how patterns vary over time

Case example: Amazon

One of the best-known examples of electronic commerce – Amazon – illustrates how the internet can be used for an interactive dialogue with customers; for example, in relation to buying a book online.

The Amazon.com website enables the customer to search for books on particular topics, and read reviews of them placed by other customers. The website also allows the customer to track the status of their order once it has been placed.

Additionally, if the customer has used the website before, Amazon uses the history of their past purchases to make recommendations for other similar items that it thinks will be of interest to the customer.

5.6.1 E-marketing and CRM

Earlier in this chapter, we discussed the concept of customer relationship management, and the three elements of customer acquisition, retention and extension.

The internet and online techniques can play an important role in these, perhaps most extensively in relation to customer acquisition.

The internet offers a number of methods for **acquiring customers**:

Search engines – Search engines (such as Google) mean that when users search for relevant key words or phrases, links to the company's website will appear in their search results. In turn, **search engine optimisation** can be used as a technique for improving the company's position in the search engine listings.

Pay per click (or cost per click) advertising – Companies can pay other websites to display a banner on their website, with the hope that potential customers will click on the banner, which then links through to the company's own website.

Affiliate marketing – A company rewards affiliates for each visitor or customer who comes to the company's website through the affiliate's own marketing efforts. Amazon is probably the best known example of an affiliate network; with an extensive range of sites directing customers to Amazon to buy books or music tracks that the affiliates have mentioned on their web pages.

Comparison sites – Comparison sites (such as www.moneysupermarket.com) allow potential customers to compare the price and features of different products, and if a product compares favourably to competitor products, this should encourage potential customers to buy it.

Viral marketing – Social networks are used to increase brand awareness, for example through video clips or images being passed from one user to another. A marketer creates the initial promotion (eg a video clip) but then relies on people to distribute it voluntarily across their social network. Therefore, marketers need to make the promotion appeal to the people who have the highest propensity to pass it on.

Business blogs – Companies can use blogs to showcase the knowledge and expertise of their employees, and thereby hopefully attract new customers. Blog marketing follows a similar logic to viral marketing. If a business can get itself or its products mentioned on different blogs, that will help generate interest among prospective customers. However, it is important that marketers concentrate their efforts on blogs covering topics which are relevant to their product or service offering.

Retention

The internet can also be useful for helping to **retain customers,** for example through the use of **personalised reminder emails**, possibly with discount codes or other incentives, to customers who have not made any purchases recently.

Online communities – The creation of online communities and forums could also help retain customers' interest in a product or service. However, these forums can also have an additional benefit for companies. By reading customers' feedback and comments, businesses can improve their understanding of customer needs, and can take steps to improve their products or services to address any issues which are currently attracting criticism on the forums.

Extension

Recommendations – Probably the best known examples of customer extension are the 'recommendations' that customers are given on Amazon. Amazon's data modelling software allows them to monitor products which customers often buy together. Therefore, when existing customers log back in to Amazon, they are given recommendations of other products they might like to buy, based on their previous purchases.

However, recommendations are not only made when customers log on, they also occur at the point a customer makes a purchase. For example, if a customer purchases a television, they might then be asked at the checkout if they also want to buy a television stand to go with their television.

5.7 Web 2.0 technologies and social media

The phrase 'Web 2.0' has become synonymous not only with a new generation of web technologies and softwares, but also with changes in the ways users interact with content, applications, and each other.

One of the key benefits of Web 2.0 technologies is that they increase opportunities for collaboration and the sharing of knowledge.

The most commonly used technologies – such as blogs, microblogs (Twitter), wikis and podcasts – can help companies strengthen their links to customers, especially with the use of automatic information feeds such as RSS (Really Simple Syndication). Not only do Web 2.0 technologies allow companies to distribute information about their products or services, but, perhaps more critically, they invite customer feedback and even customer participation in the creation of products and services.

Earlier in the chapter, we highlighted the importance of viewing marketing as a customer-centric process. By enabling marketers and sales staff to develop better insights into markets, or to interact with consumers, Web 2.0 technologies can be seen as being integral to a customer-centric process such as marketing.

Web 2.0 technologies and networked companies

Interestingly, a podcast by McKinsey Quarterly in March 2013 ('How companies are benefiting from Web 2.0') suggested that Web 2.0 deployments are not confined to companies' relationships with customers, but can also contribute to work flows and knowledge sharing between employees, and help create more **'networked' companies** – strengthening the links between companies and their suppliers and other business partners.

If Web 2.0 technologies improve knowledge sharing and access to knowledge within and across companies, this may also be able to help companies innovate more effectively.

5.8 The potential impact of Web 2.0 technologies and business strategy

Web 2.0 technologies can provide firms with opportunities in a range of activities – from market research to marketing, collaboration, innovation and design.

5.8.1 The importance of user experience and participation

Web 2.0 allows internet users (and potential customers for businesses) no longer simply to be recipients of information, but to participate in the creation, sharing and evaluation of content. In other words, users can actively take part in 'many-to-many' communications. A crucial aspect of Web 2.0 is that it focuses on **user experience** and **participation**.

This is important for businesses. Web 2.0 allows firms of all sizes to engage with customers, staff and suppliers in new ways. In particular, it allows firms to have a more customer-focused approach to **new product development** – because customers can be involved in the design of the new products.

Web 2.0 has highlighted the significance of **dynamic social interactions** in the environment, rather than considering business and business transactions as a set of static business processes.

We have already identified the **importance of knowledge** to businesses, and Web 2.0 plays an important role in this 'knowledge economy' through supporting **collaboration**, **knowledge sharing**, and ultimately, innovation.

The idea of **collaboration** is also very important when considering how Web 2.0 technologies could affect business strategies. The potential impact could be significant if organisations find it becomes as efficient to do business through collaborating **outside** the organisation's structure, rather than doing business within the organisation's own structure.

In effect, collaboration is an extension of the idea of **outsourcing**, although whereas with outsourcing, specific processes are outsourced **to** specific companies, in the case of collaboration, anybody can contribute to the discussion in progress. (The collaborative online encyclopaedia – Wikipedia – is probably the best known illustration of this, but Procter & Gamble has also promoted the idea of collaborative innovation through their 'Connect + Develop' programme, in which external innovators form partnerships with Procter & Gamble to develop new products.)

We will now look at some of the key aspects of Web 2.0.

Web-based communities

Probably the most popular aspect of Web 2.0 has been social networking sites, such as Facebook, which now has more than 500 million unique visitors.

Web-based communities are enhanced by:

- **Social networking** – Social networks (such as Facebook*)* allow users to make contact with other users. As well as mass market social networks, a number of smaller, more focused **niche social networks** have also begun to emerge. The value of these sites is that they allow users to connect with others whom they share a common interest with. For example, LinkedIn is a network for business people looking to build business contacts, and also to advertise their skills and experience to potential employers or clients.
- **Blogs** – Blogs provide an easy way for users to publish their own content. Blogs are usually text based. Users can publish audio and visual content as podcasts, and the growth of sites such as YouTube illustrates how popular podcasts have become.

  The microblogging site, Twitter, provides a platform for people who want to publish very short blogs – of up to 140 characters each.
- **Wikis** – Wikis allow user groups to collaborate in contributing and editing educational or reference-based content. Wikipedia, the collaborative online encyclopaedia, is the best known example of this.
- **Instant messaging** – This allows real time conversations between two or more participants using pop-up dialogue boxes (eg instant messaging is now available in Skype).

These web-based communities mean that web **users are now participants in the web experience**, rather than simply being observers. Moreover, these communities allow people to get to know each other and to interact, regardless of their physical or geographical location.

5.8.2 Socialisation of knowledge sharing

Web 2.0 technologies encourage the socialisation of knowledge sharing through:

- **Tagging of information** – A tag is a keyword assigned by a user to describe a piece of information (such as a file, an image, or an internet bookmark). Tagging is a key feature of many Web 2.0 applications and is commonly used on file storing and file sharing sites. Once a file has been tagged, the tag allows it to be found again when a relevant search enquiry is made.

  Tags are examples of **metadata**, which is 'data about other data'. The title, author and publication date of a book are examples of metadata about a book, and this data could help a user find the book he or she is looking for.

  Tagging also highlights an important point which businesses need to consider. The new technologies mean that the amount of information on the internet is rising constantly. However, information is no use if it can't be found. Search engine optimisation (SEO) is therefore, increasingly important for businesses – making sure that the information on the website of a business is findable and relevant.

- **Mashups –** A mashup is a web publication that combines data from more than one source into a singe web page. For example, a restaurant review website could take the location details of all the local restaurants in an area and map them onto a single Google map page.

- **Feedback** on sources of information.

- **Promoting collective intelligence** – Collective intelligence refers to both structured and unstructured group collaboration. It describes the way people's opinions or behaviours can be aggregated so that others can learn from their collective decision making.

  The online auction site eBay uses collective intelligence to let potential buyers see how efficient and trustworthy vendors are. Equally, Amazon and a number of online sites include product reviews, allowing people who have purchased an item to comment on the item and rate its performance.

  Amazon also uses collective intelligence to make product recommendations based on purchasing patterns. When a user selects an item to buy, he or she is presented with a list of other items purchased by people who have already bought the current selection, which may encourage a user to make follow up purchases.

User generated content (UGC): Websites can now have sections of content created by their readers. One of the main ideas behind Web 2.0 technologies is that users can generate the content of sites themselves, and these technologies allow users to create, capture and share information across the web. The video streaming website, YouTube, and the image and video hosting website, Flickr, are popular examples of content sharing sites.

Consumer generated content (CGC): Websites can now contain shared feedback from consumers; for example, product reviews. This has important implications for businesses, because it means customers can communicate with other (potential) customers very easily. If a customer receives poor customer service, they can now tell everyone else about it, which could damage the business' reputation, and lead to a decline in sales.

The most widely known example of CGC is the user reviews developed by Amazon noted above. Many customers review users' product reviews when assessing prospective purchases.

5.8.3 Applications of Web 2.0 for business

In recent years, we have seen the emergence of a number of new online companies. Most are probably also run by young entrepreneurs for whom technology will play a key role in their business strategy:

- The business can find partners, collaborators, customers and suppliers through social networks and blogs.
- It can use blogs and social networks for publicity and to market itself, and it can encourage customers to leave feedback on its site (customer generated content).

- It can manage the development, creation and delivery of its products through virtual workspaces and wikis that support collaboration, innovation and the management of workflow. The collaborative nature of Web 2.0 enables external third parties to participate in product development.
- It can get market intelligence through blogs and online reference sites. It can also get feedback on how customers perceive its own products or services.

Staff – Importantly also, if a business wants to attract and retain young, dynamic employees, they will need to provide them with tools they are familiar with, and offer a work environment that fits in with their lifestyle.

Marketing – Web 2.0 can have significant implications for marketing approaches. Teenagers and young adults can be an important demographic for many businesses, and sites such as Facebook and Twitter play an important part in their lives. In this way, running campaigns through popular social networking sites can offer businesses a way of engaging with these users, allowing them to reach a demographic that has traditionally been difficult to reach. Marketers can also use pre-existing social networks as a mechanism for promoting **viral marketing** campaigns. In these, a company will generate an initial marketing message, but people then pass it along to their friends and contacts through their social networks.

Case example: Social media and promotions

Discounts are a very important marketing tool for attracting new customers or clients to a company, and a number of companies now distribute special offers and promotional codes via Facebook. In effect, the companies are offering discounts to users who 'like' their Facebook page. Importantly, the promotional codes are offered exclusively to people who 'like' a company or brand's page on Facebook.

By using promotional codes in this way, a company could hope to encourage loyalty among its Facebook fans, but it can also gather information about them (for example, email address; age) if users have to provide these details in order to validate their code.

Similarly, companies are encouraging customers to 'follow' them on Twitter, to receive voucher codes as well as updates on other special offers.

However, the value of social media comes from allowing companies to engage with customers and build relationships with them, not simply from selling to them.

For example, Starbucks communicates with fans on Facebook on an ongoing basis, with a stream of offers and benefits; only some of which are revenue generating. Starbuck's Facebook page combines its offers with stories about the brand, the history of its coffees, and the history of Starbuck's stores. Moreover, Starbucks' Facebook page also incentivises people to 'share' the page with friends. In turn, this sharing adds to the number of customers (and potential customers) Starbucks can build a relationship with.

By September 2013, Starbucks was liked by over 35 million people on Facebook, and had more than 4.3 million Twitter followers.

Porsche and Twitter

Social media can be used effectively by a wide range of brands – including luxury brands.

In the build up to the launch of its 2012 model, Porsche wanted to evoke the rich history of its brand and build excitement amongst sports car enthusBASts. In the days leading up to the launch of the new Porsche 911, Porsche began to seed the hashtag '#2012Porsche911' using Promoted Tweets(*) to develop interest in the launch of the new model.

These Tweets featured photos and videos that highlighted the history of the car, and included links to teaser videos which were then featured in greater depth at the launch.

(*: In terms of its content, a 'Promoted Tweet' is no different to an ordinary tweet, but a tweet is 'Promoted' when an advertiser has paid for its placement on Twitter. In this respect, Twitter can be seen directly as an advertising medium, in the same way that television or newspapers have historically been used as advertising media.)

However, if companies do engage in social networking or publish blogs, they need to monitor how these are perceived by the online communities. **Brand management** remains very important – perhaps even more so now, because of the way users can publish negative feedback on poorly designed or presented content.

Conversely though, favourable customer review comments on products or services can be very useful PR material for an organisation.

By allowing web users to provide feedback and share ideas, Web 2.0 is encouraging a model in which people from outside an organisation can have an impact on that organisation's strategy.

Moreover, the internet becomes, in effect, a research tool, where companies can find out about customers' opinions about products and services. Web 2.0 allows businesses to aggregate opinions from many different individuals to guide idea generation and strategic decision making.

In this way, customer networks and social interaction have become much more important in marketing.

5.8.4 Potential limitations of social media

In recent years, there has been considerable hype about the growth of social media. However, some commentators still urge caution about the impact of social media on purchasing decisions. In particular, questions are raised about the sort of information which people actually exchange on social networking sites.

People use social media mainly to socialise, not to buy goods or services. As a result, much of the information that is exchanged is non-commercial in nature, and so may be of limited value to businesses.

Clearly, there is some overlap between the conversations people have about their social lives and conversations about products, services and brands. In this respect, social networking platforms may be a good way for companies to 'listen' to what customers are saying about their brands.

Similarly, social media can be very useful for networking, building relationships and engaging with customers and prospects. However, the actual expenditure generated through social media has, so far, been relatively low, so other marketing channels may remain more relevant and powerful for influencing customers' purchasing decisions.

For example, many brands boast very large numbers of Facebook fans or 'likes'. But marketing directors could be justified in asking what benefits these 'likes' actually bring a brand. Simply 'liking' a brand on Facebook doesn't mean that someone is going to purchase that brand.

Potential issues with social media

Potential threat to companies/brands – Social media gives customers the power to transmit/share messages which may not be the messages the companies actually want to be transmitted (for example, if a guest has had an unsatisfactory meal in a restaurant, or stay in a hotel, they can publicise this on review sites such as Trip Advisor).

Equally, conversations between social networkers may not be in the best interests of a company. For example, many Facebook groups are set up to complain about organisations.

In this way, the internet and social media are not simply increasing the role of the consumer in the marketing process, they could also be seen to be increasing consumers' power over the marketing process.

6 Brand management

Section overview

- Strong brands are important to companies and consumers. Strong brands add value to companies, justify premium prices and therefore higher profits, strengthen customer perceptions of a company, act as a barrier to competition, and provide a base for brand extension. Customers benefit because they can trust the brand and rely on the quality of the product/service they are buying.

6.1 Brands and strategic performance

Traditionally, a **brand** is a name, term, sign, symbol or design intended to identify the product of a seller and to differentiate it from those of competitors.

However, as Morgan Witzel stresses in his article, 'Strategy and Brands' (ICAEW, *Finance & Management*, October 2010) a brand is much more than just a name or marque.

In his article, Witzel stresses that no company, whatever market or sector it operates in, will enjoy long-term strategic success unless it has a strong brand. Companies need strong brands in order to survive, and therefore, a key task for managers thinking about their company's strategy, is to understand what their brand is and how to strengthen it.

In Chapter 1 of this Study Manual we considered the role of resources and capabilities shaping an organisation's strategy. However, as the business environment becomes increasingly dynamic, many sources of competitive advantage, such as technology, become increasingly short-lived. Despite this, brands remain one of the few assets that can provide and sustain long-term competitive advantage.

Strong brands can enhance business performance through their influence on key stakeholder groups. For example:

Customer – Influencing customer choice, and creating loyalty

Employees – Attract, motivate and retain talent

Investors – Lowering the cost of financing

The influence of brands on customers is a particularly important driver of economic value. Strong brands help shape customer perceptions and therefore, purchase behaviour, making products and services less substitutable. In this way, brands help to create and sustain demand, allowing their owners to enjoy higher returns.

Interactive question 4: Brand marketing [Difficulty level: Easy]

The CPH Group comprises four companies, operating in very different market sectors.

- CPH Construction Ltd (Construction)
- CPH Engineering Ltd (Engineering)
- CPH Transport Ltd (Transport)
- CPH Gaming Ltd (Gaming)

Each of the companies has its own management team, headed by a managing director.

Recently, the managing director of CPH Gaming has come under increasing pressure from the board of the CPH Group to justify the comparatively large outlay the business incurs on marketing and advertising, compared to the other three companies. The managing director maintains that Gaming relies more heavily on its brand than the other CPH companies and as such, must invest a much higher proportion of its turnover into marketing and promotion.

Requirement

Describe how the CEO of Gaming could substantiate assertions about the level of brand investment his business requires.

The brand management consultancy, Interbrand, highlights two key concepts which influence the value of a brand:

Role of brand – The brand's influence on current purchase behaviour; the influence that brands can have on demand by encouraging customers to select one product in preference to another.

Brand strength – Brand strength is a brand's ability to sustain demand into the future by encouraging customer loyalty, and thereby reducing risk associated with the brand's financial forecasts (for example, arising from the risk that customers will switch to competitor products or services).

Case example: Brand strength

The Interbrand Report of Top Global Brands (2012) identified Coca-Cola as the most valuable global brand, with a brand value of $77,839 million.

Coca-Cola itself has acknowledged that only a relatively small percentage of the company's value lies in its plant and machinery; because most of the value lies in its brand.

Strong brand names have positive effects on consumer perceptions and preferences.

Jobber, in *Principles and Practice of Marketing,* highlights a striking example of this:

> *Two matched samples of consumers were asked to taste Diet Coke and Diet Pepsi, and state a preference between the two drinks. The first group carried out a 'blind test' (that is, they tasted the drinks without being told which one was which.) The second group carried out an 'open test' (that is, the group knew which drink was which when they tasted them).*

The results of the tests were as follows:

	'Blind' tasting	'Open' tasting
Prefer Diet Coke	44%	65%
Prefer Diet Pepsi	51%	23%
No clear preference	5%	12%

The tests clearly show how a strong brand name influenced perceptions and preferences towards Diet Coke.

This kind of positive brand equity is likely to result in high customer loyalty and low price sensitivity, which in turn should enable market-leading brands (like Coca-Cola) to be able to sustain high profits.

Brand identity

Brand identity conveys a lot of information very quickly and concisely. This helps customers to identify the goods or services and thus helps to **create customer loyalty** to the brand. It is therefore a means of increasing or maintaining sales. (In some extreme cases, a strong brand could even act as a **barrier to entry**, preventing potential entrants from entering a market if they think customers will not be persuaded to move away from the brand.)

Where a brand image promotes an idea of **quality**, a customer will be disappointed if their experience of a product or service fails to live up to expectations. Quality assurance and control is therefore of the utmost importance. It is essentially a problem for **service industries** such as hotels, airlines and retail stores, where there is **less possibility** than in the manufacturing sector of **detecting and rejecting the work of an operator before it reaches the customer**. Inappropriate or unhelpful behaviour by an employee in a face-to-face encounter with a customer will **reflect on** the **entire company** and possibly deter the customer from using any of the company's services again.

Brand awareness is an **indicator of a product's/organisation's place in the market**. **Recall tests** can be used to assess the public's brand awareness.

6.1.1 Branding and strategy

Branding messages are usually qualitative rather than focusing on price. One of the perceived advantages of branding is that by creating an 'identity' for a product, an organisation can reduce the importance of price differentials between their product and rival products. This may, in turn, allow an organisation to charge a higher price for their product.

However, some brands will position themselves on the basis of value for money, so branding does not necessarily mean charging premium prices. Moreover, certain consumers reject 'branded products', especially when considering **value for money.** This can be seen in supermarkets where shoppers choose generic (own label) products in preference to brand names, because the own label products are seen as being cheaper but having the same use.

In this respect, branding is perhaps most appropriate to organisations or products which are following a differentiation strategy. Branding is a form of **product differentiation,** which makes it possible for organisations to charge premium prices for a product (or service) and therefore earn higher profits than if products had to be sold at a lower price. (Think, for example, of designer clothes labels. The kudos attached to the brand means that the clothes can be sold for significantly higher prices than non-branded equivalents.)

Luxury brands use quality and exclusiveness to appeal to consumers. Recent reinventions of 'tired' brands include Burberry, where a new designer has extended the brand life by reinventing the house style and transferring this into new products. Extending the brand life in this way means the business can continue to benefit from the status of an existing brand. Burberry had a loyal customer base who bought the signature check products and these are still produced. However, it was also able to extend the brand life by attracting younger and high-spending customers who prefer modern interpretations but associated with established quality. This represents additional revenue.

Another important aspect of branding is the creation of brand loyalty, thereby improving **customer retention** rates and encouraging repeat purchases. An example of the way organisations try to increase band loyalty is in the use of loyalty cards by supermarkets (for example, Tesco's Clubcard).

6.1.2 Reasons for branding

The following are reasons for branding:

(a) It is a form of product **differentiation**, conveying a lot of information very quickly and concisely. This helps customers to identify the goods or services readily and thereby helps to create a customer loyalty to the brand. It is therefore a means of increasing or maintaining sales.

In this way, a brand can also act as a **barrier to entry**. If a supplier has already established a strong brand in a market, it will discourage new entrants into that market.

(b) **Advertising** needs a brand name to sell to customers, so advertising and branding are very closely related aspects of promotion; the more similar a product (whether an industrial/commercial or consumer) is to competing goods, the more branding is necessary to create a separate product identity.

(c) Branding leads to a **readier acceptance** of a manufacturer's products by wholesalers and retailers.

(d) It facilitates **self-selection** of goods in self-service stores and also makes it easier for a manufacturer to obtain display space in shops and stores.

(e) It **reduces the importance of price differentials** between products.

(f) Brand loyalty in customers gives a **manufacturer more control over marketing strategy** and of choice of channels of distribution.

(g) Other products can be introduced into a brand range to 'piggy back' on the articles already known to the customer (but ill-will as well as goodwill for one product in a branded range will be transferred to all other products in the range). Adding products to an existing brand range is known as brand extension strategy.

(h) It eases the task of personal selling (face-to-face selling by sales representatives).

(i) Branding makes market segmentation easier. Different brands of similar products may be developed to meet the specific needs of different categories of users.

The relevance of branding does not apply equally to all products. The cost of intensive brand advertising to project a brand image nationally may be prohibitively high. Products which are sold in large numbers, on the other hand, promote a brand name by their existence and circulation.

Brand strength

The brand management consultancy, Interbrand, has highlighted a range of factors which determine a brand's strength. If organisations are trying to manage or sustain their brands, they would be advised to check how well their brands perform against these factors:

Internal factors	
Clarity	It is important to be clear about what the brand stands for: its values, its positioning, its value proposition, and what customers can expect from using the brand. (In this respect, note the links between branding and positioning that we discussed earlier in the chapter.) It is also important to be clear about who the brand's target audiences are, and what they value.
Commitment	An organisation needs to be committed to its brand, and believe in the importance of its brand.
Protection	How secure is the brand; for example, through legal protection, or through proprietary ingredients or design?
Responsiveness	The ability to respond to market changes, whether they are opportunities or threats. In this way, the brand needs to be able to evolve and renew itself, to ensure it remains relevant to the market.

External factors	
Authenticity	The brand needs to be based on an internal truth and capability, and can consistently deliver against the expectations which customers have of it.
Relevance	What the brand offers needs to fit with customer needs and desires, across all relevant market segments and geographies.
Differentiation	The brand's strength will be influenced by the degree to which customers perceive the brand to have a differentiated position, which is distinctive from its competitors.
Consistency	The brand experience needs to be consistent across all touch-points or formats.
Presence	How aware are people of the brand? How much is it talked about (positively) by consumers, customers and opinion-formers; in both traditional media and social media?
Understanding	Do customers recognise the brand, and also understand its distinctive qualities and characteristics? Where appropriate, do customers also understand the company that owns the brands, and the distinctive qualities of that company?

When looking at strategies to maintain or develop their brands, companies should consider how well the proposed strategies will help to strengthen these factors.

However, it is also important to ensure that the brand's position fits with the other elements of the marketing mix.

Note: the link back to the idea of positioning which we covered in Section 3 of this chapter. Brands can be positioned against competitor brands on product maps defined in terms of how buyers perceive key characteristics of the brands.

Case example: Coca-Cola

The power of Coca-Cola's brand comes from the fact that its name is more universally recognised than any other in the world.

The following points are summarised from the 2012 Interbrand 'Best Global Brands' report:

Some people choose Coke for its flavour, but for millions, it's the way Coke makes them feel. A brand that's always evolving, Coke's promise of fun, freedom and refreshment resonates almost everywhere.

The company excels at keeping the brand fresh while maintaining a powerful sense of nostalgia that unites generations of Coke lovers and reinforces consumers' deep connections to the brand.

Although Coca-Cola sold millions of beverages on the Olympic grounds in London [at the 2012 Olympics], the brand's real returns have come from global viewership. The Olympic games is one of the few marketing platforms which are relevant to a truly global audience, and so the Olympics has allowed Coca-Cola to solidify a powerful association in the minds of billions of people. Coke has been a sponsor of the Olympics since 1928, and through its consistent presence at the Games, it continues to build its brand strength, reach, and impact every time the Olympic torch is lit.

Yet, despite its vast size, Coke has proved its ability to be nimble, flexible and innovative; being able to adapt to local markets and new eras without diminishing its legacy. The brand continues to embrace digital media; expanding its online presence and engaging with consumers via its 'Coca-Cola Music' promotion.

Coca-Cola may be more than 125 years old, but with more than 50 million fans on Facebook, more than 1.8 billion Coke products consumed daily, and 3,500 beverages in its diverse portfolio – 'Coke's still got it.'

(Sourced from: Interbrand – Best Global Brands 2012. www.interbrand.com)

6.2 Brand strategy and marketing strategy

Brand positioning is a crucial part of marketing strategy. As we identified in Section 3 of this Chapter, **positioning** is the 'act of designing the company's offer and image so that it occupies a distinct and valued place in the target customer's mind.' As its name implies, positioning involves finding an appropriate position for a product or service in the market place so that consumers think about that product or service in the 'right' way. Equally, brand positioning involves identifying the optimal location of a brand in the minds of consumers, and in relation to its competitors, to maximise the potential benefit of the brand to the company which owns it.

If we consider the general functions of a brand (per the bullet points below), we can see how closely they are also linked to the logic of positioning:

- To distinguish a company's offering, and to differentiate one particular product from competitor products
- To deliver an expected level of quality and satisfaction
- To help with promotion of the product and to develop awareness of it

Brand positioning should help to guide marketing strategy by clarifying: what a brand is; how it is unique or how it is different from competing brands; and why consumers should purchase and use the brand.

Once a brand's positioning strategy has been determined, the brand's marketers can then develop and implement their marketing strategy to create, strengthen or maintain brand associations. In this respect, obtaining an appropriate combination of the 'marketing mix' elements (4 Ps, or 7 Ps) will be very important when designing the marketing campaigns to support the brand.

Product – The product (or service) is central to brand equity because it is the primary influence on consumers' experience with a brand, as well as on what they hear about a brand from others, and about what a company can tell consumers about the brand in any marketing communications.

Products must be designed, manufactured, marketed, sold, delivered and serviced in a way which creates a positive brand image with customers. If a company does not have a product or service which satisfies customer needs (particularly in relation to perceived quality and value), that company will not be able to develop a successful brand, or engender any customer loyalty to that brand.

The importance of acquiring and retaining loyal customers has led to relationship marketing becoming a priority for branding. The marketers who are most successful at building customer-based brand equity will be those who ensure they understand their customers, and understand how to deliver value to their customers before, during and after purchase.

Price – The price element of the marketing mix pricing policy for a brand is very important because it can play a key role in shaping consumers' perceptions of a product (eg. as being high-, medium, or low-priced.) However, price often also has an association with quality; and consumers often infer the quality of a product or service on the basis of its price.

In some cases, consumers are willing to pay a premium for certain brands because of what they represent. But in terms of preparing a marketing strategy to develop a brand, it is important to ensure that the price is consistent with the perceived quality or value of a product to the customer. The benefits delivered by a product, and its competitive advantages compared to rival products, can often have a significant impact on what consumers believe to be a fair price for a product.

In this context, the concept of **value pricing** could be very useful. The objective to value pricing is to identify the right blend of product quality, product costs and product prices to satisfy both the needs and wants of consumers and also the profit targets of the company.

Place – The manner in which a product is sold or distributed can have a profound impact on the sales success of a brand. In this respect, channel strategy (the way firms distribute their products to consumers) is important for building and maintaining a brand.

In this respect, channel strategy involves deciding whether to sell directly to customers or to sell through third-party intermediaries (eg wholesalers, or retailers). In either case, however, it is important to ensure that the shop's image is aligned to the brand's image – for example, it would not seem appropriate to use a discount retailer for selling a brand which seeks to emphasise high quality and luxury as differentiating factors.

Another important decision in relation to channel strategy is whether to sell online, offline, or through a combination of both.

For many companies, the best channel strategies will be ones which develop an integrated shopping experience, combining physical stores and internet. For example, Nike sells its products through a range of department and clothes shops as well as through some of it own 'Nike Town' shops. Alongside this, Nike's own e-commerce website (store.nike.com) allows customers to buy directly from it online, while a number of the other shops which stock Nike products also have their own e-commerce websites.

Promotion – It should be obvious that the aim of promotion and marketing communications should be to increase consumers' knowledge of a brand and to entice them to buy that brand.

Companies have a wide range of potential communication options they could use for a marketing campaign: for example, broadcast media, print media, direct response (eg phone calls), online advertising; consumer and trade promotions; or event marketing and sponsorship. Crucially, however, when deciding on its promotion strategy, a company must evaluate the effectiveness and efficiency with which that strategy affects brand awareness, and how it creates or strengthens favourable brand associations.

In their text, Strategic Brand Management, Keller *et al*, highlight a number of marketing communications guidelines (shown in the table below). The need to focus on well-defined target markets is particularly relevant here because it again highlights the link to positioning. Equally, the need for consistency across all communications options can be seen as a parallel reminder of the need for consistency between an organisation's brand and its strategy.

Be analytical	Use frameworks of consumer behaviour and managerial decision-making to develop well-reasoned communication campaigns
Be curious	Use a variety of forms of research to understand consumers better; always thinking how you can create value for consumers
Be single-minded	Focus your message on well-defined target markets
Be integrative	Reinforce your message through consistency and cueing across all communication options and media
Be creative	State your message in a unique fashion; use different proposition and media to create favourable, strong and unique brand associations
Be observant	Keep track of competition, competitors, channel members and employees through monitoring their activities
Be patient	Take a long-term view of communication effectiveness to build and manage brand equity
Be realistic	Understand the complexities involved in marketing communications

Marketing communications guidelines (from Keller, K. *et al*, *Strategic Brand Management*)

6.3 Brands and strategic alignment

In order for a business to be successful, there needs to be alignment between its strategy and its brand.

Brands will ultimately only succeed if they are capable of delivering what they promise, day in and day out; year in year out.

Although Toyota has had problems with product recalls in recent years, its sales figures have bounced back, because customers have offset the recent problems against their own long experience of reliable Toyota cars, and this experience has won in the long run. Although brand equity has been tarnished slightly by the product recalls, it has not been badly damaged.

Links between branding and operational strategy

To deliver reliable brands, a company needs to ensure that its production and distribution systems are reliable, that its marketing staff are in touch with its customers, and that any faults get reported so that they can be repaired quickly.

In short, in order to deliver a reliable brand, an organisation needs to ensure that all its staff members are focused on doing their best for the customer, and that senior managers within the organisation are also engaged with this customer-centric process.

To be effective, brand marketing strategy and business strategy must be properly aligned; both internally and externally. Internally, employee commitment will be required to support internal service quality, while externally the brand quality will influence customer satisfaction and retention.

If companies become complacent, or fail to cherish their brands, the results can be very damaging. Marks & Spencer has historically been an iconic name in British retailing, but in the 1990s its senior managers took their eye off the ball, and by the time they realised how customers' opinions of the brand were falling, it was almost too late. It has subsequently taken many years, and a lot of hard work, to restore the M&S brand.

The social value of brands

Although the economic benefit of brands to their owners is clear, the social value of brands may be less clear. For example, critics argue that brands only create value for their owners, rather than society at large. In this respect, the critics argue that brands lead to the exploitation of workers in developing countries, and the homogenisation of cultures. Furthermore, if brands establish monopoly positions in markets, they stifle competition and limit consumer choice.

The counter argument is that brands create significant social as well as economic value, as a result of increased competition, improved product or service performance, and the pressure on brand owners to behave in socially responsible ways in order to uphold the image of the brand.

Moreover, competition on the basis of performance as well as price, fosters product developments and improvement. The need to keep brands 'relevant' can therefore also act as an incentive for research and development. In this respect, there is evidence that companies which promote their brands more heavily than others in their market segments, also tend to be more innovative than their rivals.

6.3.1 Customers and brand value

Brand value is created by customers' reactions to a brand. If a customer has a positive experience of a brand, they will be more likely to use that brand again and become loyal to it, so the brand's value increases. Conversely, if customers have a negative experience of a brand or are dissatisfied with it, then the brand's value will effectively go down.

As with so many aspects of marketing we have discussed in this chapter, here again we can see the importance of customers in the success of a brand. The growth of social media reinforces this too.

As Morgan Witzel notes in his article in *Finance & Management*:

> *Today, every action a company takes, every experience people have of a brand, is likely to be discussed on the internet – often almost immediately. Take for example the popular website TripAdvisor, where people post their experiences of hotels and holiday destinations. Many people, before making a booking, look up the destination on TripAdvisor and make purchase decisions on what they read there. Brand value – both positive and negative – is created in the process.*

The reference to social media also highlights the importance of companies listening to customers and reacting to their views. However, this engagement and interaction between companies and customers is ultimately critical for creating brand equity.

6.3.2 Brand value

We will look at the techniques for valuing brands later in this chapter, but in terms of developing strategies for managing brands, it is important to understand the sources of brand value:

Source	Comment
Experience	The customer's actual usage of a brand can give positive or negative associations.
User associations	Brands get an image from the type of people using them; brands might be associated with particular personalities.
Belief	This might be a 'placebo' effect; belief in a brand may enhance its effectiveness.
Appearance	Design appeals to people's aesthetic sensibilities.
Manufacturer's name	The company reputation may support the brand.

(Based on: Doyle & Stern, *Marketing Management and Strategy*)

These sources of brand value suggest that **customers** play a key role in creating brand value. As the case example (earlier) of the 'blind test' between Coca-Cola and Pepsi shows, customers exhibit a **subjective** preference for a strong brand name, even though they cannot tell the difference between two products.

However, brand equity doesn't solely come from customers. There are also two important sources of brand value which are controlled by the brand's company:

(a) **Patents** – Patents protect a brand from competitive threat over the lifetime of the patent. Patents are often used to protect pharmaceutical brands, but the value of the brand will fall as its patents expire and it becomes subject to competition from low-priced generic manufacturers.

(b) **Channel relationships** – Close relationships with distributors and suppliers can enhance the value of company brands. This reinforces the importance of effective supply chain management (which we have discussed in Chapter 3).

7 Branding and marketing strategy

Section overview

- The importance of having a strong brand means that developing brands is a key marketing activity for a company. Developing a brand involves a continuous search for ways to increase the brand's full potential.

7.1 Branding strategies

In the previous section, we looked at ways a company could manage or sustain its existing brand. However, companies may also want to use branding strategies to develop and expand their brands.

Kotler has identified the following five strategies a company can use once it has established its brand(s):

(a) **Line extension** – An existing name is applied to new variants of existing products, for example Coca-Cola launching Diet Coke.

(b) **Brand extensions** – Using an existing brand to launch a product in a new category, for example chocolate bars such Mars or Galaxy and Mars/Galaxy ice creams.

(c) **Multi-branding** – Launching several brands in the same category, for example Kellogg's offers a range of breakfast cereals with their own brands – for example, All-Bran, Cornflakes, CocoPops, Rice Krispies.

(d) **New brands** – New products are launched under their own brand, for example Coke attempting to sell bottled water under the 'Dasani' brand.

(e) **Co-branding** – Two brands are combined in an offer, for example Sony Playstations were offered in a package with a Tomb Raider game.

The decision as to whether a brand name should be given to a range of products, or whether products should be branded individually, depends on quality factors.

(a) If the brand name is associated with quality, all goods in the range must be of that standard.

(b) If a company produces different quality (and price) goods for different market segments, it would be unwise to give the same brand name to the higher and the lower quality goods because this could deter buyers in the high quality/price market segment.

7.2 Developing an effective position

Deepening a brand means moving a brand, in the minds of consumers, from a **defined product** with **differentiated features**, to a product they identify with their **personal goals and values**.

A brand's position can be strengthened by 'laddering' from functional to more emotional benefits – in effect, giving a customer multiple reasons to believe in the brand. Procter & Gamble grew the Pantene shampoo brand by emphasising how the ingredient, *ProV*, not only led to healthy hair, but could also make hair feel softer or thicker.

7.2.1 Strategic planning and brand development

The 'classic' approach to developing brands is outlined below. Brands are developed from the strategic plan and are part of the hierarchy.

Stage	Description
Market analysis	An overview of trends in the environment, markets, customers and competitors and the identification of any PESTEL factors which may affect the brand.
Brand situation analysis	Analysis of the brand's personality and individual attributes. This represents the internal audit and questions such as, 'Is advertising projecting the right image?', 'Is the packaging too aggressive?', 'Does the product need updating?' need asking. This is a fundamental evaluation of the brand's character. There are three aspects. **Core**. Fundamental, unchanging aspect of a brand. **Style**. This is the brand's culture, personality, the identity it conveys and so on. **Themes**. These are how the brand communicates through physical appearance of the product. Clearly, themes are easier to change than style, which in turn is less difficult to change than the core.
Targeting future positions	This is the core of brand strategy. Any brand strategy could incorporate what has been learnt already into a view of how the market will evolve and what strategic response is most appropriate.
Testing new offers	Once the strategy has been decided, the next step is to develop individual elements of the marketing mix and test the brand concept for clarity, credibility and competitiveness with the target market.
Planning and evaluating performance	The setting of the brand budget, establishing the type of support activity needed and measurement of results against objectives. Information on tracking of performance feeds into step one of the brand management process.

7.3 Global or local brand?

In Chapter 2, we discussed international strategies and the idea of firms expanding internationally.

International growth also has important implications for branding though: should there be one global brand for a product, or a range of different national brands?

In most cases, firms will have to evaluate the benefits of having a single global brand (eg for advertising synergies) against the benefits of being able to meet specific needs more closely. However, there may also be specific practical issues – for example, if a brand name means something rude or offensive when translated into another language.

7.4 Off-line and on-line branding

IT and the internet have particular implications for branding.

- The domain name is a vital element of the brand
- Brand values are communicated within seconds *via* the experience of using the brand website
- Online brands may be created in four ways
  - Migrate the traditional brand
  - Extend the traditional brand
  - Partner with an existing digital brand
  - Create a new digital brand

7.4.1 Online brand options

Migrate traditional brand online – This can make sense if the brand is well known and has a strong reputation eg, Marks & Spencer, Orange and Disney. However, there is a risk of jeopardising the brand's good name if the new venture is not successful.

Extend traditional brand – A variant. For example, before the growth of online shopping, when Aspirin could only be bought over the counter in shops and pharmacies, Aspirin's brand positioning statement was 'Aspirin – provides instant pain relief'. However, management felt this didn't work as a meaningful statement in relation to e-commerce, because consumers can't get instant pain relief on the web. So the brand positioning statement was changed to 'Aspirin – your self help brand', and the website offered 'meaningful health oriented intelligence and self help'.

Partner with an existing digital brand – Co-branding occurs when two businesses put their brand name on the same product as a joint initiative. This practice is quite common on the internet and has proved to be a good way to build brand recognition and make the product or service more resistant to copying by private label manufacturers. A successful example of co-branding is the Senseo coffeemaker, which carries both the Philips and the Douwe Egberts brands.

Create a new digital brand – Because a good name is extremely important, some factors to consider when selecting a new brand name are that it should suggest something about the product (eg Betfair), be short and memorable, be easy to spell, translate well into other languages and have an available domain name.

8 Valuing brands and intangible assets

Section overview

- Brand value (or brand equity) is a measure of the strength of a brand in the market place and its ability to add tangible value to a company through the resulting sales and profits.
- Nonetheless, brand valuation is a very difficult task. However, if a company is considering an acquisition, it will need to assess the value of any brands it will be acquiring. IAS 38, *Intangible Assets* prescribes that internally generated brands are not recognised as intangible assets and so should not be capitalised on a company's statement of financial position.
- IFRS 3, *Business Combinations* and IFRS 13, *Fair Value Measurement* contain rules on valuing intangible assets in a business combination. This includes in intangibles, such as brand assets, which may not have been recognised in a subsidiary's separate financial statements.

8.1 Brand equity and the brand asset

One of the key aspects of branding is that branding and a firm's reputation are linked. The important thing to remember is that a brand is something which **customers** value: it exists in the customer's mind. A brand is the link between a company's activities and the customer's perception.

Brand equity is the asset the marketer builds to ensure continuity of satisfaction for the customer and profit for the supplier. The asset consists of consumer attitudes, distribution and so on. It is thus the public embodiment of the organisation's strategic capability.

A strong brand should help to generate future cash inflows and higher profits for a company. Brands can build market share. They can be used to support higher prices (by differentiation) and enable manufacturers to exercise some control over distributors. Despite all of these attributes, however, internally generated brands are not recognised as intangible assets under IAS 38, *Intangible Assets*.

8.2 Valuing brand equity

Brand equity is a way of expressing how much a brand is worth to a company. Although internally generated brands cannot be capitalised, IFRS 3 provides that brands should be measured as part of the intangible assets acquired in an acquisition. Therefore, in the context of an acquisition, a brand's value will affect the price that a company will be prepared to pay to acquire another company which owns valuable brands.

We will look more generally at acquisitions and company valuation in Chapter 12 of this Study Manual. However, the key point to note here is that the fair value of any internally generated brands should be included when determining the value of the assets acquired, despite not being included in the financial statements of the company being acquired.

Moreover, following the acquisition, the **fair value of the brand acquired** can be capitalised and included in the group accounts, and should subsequently be amortised or reviewed for impairment on an annual basis.

The nature of this treatment, however, and the difference between the way internally generated and acquired brands are accounted for, could make it harder to compare the performance of companies. The value of **acquired brands** is included within consolidated statements of financial position, but the value of internally generated brands remains unaccounted for. This could be a significant issue when comparing groups which have grown organically (and in which brand-building expenditure is written off as incurred) against groups which have grown by acquisition.

8.3 IFRS 3 *Business Combinations*

IFRS 3 contains detailed rules on how to determine the consideration transferred in a business combination and the fair value of the assets acquired and liabilities assumed to ensure the goodwill figure is accurate. The acquirer recognises (separately from goodwill) and measures the identifiable assets acquired and liabilities assumed at their **acquisition-date fair values** (measured in accordance with IFRS 13 *Fair Value Measurement,* see Section 8.3.2 below).

To be recognised as part of applying the acquisition method, the assets and liabilities must:

- Meet the definitions of assets and liabilities in the *Conceptual Framework*, and
- Be part of what the acquirer and the acquiree (or its former owners) exchanged in the business combination, rather than the result of separate transactions.

These recognition rules **include intangible assets that may not have been recognised in the subsidiary's separate financial statements,** such as brands, licences, trade names, domain names, customer relationships and so on, where the acquiree had developed the assets internally and charged the related costs to expense.

There are exceptions to the recognition and measurement rules, for example reacquired rights (eg a licence granted to the subsidiary before it became a subsidiary), assets held for sale (treated as per IFRS 5) and deferred tax assets.

8.3.1 Problems with valuing brands

Although IFRS 3 recognises that the brands acquired should be valued at 'fair value' this remains a very complex tasks; not least because there are several different methodologies for valuing brands, and there is no general consensus as to which way is best.

Lack of active market

Unlike other assets such as stocks or bonds, there is no active market for brands that could provide comparable values. Almost by definition, one brand should be differentiated from another brand, and thus, the two are not comparable.

Therefore, a number of different models have been developed to try to provide authoritative brand values and to measure the performance of brands:

Research-based approaches: These use consumer research into consumer behaviour and attitudes to assess the relative performance of brands. In particular, these approaches seek to measure how consumers' perceptions influence their purchase behaviour.

However, such measures do not put a financial value on brands, so unless they are integrated with other approaches, they are insufficient for assessing the economic value of brands.

Cost-based approaches: Cost-based approaches define the value of a brand as the aggregation of all the historic costs incurred to bring the brand to its current state; for example, development costs, marketing costs, advertising and other communication costs.

However, the flaw in such approaches is that there is not necessarily any direct correlation between the costs incurred and the value added by the brand. Financial investment can be important in building brand value, provided it is effectively targeted, but if it isn't, it may have no impact at all. Moreover, the analysis of financial investment needs to go beyond obvious costs such as advertising and promotion, and also include research and development, product packaging and design, retail design, and employee training.

Premium price: Under the premium price method, the value of the brand is calculated as the net present value of the price premiums that a branded product could command over an unbranded or generic equivalent.

However, a difficulty with this method comes from finding an 'unbranded' product to compare to. Today, the majority of products are branded, and in some cases, store 'own-branded' products can be as strong as producer brands, charging similar prices.

Economic use approach: This approach combines marketing and financial principles.

Marketing principle – First, brands help to generate customer demand, which translates into revenue through purchase volume, price and frequency. Second, brands help to retain customer demand in the longer term, through repurchase and loyalty.

Financial principles – The brand's future earnings are identified and then discounted to a net present value (NPV) using a discount rate which reflects the risk of the earnings being realised.

Interbrand calculates brand valuations using this kind of approach. Interbrand's procedure for calculating the fair value of a brand can be summarised as follows:

(a) Prepare a five year forecast for the company's revenues and earnings (NOPAT).

(b) Estimate the percentage of a company's earnings that can be attributed to the brand. This percentage of the company's profit represents the brand's earnings.

(c) Assess the competitive strengths and weaknesses of the brand in order to determine the discount rate that should be applied to reflect the risk profile of the brand's expected future earnings.

(d) Apply the discount rate to the brand's future earnings to calculate a net present value.

However, the difficulty in valuing a brand can be seen by the following statistic (reported in the January 2012 edition of *Economia*):

Although Interbrand had valued the Coca Cola brand at $72 billion in October 2011, the previous month (September 2011), *Brand Finance* had placed its brand value at $27 billion. Interbrand and Brand Finance are both specialist brand valuation consultancies, so the fact that they can value the same brand so differently suggests there is significant scope for subjectivity in brand valuation.

8.3.2 IFRS 13 and brand valuation

Although we noted in the previous section that a number of methodologies have been developed, the reference to 'fair value' is very important. If a brand, which has been acquired, is being included as an asset with in a consolidated statement of financial position, it needs to be shown at fair value.

IFRS 13, Fair value measurement, defines fair value as 'the price that would be received to sell an asset, or paid to transfer a liability, in an orderly transaction between market participants at the measurement date.'

IFRS 13 also requires the fair value to be determined on the basis of its 'highest and best use' from a market participant's perspective. This needs to consider what is physically possible, legally permissible and financially feasible. It also needs to take into account market conditions at the measurement date.

The reference to the market participant's perspective is important. Even if a company acquires a brand but doesn't plan to continue using that brand name (because it intends to merge the acquired brand into its own brand), the acquired brand could still have a value – namely the highest and best use that *could* be made of it by a market participant (an alternative buyer of the brand). However, if the company which has acquired the brand, intends to use it, then (in the absence of any market factors to the contrary) the company's use of the brand can be taken to represent the highest and best use of it.

Nevertheless, the post-acquisition strategy of the acquiring company may affect the subsequent value of the brand. For example, if a brand name becomes tarnished post-acquisition, its commercial value will fall. This would be dealt with under the rule of IAS 36, *Impairment of Assets*.

Fair value hierarchy

IFRS 13 requires that entities should maximise the use of relevant observable inputs when determining a fair value, and minimise the use of unobservable inputs. In relation to this, IFRS 13 uses a 'fair value hierarchy' which categories inputs into three levels:

- Level 1 inputs – Quoted prices in active markets for identical assets or liabilities that the entity can access at the measurement date.
- Level 2 inputs – Inputs (other than quoted market prices included within Level 1) that are observable for the asset or liability, either directly or indirectly.
- Level 3 inputs – Unobservable inputs for the asset or liability.

It is not normally possible to identify Level 1 inputs when dealing with brands, due to their unique nature. By definition, if all brands are different, or have different characteristics, it will not be possible to identify any identical assets. Therefore, the fair values of brands will have to be determined using the lower two levels of inputs (although a possible Level 2 input could be the value of similar brands which have already been valued).

Bases of valuation

Within the context of the three levels of the 'fair value hierarchy,' and the preference to use observable over unobservable inputs wherever possible, IFRS 13 sets out three possible valuation techniques which could be used when determining the fair value of an asset:

(i) **Market approach** – This uses prices and other relevant information generated by market transactions involving identical or comparable assets.

(ii) **Cost approach** – This reflects the amount of cost that would be required to replace the service capacity of an asset (the current replacement cost).

(iii) **Income approach** – This converts future amounts (cash flows or income and expenses) generated by an asset to a single, current (discounted) amount, reflecting current market expectations about those future amounts.

Given the unique nature of a brand, and the lack of an active market, it is likely to prove difficult to determine the fair value of a brand using the market approach.

However, the income approach resembles Interbrand's 'economic use' approach we discussed in the previous suggestion and so may prove an appropriate technique for determining the fair value of a brand. For example, if a 'brand name' enables a product to be sold for a higher price than a generic equivalent, or if the strength of the brand enables additional units of a product to be sold, the incremental income from these sales can be used to determine the value of the brand.

8.3.3 Benefits of brand valuation

Companies may find brand valuation useful for the following reasons:

Making decisions on business investments: Treating the brand in a comparable way to other intangible and tangible assets will assist the company when making resource allocation decisions between different asset types (for example, on the basis of return on investment requirements).

Organising and optimising the use of different brands in the business, according to the contributions they make to creating economic value.

Making decisions about licensing the brand to subsidiary companies: If subsidiaries are granted a licence, they will be accountable for the brand's management and use. An asset that has to be paid for is likely to be managed more rigorously than one that is free.

Transfer pricing: Assessing fair transfer prices for the use of brands in subsidiary companies.

Acquisition: Most importantly, as we have already noted, brand valuation will be crucial for determining a price for brand assets in the context of an acquisition. Although IAS 38 dictates that internally generated brand value cannot be capitalised in a company's own statement of financial position, if a company is being taken over, then the value of its brands will need to be calculated when assessing the values of the net assets acquired.

Brands can be a key driver of acquisition premiums in mergers and acquisitions, because 'brand' offers the potential to enter new markets and expand into adjacent categories.

Case example: Microsoft and Skype

In October 2011, *Microsoft* acquired *Skype* for $8.6 billion, with the deal becoming Microsoft's largest acquisition.

Microsoft's Annual Report (2012) discloses that the major classes of assets and liabilities to which it allocated the purchase price were goodwill of $7.1 billion, identifiable intangible assets of $1.6 billion, and unearned revenue of $(222) million.

The goodwill recognised in connection with the acquisition was primarily attributable to Microsoft's expectation of extending Skype's brand and the reach of its networked platform, whilst also enhancing Microsoft's existing portfolio of real-time communications products and services. Microsoft already had a long-standing focus and investment in real-time communications across its various platforms, including Lync, Outlook, Messenger, Hotmail and Xbox LIVE.

The intangible assets acquired through the Skype deal were allocated to the following categories:

Intangible assets acquired	$ million	Weighted average life
Marketing-related (trade names)	1,249	15 years
Technology-based	275	5 years
Customer-related	114	5 years
Contract-based	10	4 years
Total	**1,648**	**13 years**

The acquisition gave Microsoft a major foothold in the growing market for internet telephony services. In July 2011, Skype had 65 million users daily. Collectively, they spent 700 million minutes per day on Skype audio calls, 300 million minutes a day on Skype video calls, and 30 million minutes a day on calls with ordinary phones.

When the acquisition was announced, Microsoft's CEO said 'Skype is a phenomenal product and brand that is loved by hundreds of people around the world… We look forward to working with the Skype team to create new ways for people to stay connected to family, friends, clients and colleagues – anytime, anywhere.'

Skype's chief executive was equally positive about the deal's prospects, saying it would help Skype expand its audience from hundreds of millions of users into billions.

Skype's voice over Internet Protocol (VoIP) services let people hold free video and voice calls over the internet. Skype also charges a fee for "SkypeOut," which lets Skype users dial ordinary phone numbers, and "SkypeIn", which lets people dial an ordinary phone number that connects through to a Skype account online. Both services are useful for bypassing steep international calling rates using conventional telephone service.

However, critics argued that the price tag – almost three times the $2.75 Skype fetched when it was sold to Silver Lake Partners about 18 months earlier - is a sign of just how hungry Microsoft was for growth opportunities; particularly in the mobile phone and internet markets as its traditional profit engines, such as its Windows software, are showing signs of slowing.

The technology industry's momentum is seen as being fuelled increasingly by consumers, with the rise of social networking sits (such as Facebook) and devices such as Apple's iPad reshaping the computer markets. Therefore big technology companies which had previously relied on businesses for growth are now seeking ways into consumer technologies.

Nevertheless, despite its widespread use, Skype had been slow to convert users into paying customers and to generate meaningful profits. In fact, it made a net loss of $7 million in 2010.

Consequently, a number of commentators were asking at the time of the deal, how Microsoft could make Skype's assets work for it, and how could it justify the purchase price.

www.microsoft.com

8.3.4 Brand valuation and assurance

As we have already noted in Section 8.2 above, brand valuation is required under IFRS 3 for all acquisitions made by companies reporting under International Financial Reporting Standards, and brand value is often the most valuable of the identifiable intangible assets. In their paper 'Brands: What's in a name' (published in March 2013), PwC note that, within the consumer products sector, brands are typically the most significant asset recognised in an acquisition deal.

However, the recognition and measurement of intangible assets tends to be one of the most difficult areas of IFRS 3 to apply in practice.

In this respect, carefully identifying the intangibles being acquired and considering their fair value is a vital step in determining the consideration to be paid for an acquisition. And obtaining a fair valuation for the intangible assets being acquired is a crucial part of ensuring that the company making an acquisition pays a fair price for the company they are acquiring.

PwC's paper acknowledges that brand valuation requires significant industry-specific judgement and expertise to ensure supportable measurements are carried out, and to avoid audit surprises and the risk of subsequent re-statement.

The issue of determining a fair value for a brand is also likely to be a key part of the due diligence process supporting any acquisition deal.

PwC's paper also serves to promote its own valuation services team and the ways this team can help clients in valuation exercises. However, in this context, it is also important to remember the concept of auditor independence; and particularly the fact that an audit firm cannot offer valuation services to its own audit clients.

In addition to accountancy firms there are also specialist valuation consultancies, such as Interbrand and Brand Finance, which could carry out valuation exercises.

On its website, Brand Finance states emphatically that, 'We value brands, intangible assets and intellectual property in many jurisdictions for accounting, tax, corporate finance and marketing purposes.'

The website goes on to explain how Brand Finance uses one or more of the three 'approaches' (market approach, cost approach or income approach) based on the circumstances of a particular assignment. The website concludes that, 'Our understanding of your business, the data available, and our technical expertise ensure that your brand will be robustly valued, using the most appropriate Approaches and Methods.'

Consequently, a company that is seeking to value a brand (or seeking to gain assurance over the value already implicit in a brand) could either engage a valuation services team at a firm of accountants to carry out this valuation work for them or else it could engage the experience of a specialist consultancy to undertake the work.

Equally, in the context of acquiring a brand, the company considering the acquisition will need to obtain assurance over any assumptions which have been made when arriving at the value – for example, market assumptions, and the impact that market conditions could have on future income generated by the brand.

Due diligence

However, the due diligence relating to brands acquired in acquisitions shouldn't be confined to narrow issues around valuation. It is also important to recognise the role of the brand in the business logic of the deal; for example to consider how the brand will contribute to the group post-acquisition, and how it fits with the group's overall brand strategy. How will the brand affect the company's ability to achieve its long-term objectives? And what impact will it have on shareholder value in the future?

If these strategic level issues are not considered in advance of a deal, then the acquirer risks overpaying for assets that are not used, or which have little value to it. One of the risks attached to brand valuation comes from valuing a brand in a way which has little or no relation to how a company plans to use it in the post-acquisition business. The result could be a large asset write-down in future, or an equally significant constraint on future business strategy (if possible future strategic options don't 'fit' with the brand).

Equally, if an acquiring company does not research a brand properly, it could risk overpaying for assets which have lost their lustre, or which may not translate effectively into the business environment facing the post-acquisition group.

In this respect, we can suggest there is a need for some due diligence to take place *before* the final decision to acquire a brand is taken.

Therefore the scope of commercial due diligence in relation to acquiring brands and intangible assets more generally, needs to cover a number of areas which are important in strategic marketing.

In Chapter 2 we highlighted that commercial due diligence considers a target company's market and external economic environment, including analysis of information about the company's main competitors, its marketing history/tactics, competitive advantages, its strengths and weaknesses, and market growth forecasts. In this respect, the due diligence work will resemble a **marketing audit** (which we discussed in Section 1 of this Chapter).

Brand value and licensing

Another situation in which it may be necessary to gain assurance over the value of a brand is in relation to franchising or licensing. Part of the franchise fee that a franchisor (such as McDonald's) charges its franchisees will relate to the value the franchisee gains from the brand name of the franchise. Therefore, for example, if the franchisor wishes to increase its franchise fees because it believes the brand has become stronger over a period of time, the franchisor's position would be strengthened by having an independent valuation of its brand.

8.4 IAS 38, *Intangible Assets*

Although we have been focusing primarily on brands so far in this chapter, they are not the only intangible assets which could be a source of value or competitive advantage for a company. For example, research and development, and patents are also valuable intangible assets. And refer back to the case example of Microsoft's acquisition of Skype in Section 8.3.3. The intangible assets Microsoft acquired included technology-based and customer-related ones, as well as trade names.

IFRS 3 provides a number of examples of intangible assets. In addition to contract-based intangible assets (eg licensing agreements, franchise agreements) and technology-based assets (eg patented technology, computer software), IFRS 3 also provides a number of marketing-related and customer-related intangible assets. These include:

- Trademarks and trade names
- Newspaper mastheads
- Internet domain names
- Non-competition agreements
- Customer lists
- Customer contracts and related customer relationships

However, it is important that any intangible assets capitalised in a company's financial statements are done so in accordance with IAS 38, *Intangible Assets*.

The key points in IAS 38 can be summarised as follows:

- An **intangible asset** is an **identifiable non-monetary asset without physical substance**, such as a licence, patent or trademark.
- An intangible asset is **identifiable** if it is **separable** (ie it can be sold, transferred, exchanged, licensed or rented to another party on its own, rather than as part of a business) or it arises from **contractual or other legal rights**.
- An intangible asset should be recognised if it is probable that future economic benefits **attributable to the asset**, will flow to the entity, and the **cost** of the asset can be **measured reliably**.
- At recognition, the intangible should be recognised at cost (purchase price plus directly attributable costs). After initial recognition, an entity can **choose** between the **cost model** and the **revaluation model**. The revaluation model can only be adopted if an **active market** (as defined) exists for that type of asset.
- An intangible asset (other than goodwill recognised in the acquiree's financial statements) **acquired as part of a business combination**, should initially be recognised **at fair value**.
- Internally generated goodwill should **not** be recognised.
- Expenditure incurred in the **research phase** of an internally generated intangible asset should be **expensed as incurred**.

- Expenditure incurred in the **development phase** of an internally generated intangible asset **must be capitalised**, provided **certain tightly defined criteria are met**. Expenditure, incurred prior to the criteria being met, may not be capitalised retrospectively.
- An intangible asset with a **finite useful life** should be **amortised** over its expected useful life, **commencing** when the asset is **available for use** in the manner intended by management.
- Residual values should be assumed to be nil, except in the rare circumstances when an active market exists or there is a commitment by a third party to purchase the asset at the end of its useful life.
- An intangible asset with an **indefinite life** should **not be amortised**, but should be reviewed for **impairment** on an **annual basis**. There must also be an annual review of whether the indefinite life assessment is still appropriate.
- On disposal of an intangible asset, the gain or loss is recognised in profit or loss.

Crucially, though, IAS 38 stipulates that internally generated brands, mastheads, publishing titles, customer lists and items similar in substance must not be recognised as intangible assets within an individual company. Similarly, customer relationships are not recognised as intangible assets.

Consequently, all expenditure relating to brand building or customer relationship management should be expensed as incurred, because the intangibles they relate to do not meet the criteria for recognition as identifiable intangible assets.

Once again, it is important to note the difference in the way these 'assets' are treated in individual companies (where they are internally generated and have to be expensed as incurred) and in the context of an acquisition (where identifiable intangible assets can be capitalised).

8.4.1 Expected life of intangible assets acquired

The summary points from IAS 38 above highlight that an intangible asset with a finite useful life should be amortised over its expected useful life, while an asset with an indefinite life should not be amortised but should be reviewed for impairment on an annual basis.

Again, in the case example of Microsoft's acquisition of Skype (Section 8.3.3 above) the intangible assets acquired have been treated as having a finite life, and have been amortised accordingly.

Brand assets acquired are often treated as having indefinite lives, however, and so are reviewed for impairment on a regular basis, rather than being amortised. IAS 36 prescribes that intangible assets with an indefinite useful life (such as brands) have to be subject to annual impairment tests regardless of whether there are any indications of impairment.

IAS 36 *Impairment of assets* prescribes that assets should be carried at no more than their recoverable amount, where recoverable amount is the higher of:

- Value in use
- Fair value less costs to sell

However, in the same way that valuing a brand is complex so is valuing a brand in relating to its ongoing value in use, or fair value.

Intangibles acquired but not used

The issue of impairment and useful lives could be particularly relevant in the context of brand names of logos where a company acquires the brand name or logo but has no intention of using it in the future. However, in such circumstance, the general principles for valuing the asset still apply, and its fair value is determined in accordance with its use by other market participants.

The following short example illustrates this point:

Case example: Logos acquired and not used

AAA acquires BBB. The identifiable net assets of BBB include a trademark, which was the logo previously used by BBB when it was a direct competitor to AAA. AAA has no intention of using BBB's logo in the future.

The logo is considered to be separable because it could, for example, be licensed to a third party. It also arises from legal rights. Therefore the logo should be treated as an intangible asset and should be recognised as part of the accounting for the acquisition.

In practice, AAA has no intention of using the logo after the acquisition, so it will not be possible to allocate the logo to any existing cash-generating units. Consequently, it should be identified as a cash-generating unit by itself, because AAA's management intends to exclude it from the other elements of the operating process.

The cash inflows related to the logo are nil, because it is no longer being used. However, immediately after acquisition, it would appear reasonable that the fair value less costs to sell are not significantly different from the amount recognised at the date of the acquisition. Therefore an impairment loss is not required.

However, the asset must be amortised over its useful life. The useful life to the entity is the length of time for which holding the logo will be effective in discouraging competition. This is likely to be a fairly short period, since an unused logo loses value very quickly.

As AAA acquired the logo with the specific intention of denying competitors the opportunity to use the asset, it appears unlikely that the asset will be sold in the future. Accordingly, the residual value of the asset is zero. As a result, an amortisation charge for the full carrying amount of the asset should be recognised over the useful life – which could be as a short as a single accounting period.

Sourced from: Deloitte: *Business combinations and changes in ownership interests: A guide to the revised IFRS3 and IAS 27*

8.5 Intangible assets and intellectual capital

8.5.1 Intangible assets and goodwill

Definition

Intangible assets are identifiable non-monetary assets without physical substance that are controlled by the entity as the result of past events and from which the entity expects a flow of future economic benefits.

Goodwill (acquired) is future economic benefits arising from assets that are not capable of being individually identified and separately recognised.

The above definition of intangible assets distinguishes:

(a) Intangible assets from tangible assets, by the phrase 'do not have physical substance'.

(b) Intangible assets from goodwill, by the word 'identifiable', an identifiable asset is legally defined as one that can be disposed of separately without disposing of a business of the entity.

Certain intangible assets can be recorded at their **historical cost**. Examples include patents and trademarks being recorded at **registration value,** and franchises being recorded at **contract cost**. However, over time, these historical values may become poor reflections of the assets' value in use or of their market value.

8.5.2 Intellectual capital

Definition

Intellectual capital is knowledge which can be used to create value. Intellectual capital includes:

(a) Human resources: The collective skills, experience and knowledge of employees

(b) Intellectual assets: Knowledge which is defined and codified such as a drawing, computer program or collection of data

(c) Intellectual property: Intellectual assets which can be legally protected, such as patents and copyrights

As the demand for **knowledge-based products** grows with the changing structure of the global economy, knowledge plays an expanding role in achieving competitive advantage. **Employees** may therefore be extremely valuable to a business, and it has been argued that they should be included in a full assets based valuation. However, the IASB *Conceptual Framework* has a precise definition of an asset and sets very specific criteria that must be met for an asset to be recognised in the statement of financial position.

The definition of an asset in the *Conceptual Framework* is:

'A resource controlled by an entity as a result of past events and from which future economic benefits are expected to flow to an entity.'

It can be argued that:

- Staff are a resource
- There has been a past event – the staff were recruited under an employment contract
- Future benefits are expected to flow – staff are expected to generate revenue for the entity either directly or indirectly

But:

- **Control is very hard to prove**. Even though a contract exists, an employee can leave, take time off sick, or not work to the best of their ability.

Also, the recognition criteria from the *Framework* must be met:

- **There must be probable economic benefits** – it is very hard to guarantee benefits from an employee.
- **The asset must be able to be reliably measured** – it is very difficult to put an objective value on staff skills.

The principles of valuation discussed below could be applied to all assets, resources or property that are defined as intangible assets or intellectual capital.

8.6 Measurement of intangible assets of an enterprise

The **expanding intellectual capital** of firms accentuates the need for methods of valuation for comparative purposes, for example when an acquisition or buy-out is being considered.

Ramona Dzinkowski (in *The measurement and management of intellectual capital*, Management Accounting, February 2000) identifies the following three indicators, which are derived from audited financial statements and are independent of the definitions of intellectual capital adopted by the firm.

- Market-to-book values
- Tobin's 'q'
- Calculated intangible value

8.6.1 Market-to-book values

This method represents the value of a firm's intellectual capital as **the difference between the book value of tangible assets and the market value of the firm**. For example, if a company's market value is CU8 million and its book value is CU5 million, the CU3 million difference is taken to represent the value of the firm's intangible (or intellectual) assets.

Although obviously **simple**, this method's simplicity merely serves to indicate that it fails to take account of **real world complexities.** There may be imperfections in the market valuation, and book values are subject to accounting standards that reflect historic cost and amortisation policies, rather than true market values of tangible non-current assets.

In addition, the accounting valuation does not attempt to value a company as a whole, but rather as a **sum of separate asset values** computed under particular accounting conventions. The market, on the other hand, values the entire company as a **going concern**, following its defined strategy.

8.6.2 Tobin's 'q'

The Nobel prize-winning economist, James Tobin, developed the 'q' method initially as a way of predicting investment behaviour.

'q' is the ratio of the **market capitalisation of the firm** (share price × number of shares) to the **replacement cost** of its assets.

If the replacement cost of assets is **lower** than the market capitalisation, **q is greater than unity** and the company is enjoying higher than average returns on its investment ('monopoly rents'). Technology and so called 'human-capital' assets are likely to lead to high q values.

Tobin's 'q' is affected by the same variables influencing market capitalisation as the market-to-book method. In common with that method, it is used most appropriately to make comparisons of the value of intangible assets of companies within an industry that serve the same markets and have similar tangible non-current assets. As such, these methods could serve as **performance benchmarks** by which to appraise management or corporate strategy.

8.6.3 Calculated intangible values

NCI Research has developed the method of **calculated intangible value (CIV)** for calculating the fair market value of a firm's intangible assets. CIV calculates an 'excess return' on tangible assets. This figure is then used in determining the **proportion of return** attributable to intangible assets.

A step-by-step approach would be as follows.

(a) Calculate average pre-tax earnings and average year end tangible asset values, over a time period.

(b) Divide earnings by average assets to get the return on assets.

(c) Multiply the industry average return on assets percentage by the entity's average tangible asset values. Subtract this from the entity's pre-tax earnings to calculate the excess return.

(d) Subtract tax from the excess return to give the after-tax premium attributable to intangible assets.

(e) Calculate the NPV of the premium by dividing it by the entity's cost of capital.

Whilst this seemingly straightforward approach, using readily available information, seems attractive, it does have two problems.

(a) It uses **average industry return on assets** as a basis for computing excess returns, which may be **distorted by** extreme values.

(b) The choice of **discount rate** to apply to the excess returns to value the intangible asset needs to be made with care. To ensure comparability between companies and industries, some sort of **average cost of capital** should perhaps be applied. This, again, has the potential problems of **distortion.**

8.7 Valuation of individual intangible assets

8.7.1 Relief from royalties method

This method involves trying to determine:

(a) The value obtainable from licensing out the right to exploit the intangible asset to a third party, or

(b) The royalties that the owner of the intangible asset is relieved from paying through being the owner, rather than the licensee.

A **notional royalty rate** is estimated as a percentage of revenue expected to be generated by the intangible asset. The estimated royalty stream can then be **capitalised**, for example, by discounting at a risk-free market rate, to find an estimated market value.

This relatively simple valuation method is easiest to apply if the intangible asset is already subject to licensing agreements. If they are not, the valuer might reach an appropriate figure from other comparable licensing arrangements.

8.7.2 Premium profits method

The premium profits method is often used for **brands**. It bases the valuation on capitalisation of the **extra profits generated** by the brand or other intangible asset in excess of profits made by businesses lacking the intangible asset or brand.

The premium profits specifically attributable to the brand or other intangible asset may be estimated (for example) by comparing the price of branded products and unbranded products. The estimated premium profits can then be capitalised by discounting at a risk-adjusted market rate.

8.7.3 Capitalisation of earnings method

With the capitalised earnings method, the **maintainable earnings accruing to the intangible asset** are estimated. An **earnings multiple** is then applied to the earnings, taking account of expected risks and rewards, including the prospects for future earnings growth and the risks involved. This method of valuation is often used to value **publishing titles**.

8.7.4 Comparison with market transactions method

This method looks at **actual market transactions** in similar intangible assets. A multiple of revenue or earnings from the intangible asset might then be derived from a similar market transaction.

A problem with this method is that many **intangible assets are unique** and it may therefore be difficult to identify 'similar' market transactions, although this might be done by examining acquisitions and disposals of businesses that include similar intangible assets.

The method might be used alongside other valuation methods, to provide a comparison.

8.7.5 Compliance with IFRS 13, Fair value measurement

As we discussed in Section 8.2 above, the fair value of any intangible assets shown in a company's financial statements needs to be measured in accordance with IFRS 13, *Fair value measurement*.

However, as we saw earlier, the standard permits fair value to be calculated using a market approach, a cost approach or an income approach.

Summary and Self-test

Summary

Marketing and strategic management are necessarily closely linked, because any corporate plan has to involve products/services and customers.

Specific marketing strategies are determined within the context of the overall corporate strategy. To be effective, marketing plans must be aligned with the plans for other functions within an organisation (eg if marketing plans emphasise 'quality,' then 'quality' must be a priority for other functions in the organisation).

The marketing concept highlights that, in order to be successful, an organisation must provide greater value and satisfaction than its competitors do, and to position its offering more strongly in the minds of consumers than its competitors do. In order to do this, marketers need to analyse their competitors and their competitors' strategies (competitor analysis).

An organisation's value proposition dictates how the organisation will serve its customers – how it will differentiate itself from its competitors, and how/where it will position itself in the marketplace. The value proposition also needs to inform customers why they should buy the organisation's brand rather than a competitor's.

The range of products and services to consumers, coupled with diversity of consumers' needs, mean that very few products or services can satisfy all the consumers in a market. Marketers therefore need to identify particular market segments (**segmentation**) which can be reached with a distinct marketing mix.

Having identified the different segments in a market, an organisation has to decide which segments to target (**targeting**), and then has to position its product or service in a way which earns it a distinctive place within its target market.

Positioning should be used to develop a strong and distinctive image of a company or brand in the mind of the target customers, thereby differentiating the company from its competitors.

An organisation looks to create a distinctive image for a product or brand through the marketing mix applied to it. Applying a unique and appropriate mix of the 4 Ps (product, price, place, and promotion) allows an organisation to compete more effectively than its competitors, thereby helping to generate a sustainable profit.

The internet has had a significant impact on the marketing mix (eg making price more competitive) and organisations needs to recognise this when developing their marketing strategies, particularly strategies for online marketing.

Organisations hold and manage ever-increasing amounts of data about sales, revenues, customers, competitors. Data warehousing and data mining tools can help organisations manage and use this data.

Increased recognition of the importance of customer retention has led organisations to focus more on customer relationship management. Effective customer relationship management can help an organisation to implement a relationship market strategy, using marketing resources to maintain and develop existing customers, rather than simply to attract new customers.

Web 2.0 technologies have changed the way users interact with content and with each other. Although Web 2.0 technologies provide opportunities for organisations to distribute information about their products or services, more importantly they invite customer feedback and can even lead to customer participation in the creation of products or services.

In many cases, an organisation may need to raise additional finance to achieve growth. Potential investors are likely to scrutinise an organisation's business plan before making a decision about whether to invest or not.

Strong branding is crucial for a company's long-term strategic success (eg by shaping customer perceptions and purchasing behaviour, and/or acting as a barrier to entry). Brand management may therefore be a key capability for a company.

In order for a company to be successful, its strategy and operations need to be aligned to its brand(s). Brands will ultimately only succeed if they are capable of regularly delivering what they promise. Therefore operational processes, and staff, play a key role in supporting a brand.

Although a strong brand should help to generate future cash inflows and higher profits for a company, internally generated are not recognised as intangible assets under IAS38, *Intangible Assets.*

However, a brand's value could affect the price a company is prepared to pay in order to acquire another company which owns valuable brands. Nevertheless, valuing a brand (at fair value, in line with IFRS 13) is very difficult because there is not an active market for brands and they are, by definition, unique.

Self-test

Self-test question 1

BB is an established publisher of training manuals and other training material for members of professional bodies and for personal development. The products are sold all over the world by major bookshops and online book vendors. Although the company has a website, it does not sell directly to colleges or private individuals.

Currently, all stages of the production and distribution processes are conducted within mainland Europe. All stages of these processes are conducted in-house by BB.

Over the past five years, sales of BB's training manuals have declined and the company is expecting to make little, if any, profit in the coming year.

BB's manuals are of the traditional style, that is, an extensive amount of printed material bound in a single volume. An initial market study has shown that BB's training manuals do not appeal to readers, because they are under heavy time pressure and are unable to devote sufficient time to reading these manuals. The manuals, because of their bulk, are also considered to be difficult to work with.

There are three other direct competitors in the market, which is highly competitive. In this market the products are difficult to differentiate; and profit margins are low. Although BB has no firm evidence, the directors believe that all three of their competitors are more profitable than BB. However, the directors are not aware that any of the competitors are operating in a different way to BB, and their training manuals are virtually identical to those offered by BB.

The directors of BB believe that there are product development and market development opportunities that could be pursued. They also believe that the cost structure of the products could be improved. However, they are prepared to consider any reasonable alternative strategy that will improve the competitive position of the company.

Requirements

(a) Explain how more detailed knowledge about B's competitors would help the directors of BB.

(b) With reference to Ansoff's matrix, evaluate three strategies that would enable BB to be more competitive.

Self-test question 2

Hester Bateman plc (HB plc) is a cutlery manufacturing, making knives, forks and spoons. HB is based in Sheffield in the United Kingdom which has been the centre of the UK cutlery industry for at least 100 years. When the industry was first established, it was very fragmented and there were many small entrepreneurial businesses making cutlery. Often, these businesses were organised around a family and they usually employed between six and ten people. Hester Bateman was one such entrepreneur. The industry began to consolidate, in the late nineteenth century and early twentieth century, as a series of mergers were effected.

HB plc was constituted in its present form in the 1920s when it obtained its market listing on the Stock Exchange. It now consists of a large factory, which employs 500 people and a Head Office, employing 200 people. These are both in Sheffield.

In 1990, HB plc made a rights issue to finance a modernisation programme in its factory. At that time the board reviewed the company's objectives. A statement was issued by the board which said:

> *HB plc is a UK manufacturing cutler based in Sheffield, the home of the cutlery industry. Our success is due to harnessing local skills in production and design and using these to deliver the finest quality product to our customers across the world. They know that the finest cutlery in the world is stamped "Made in Sheffield". We intend to continue with our fine traditions.*

HB plc has always made all its cutlery in Sheffield and attaches great importance to the fact that it can, therefore, be marked 'Made in Sheffield'.

HB plc usually spends approximately CU150,000 a year on research and development. Five per cent of this spending is on new designs for the export market and the remainder is evenly split on designs for the home market and on improvements in production systems.

BQ plc

There is another UK manufacturing cutler of a similar size to HB plc, BQ plc, which is based in Birmingham.

Since the early 1990s, BQ plc has followed a different production policy to HB plc. Approximately half of its cutlery is made in Korea and imported to the UK and marketed under BQ plc's brand names.

Markets

From the date of its formation until the late 1980s, HB plc did very good business with countries across the world.

Since 1990, HB plc has experienced increasing competition from countries of the Pacific Rim – Korea, Taiwan, Hong Kong and Singapore. This competition has been conducted on the basis of cost. This has been possible because the production technology involved in making cutlery is a mature one. It is also comparatively cheap and readily available. Furthermore, for many users, cutlery has become a generic product.

Generics are unbranded, plainly packaged, less-expensive versions of products, purchased in supermarkets, such as spaghetti, paper towels and canned peaches.

HB plc has experienced a growing loss of market share in the UK to imports from the Pacific Rim. HB plc's export markets have largely disappeared. The only export business which it does is an annual sale of about CU200,000 of very high quality cutlery to a department store in New York. HB plc makes a gross margin of 45% on this business.

Estimated market data at December 2010:

UK market share by:	*Quantity*	*Value*
	%	%
HB plc	35	45
BQ plc*	30	35
Imports	35	20

* These percentages include all cutlery sold by BQ plc, whether made in the UK or in Korea.

Financial performance

The increasingly competitive environment has had a marked effect on HB plc's profitability and stock market performance. After the publication of its latest annual results, the following comment was made in an influential UK financial newspaper:

> *HB plc's latest results, which show a profit after tax of CU2.25 million, look deceptively good. However, these are flattered by the fact that HB plc has not made any major investments since the 1980s.*
>
> *Its ROCE is about 4% and this could be beaten by any fixed return risk-free deposit investment. There seems to be little prospect of growth in any direction. These shares are really only a HOLD for the sentimental; otherwise SELL.*

Requirement

(a) How can Porter's classification of generic strategies be used by HB plc to analyse its current competitive position?

(b) Discuss the extent to which you believe that the statement of objectives made in 1990 is still applicable today.

(c) Recommend possible marketing strategies for HB plc. Discuss the advantages and disadvantages of your recommendations.

Self-test question 3

The Institute of Accountancy Training (IAT) offers professional accountancy education and training courses. It currently runs classroom-based training courses preparing candidates for professional examinations in eight worldwide centres. Three of these centres are also used for delivering continuing professional development (CPD) courses to qualified accountants. However, only about 30% of the advertised CPD courses and seminars actually run. The rest are cancelled through not having enough participants to make them economically viable.

IAT has developed a comprehensive set of course manuals to support the preparation of its candidates for professional examinations. There is a course manual for every examination paper in the professional examination scheme. As well as being used on its classroom-based courses, these course manuals are also available for purchase over the internet. The complete set of manuals for a professional examinations scheme costs CU200 and the web site has a secure payment facility which allows this to be paid by credit card. Once purchased, the manuals may be downloaded or they may be sent on a CD to the home address of the purchaser. It is only possible to purchase the complete set of manuals for the scheme, not individual manuals for particular examinations. To help the student decide if he or she wishes to buy the complete manual set, the web site has extracts from a sample course manual. This sample may be accessed, viewed and printed once a student has registered their email address, name and address on the web site.

IAT has recently won a contract to supply professional accountancy training to a global accounting company. All students working for this company will now be trained by IAT at one of its worldwide centres.

Website

The IAT web site has the following functionality:

Who we are: A short description of the company and its products and services.

Professional education courses: Course dates, locations and standard fees for professional examination courses. This schedule of courses is printable.

Continuing professional development: Course dates, locations and standard fees for CPD courses and seminars. This schedule is also printable.

CPD catalogue: Detailed course and seminar descriptions for CPD courses and seminars.

Downloadable study material: Extracts from a sample course manual. Visitors to the site wishing to access this material must register their email address, name and address. 5,500 people registered last year to download study material.

Purchase study material: Secure purchase of a complete manual set for the professional scheme. Payment is by credit card. On completion of successful payment, the visitor is able to download the manuals or to request them to be shipped to a certain address on a CD. At present, 10% of the people who view downloadable study material proceed to purchase.

Who to contact: A list of relevant contact details for booking professional training courses or CPD courses and seminars. It provides the name, email address, fax number, telephone number and address of a contact at each of the eight worldwide centres.

Marketing strategy

The marketing manager of IAT has traditionally used magazines, newspapers and direct mail to promote its courses and products. Direct mail is primarily used for sending printed course catalogues to potential customers for CPD courses and seminars. However, she is now keen to develop the potential of the internet and to increase investment in this medium at the expense of the traditional marketing media. Table 1 shows the percentage allocation of her budget for 20X8, compared with 20X7. The actual budget has only been increased by 3% in 20X8.

Table 1

Percentage allocation of marketing budget (20X7–20X8)

	20X8	20X7
Advertising	30%	40%
Direct mail	10%	30%
Sponsorship	10%	10%
Internet	50%	20%

Requirement

(a) Explain, in the context of IAT, how the marketing characteristics of electronic media (such as the internet) differ from those of traditional marketing media such as advertising and direct mail.

(b) Evaluate how the marketing manager might use electronic marketing (including the internet) to vary the marketing mix at IAT.

Self-test question 4

CFE was established in 20X1, and operates a chain of 40 coffee shops across Teeland. It is a privately owned company.

The number of coffee shops in Teeland has increased rapidly over the last decade, and there are now thousands of branded coffee shops operating across the country. Their total turnover now exceeds $1 billion. Although the majority of the branded shops are run by internationally recognised multi-national companies, CFE only operates in Teeland.

The range of products offered by the shops has increased over the last few years, in response to customer demand for a larger range of foods and better quality products. The branded coffee shops have been able to command higher than average prices for their products by using quality and service as differentiators. Price appears not to be a particularly sensitive factor, although CFE's prices are largely the same as those charged by the branded shops run by the multi-national companies.

In 20X1, when CFE first opened, most other coffee shops only served a selection of hot and cold drinks and a small range of snacks and cakes. However, right from the outset, CFE also sold a range of freshly made sandwiches and other food items, all made from high quality ingredients.

All CFE's shops operate from rented premises, but before opening, they are fitted out to ensure they have the same high standard of shop design and fittings. Having a high quality of shop design creates a good atmosphere, and makes the coffee shops a popular place for people to meet.

CFE's shops generate a high turnover. However, profitability has been lower than some of its competitors. Reasons for this include: high rental costs for some of its city centre shops; high staff costs (as high quality customer service remains a priority for CFE, so it pays above the industry average); and lower than average gross margins on some products (due to the high procurement cost of the quality ingredients chosen).

CFE also earns lower margins than some of its rivals on its coffee products because over 80% of its coffee beans are procured from suppliers who deal only with 'Fair Trade' coffee producers. Some of the regional managers have argued that their shops would be more profitable if they stopped using 'Fair Trade' coffee, but CFE's directors remain adamant that the company will continue to buy coffee from Fair Trade suppliers wherever possible, because it is a socially responsible company.

At a recent board meeting, the marketing director said he thought CFE should introduce a loyalty card scheme, and for every six hot drinks loyalty card holders buy, they get their next one free. He argued the card scheme will help CFE's profitability by improving customer loyalty and strengthening the brand.

The finance director said that CFE should also consider whether it could increase the prices of its coffee products in order to increase the margins it earns on them.

A summary of CFE's trading results for the last year is shown below:

($'000)	*Coffee*	*Other drinks*	*Food & snacks*	*Total*
Revenue	19,517	5,541	32,322	57,380
Cost of sales	(3,767)	(2,638)	(13,975)	(20,380)
Gross margin	15,750	2,903	18,347	37,000
Operating profit				5,606

The largest branded coffee shop in Teeland (which has 130 shops) generated revenues of $180m in the last year, with a gross margin of $124m and operating profit of $22.5m.

Requirements

(a) With reference to the marketing director's proposal to introduce a loyalty card scheme, evaluate the importance of brand awareness on CFE's business performance.

(b) Discuss the importance of external information in relation to the finance director's suggestion for CFE to increase the prices of its coffee products.

IFRS 15, Revenue from Contracts with Customers

- Outlines the requirements for when to recognise revenue from the sale of goods or rendering of services. Revenue is measured at the fair value of the consideration received or receivable, and is recognised when prescribed conditions are met. These depend on the nature of the revenue. Overview

IFRIC 13, *Customer Loyalty Programmes*

- Addresses the appropriate accounting treatment for loyalty award credits (such as reward points or travel miles) which entities give to customers who buy other goods or services. In particular, IFRIC 13 explains how entities should account for their obligations to provide free or discounted goods or services to customers who redeem award credits. Overview

IFRS 3, *Business Combinations*

- Outlines the accounting when an acquirer obtains controls of a business through an acquisition or merger. These business combinations are accounting for using the 'acquisition method' which generally requires the assets acquired, and the liabilities assumed, to be measured at their fair values at the acquisition date. Overview

IFRS 13, *Fair Value Measurement*

- Defines fair value as the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date. The Standard defines fair value on the basis of an 'exit price' notion and uses a 'fair value hierarchy' which results in a market-based measurement rather than an entity-specific one. Overview

IAS 38, *Intangible Assets*

- Outlines the accounting requirements for intangible assets, which are non-monetary assets which are without physical substance but which re identifiable (either being separable or arising from contractual or other legal rights.) Intangible assets are capitalised and amortised on a systematic basis over their useful lives, unless an asset has an indefinite useful life, in which case it is not amortised. Overview

IAS 36, *Impairment of Assets*

- Seeks to ensure that an entity's assets are not carried at more than their recoverable amount (being the higher of fair value less costs of disposal and value in use.) An annual impairment test is required for goodwill and certain intangible assets, but for the majority of assets an impairment test is only required where there is an indication of impairment of an asset. Overview

Answers to Interactive questions

Answer to Interactive question 1

Competitors are one of the main elements in a company's immediate **task environment** and it is essential that CCC should acquire as much information as possible about them, especially as the market is now maturing.

The benefits of undertaking competitor analysis, monitoring and analysing information about competitors are as follows:

Understand the basis of competitive advantage

If CCC analyses its value chain compared to its competitors', it can assess the ways in which each firm adds value for its customers. Given that the market is becoming increasingly competitive, such analysis will be useful for CCC in determining whether its current competitive strategy is sustainable, and which of its processes will need improving to enhance competitiveness.

Understand competitors' strategies

If CCC analyses its competitors' current strategies and how they have developed over time, this may give it some insight into its competitors' future strategies. This could help CCC plan how to compete and preserve its market position, rather than simply having to react to its competitors' actions.

Identify risk of new entrants

As well as using it to analyse current competitors, CCC can also use competitor analysis to identify possible new entrants into the specialist communications equipment market. Given that the market is reaching a level of overcapacity, this could be useful to CCC to assess how barriers to entry could be strengthened to deter the potential new entrants from joining the industry.

Develop future strategies

CCC can use the information it finds out about its competitors to help determine its own strategy. CCC is currently the market leader and so it needs to develop strategies to maintain its market share in a changing and increasingly competitive industry. For example, could CCC afford to reduce prices in order to increase market share, or are competitors likely to respond in kind, meaning CCC doesn't increase market share, but instead both CCC and its rivals are left with lower margins? Are there certain competitors who are likely to be more aggressive than others, in which case should CCC target growth in specific sectors of the market to avoid those competitors? Competitor analysis could help answer these questions and thereby help CCC determine its business strategy.

Improve forecasting

By improving CCC's understanding of its competitors' behaviour and how it will affect CCC's sales, competitor analysis will also enable CCC to improve its forecasts and business plans.

Answer to Interactive question 2

Segmentation would be Lucy's first step towards a more active relationship with her existing and potential customers. If she knew who they were in more detail, she could design her market offering in a way that would improve her own **efficiency** while also providing increased **customer satisfaction**.

The simplest form of segmentation is probably **geographical**. Lucy's potential market could be very simply split into domestic and overseas, for instance. Indeed, she probably does this already, in a sense, since she must make appropriate arrangements for the extra complications of shipping to foreign customers. Geographical segmentation would be necessary if Lucy wished to sell in other ways than via the internet, perhaps by issuing catalogues, since the styles of knitwear offered would have to appeal to varying local tastes.

Geographical segmentation becomes much more useful when it is combined with demographic information. This **geo-demographic** segmentation would enable Lucy to target segments defined by such variables as place, age, sex, income and social class. A consideration of these variables might, for instance, lead her to concentrate her marketing effort on older, affluent people in specific metropolitan areas. This would have immediate implications for design, quality, promotion, price and distribution.

Psychographic segmentation analyses the market according to personality and lifestyle. This might be difficult for Lucy to use, but if she could, perhaps by continuing to employ her marketing consultant, it might offer important advantages in the areas of design and promotion in particular.

A further segmentation variable is customer **behaviour**. This includes such matters as sensitivity to changes in the marketing mix variables, purchase frequency and magnitude and how the product is used. This approach might be useful to Lucy. For example, she might find that some of her designs are frequently bought by women for their partners or families. This might have important implications for design and sizing.

The benefit of accurate market segmentation is that it permits a more precise specification of the marketing mix variables, so that they are shaped to conform to the needs of the target segment or segments.

Product. Different segments will probably require different products. When the size of each segment, its product requirements and their costs are known, it will be possible both to estimate the most profitable segment to attack and to specify fairly precisely the nature of the products needed to do so. Lucy might find, for instance, that she needed to adjust her designs to make her range more recognisable and coherent.

Price. Pricing decisions are fundamental to trade and very difficult to take. It is very easy to set prices too high, so that customers are put off, or too low, so that potential profit is lost. The problem is compounded by the complex messages about quality, exclusivity and value that can be sent by price levels and changes to them. At the moment, Lucy's products are relatively cheap and this is preventing her from generating the funds needed for expansion: she may find that she can charge more for some of her knitwear.

Promotion. Lucy's consultant has identified her promotion efforts as insufficiently focused, which has led to a diffuse image and little brand awareness. Detailed knowledge of the characteristics of her target segments will allow Lucy to develop the accuracy of her promotion. She may find, for example, that a large market exists that is unwilling to use the internet at all, and so remains in ignorance of her products.

Place. Lucy's distribution is currently largely via her website. This limits her potential market to those who are both confident in the use of computers and interested in original design knitwear. It is likely that a much larger market could be served through a more traditional approach using prestige clothing outlets. This could be established by careful consideration of the results of the segmentation exercise.

Answer to Interactive question 3

Calculations	FMC	GMC	HMC
Sales revenues CUm (before discounts/returns)	28,000,000	14,000,000	17,000,000
Forecast margin @ 18%	5,040,000	2,520,000	3,060,000
Discounts	2,240,000	980,000	850,000
Sales visits costs	9,000	7,500	10,500
Purchase order costs	8,400	9,975	8,050
Customisation cost	130,875	183,225	863,775
Replacing Faulty goods (sales returns @ 82% Cost of sales)	482,160	206,640	460,020
Actual margin	2,169,565	1,132,660	867,655
Actual margin %	7.7%	8.1%	5.1%

Answer to Interactive question 4

1 Where there is no physical product, the service may only be differentiated by brand. Whereas construction and engineering have tangible products, gaming is a service business.

2 In a competitive market, building brand loyalty may help retain customers. It is likely to be very easy for customers to switch between different gaming companies (online) so continuing promotions to retain 'share of mind' are likely to be very important for gaming companies.

3 A strong brand reduces the risk when launching associated/new services. The gaming industry is likely to be at an earlier stage in its life cycle than the others, so could offer more opportunities for growth (eg through offering new products/services.) A strong brand could help improve CPH's chances of success when introducing any such new products or services.

Answers to Self-test questions

Answer to Self-test question 1

Part (a)

Strategy development – If B's directors gain an understanding of their competitors' strategies, they can use this to help develop their own strategies.

If the directors understand their **competitors' strengths and weaknesses,** this understanding could highlight areas for B to focus on. For example, B could target competitors' weaknesses in order to try to win business from them and increase its own market share.

Basis of competitive advantage – Equally, if B understands the basis on which its competitors are competing and their areas of competitive advantages, this can also help it determine the basis of its own strategy. For example, if one of the competitors is aiming to be the cost leader, B could look at that competitor's processes and see if there are any efficiencies of improvement B could introduce to reduce their own cost structure.

Increased profitability – B's directors believe that the three direct competitors are currently more profitable than B, although the directors have no evidence to support this. By improving their knowledge about the competitors, B's directors will be able to establish for certain how profitable they are.

The directors may also be able to establish why B's competitors are more profitable than it is. For example, if the competitors have outsourced any of their production and distribution processes, or relocated them to cheaper locations, this could suggest possible ways for B to increase its own profitability.

Responding to competitors' strategies – B could also benefit from trying to gain some knowledge about its competitors' future strategies as well as their current strategies. In this way, B should have a better chance of being able to respond to new products or innovations which the competitors are planning to introduce, thereby maintaining B's competitiveness in the market place. Although at the moment, all the training companies seem to offer very similar training manuals, it is possible some of the competitors could be developing new products – for example, e-learning materials which students would find more appealing and more accessible that then traditional printed materials.

However, it is important that B does not simply imitate competitors' strategies but develops its own strategies to increase competitiveness, based on its own competences and resources.

Competitors' responses – Gaining competitor intelligence can also help B's directors to gauge competitors' likely responses to any new strategies which B is planning to introduce.

Part (b)

Note: The question asks you to evaluate **three** strategies only. However, for tutorial purposes, we have included four possible strategies in our answer because these are all potential strategies you could have evaluated and which would have been plausible strategies to consider in this scenario.

Currently, B only produces paper-based manuals, and it sells these through bookshops and online vendors, not directly to students. B could look to increase its competitiveness by reviewing its product range and the downstream supply chain through which it makes its products available to students.

1 **Product format (product development)** – Currently, B will incur significant printing and production costs associated with publishing their training manuals. However, an alternative strategy would be to offer the manuals in **electronic format**. For example, the manuals could be sold as e-books or in a downloadable online format.

   Suitability – Reduced cost – By producing the manuals in electronic format, B's **costs would be significantly reduced**: it wouldn't have to buy paper to print the manuals on, or incur packaging and freight costs for distributing the manuals to suppliers. As a result, B should also be able to sell its electronic books at a lower price than the hard copy manuals (and its competitors' manuals), thereby possibly enabling it to capture market share from its competitors.

Feasibility – Converting an existing hard copy manual to an e-book or a downloadable file is a relatively simple process, and so there shouldn't be any problems as to the feasibility of this strategy, although B may outsource the actual production of the e-products to a specialist producer.

Suitability – Usability – However, if the 'new' products are simply electronic versions of the existing manuals, this will not address the problem that the content is time-consuming to read, and students do not have time to read them. In this respect, B might consider allowing students to buy individual chapters of the downloadable manuals at any time, rather than having to buy the whole text in one bundle.

Acceptability – However, there is a danger that allowing students to buy single chapters may cannibalise sales if students choose to only buy a small number of chapters at any time (whereas they had previously bought a whole manual).

Acceptability – This strategy opens up the possibility that the manuals will be illegally reproduced, thereby damaging B's sales growth. There is a risk that a student could buy a single copy of the downloadable text, and then distribute it to friends and colleagues studying for the same courses, meaning that those friends and colleagues won't buy the manuals themselves. The directors may consider that the extent of this risk may make this strategy unacceptable.

2 **Product range (product development)** – At the moment, B seems only to produce a single type of manual which requires a lot of reading time to work through. However, as an alternative to this manual, B could develop some more interactive or user-friendly online material. For example, B could develop some online tutorials which only cover the key topics from each chapter of the manuals, along with case studies and examples for students to work through to reinforce their understanding of subject areas.

Suitability – The readers have said that B's existing manuals are very time-consuming to read, but time is often scarce for them. Therefore, an alternative product which is **less time-consuming** and more **user-friendly** should prove attractive to them. Users may find a product which focuses only on the key topics **more approachable** than one that covers everything in great detail.

Also, because the new product is also online, it should be easier for users to work with than the bulky hard-copy manuals which were considered impractical. In time, the material could even be produced as a mobile phone application, making it even more convenient for students to access.

Feasibility – This strategy will require B to create new materials for its online product because the text will not simply be copied from the existing hard copy manuals. Therefore, it is likely to take a significant amount of **time** to create the online materials in the first instance. This suggests this strategy is more appropriate in the longer term than in the short term.

Acceptability – Moreover there is likely to be a significant cost involved, especially if B uses an external agency to design and develop interactive online materials. However, this product will be clearly differentiated from the products which B's competitors offer, and so could provide a useful tool for gaining market share. In addition, having a differentiated product may allow B to charge a higher price for it, in turn giving it a chance to improve profit margins, which are currently low.

3 **Direct sales (Market development)** – Currently, B only sells its materials through bookshops or online vendors, rather than selling directly to students. This means that B has to pay some of the sales margin from the books to the 'agents' who have sold them.

As an alternative, B could sell the books itself, allowing customers to purchase them directly from B's own website. In this way, B will retain all the profit from the sale, in turn increasing its profit margin, making this strategy **acceptable to B**. However, this option doesn't make the manuals any more user-friendly to the students, so won't provide B with any means of differentiating itself from its competitors in that respect.

Suitability – Ease of switching – A number of customers may already be buying materials online from online bookstores, in which case there should be very little switching cost in changing to buy the manuals directly from B. However, B will need to ensure that its products are still visible for students when they are looking to buy materials. If B's competitors continue to sell through the bookstores and online vendors, and if students look there to buy their books, then they may buy one of the competitor's books instead of B's. B may need to look at search engine optimisation, for example, so that students looking to buy a text online see that they can buy B's text directly from B.

Feasibility – e-commerce capability – Although B currently has a website, it is unlikely that the company currently handles any e-commerce transactions. Therefore, B will have to upgrade its website to provide the functionality required for customers to select manuals online, as well as providing a secure payment facility so that customers can pay for their books online.

Feasibility – logistics – Under this strategy, B will also have to deliver (or oversee delivery of) individual manuals to private customers and the colleges whose students use its manuals. This will result in a much **greater number of deliveries** than at present where B delivers bulk orders to a smaller number of bookshops.

Consequently, B is likely to need to recruit additional logistics staff. Alternatively, B could outsource the packaging and distribution process to a specialist logistics firm – although it would need to consider the cost-benefit implications of this before choosing to do so. The fee paid to the logistics firm will reduce B's profit margin in a similar way that a commission paid to bookshops would.

Potential fourth strategy:

Cost reduction

Currently, B carries out the production process (typesetting and printing) in-house, and in Europe. However, it is possible that some of the production activities could be done more cheaply by using external contractors.

In particular, electronic versions of the manuals could be sent for printing by contractors based in countries outside mainland Europe, whose costs are cheaper.

Suitability – **Cost reduction** – This strategy should allow B to reduce its costs, and thereby improve margins.

Feasibility – **Relationship management** – However, although this strategy may reduce B's costs, it will lead to a new problem of having to manage the relationship with the companies responsible for printing the materials. B will also need to ensure that the print quality of its manuals is not compromised by switching to new, cheaper printers.

Acceptability – **Redundancies** – This strategy is also likely to lead to redundancies amongst B's in-house production teams, and other one-off costs associated with shutting down the in-house production facilities.

Moreover, this strategy may effectively prove only to be an interim solution, with the longer term solution being the switch to using electronic media in preference to hard copy printed manuals.

Answer to Self-test question 2

Part (a)

In Hester Bateman's (HB's) case, the issues are not particularly clear cut. The size of the market is changing. From being strictly demarcated on national lines, the market has become global. This trend is certain to continue. In this new global market, what strategies can HB pursue?

- **Cost leadership** would seem out of the question, in the short term at least. This is because cutlery making technology can be easily imitated by countries in the Pacific. At the moment, their labour costs are much lower; how long this will remain the case, is a different question.
- **Differentiation**. HB could differentiate the product on a global basis, on the basis of quality (by using special alloys) or by designing products that are attractive to users, or by introducing a range of new designs.
- **Focus**. HB could decide to serve the UK or European market only, but it will still be vulnerable to cheaper competition. On the other hand, it could position itself as a luxury brand to serve wealthier consumers.

Clearly, differentiation or focus are the way forward, as HB will always be vulnerable to lower cost competition, from Pacific Rim countries first of all, and then from other countries as they industrialise.

Part (b)

Statement of objectives

The statement of objectives contains remarkably few points which meet the criteria of good (SMART) objectives. For example, nothing has been quantified. As a mission statement, it addresses the past and not the future, on the assumption that past traditions can be preserved as a guarantee for future success.

To some extent, having survived the recessions of the early 1980s and 1990s, HB is in a strong position, having obviously taken steps to maintain its competitiveness. It is still able to trade on its quality image, as it has 45% of the market by value, as opposed to only 35% by volume. This is still significantly more than its competitors from overseas, suggesting that they are fighting over a niche that is relatively unprofitable for UK companies. Concentrating on the higher end of the market, rather than battling over market share for cheap generic items has been a sound strategy.

However, can this strategy be continued? It is possible that competitors will do their best to raise quality and HB's premium position will no longer be secure. Furthermore, the lack of investment will begin to tell. Finally, although the firm has maintained its market position in the short term, it has lost the confidence of investors in its ability to deliver long-term improvements.

HB therefore needs to update its objectives with a proper mission statement to satisfy the needs of its various stakeholders.

- To what extent can it continue to trade on its quality image?
- What customers is it looking to satisfy?
- What does it intend to do to address the concerns of its investors?

Clearly, the survival of the firm itself as an independent entity is in doubt. Investors are being advised to sell, yet the firm is still profitable and has a large share of the UK market. An argument perhaps, is that it has failed to capitalise on the competitive strengths it has. If it is exporting to a New York department store, it is clear that there might be further export opportunities, which are not being satisfied, in the luxury goods market.

HB's position is therefore, confused. On the one hand, it has survived two recessions – no mean feat. It has a commanding position in the British market, and its designs satisfy choosy US customers. Investors, however, have another viewpoint. The firm seems vulnerable to a take-over.

Part (c)

Marketing strategies

HB must first of all decide which generic strategy it is to pursue. We have suggested that cost leadership is out of the question, and so either differentiation or focus should be pursued. Once this is decided, a suitable marketing mix must be devised. We can suggest a focus strategy, exploiting product differentiation (ie a differentiation-focus strategy). HB already produces cutlery of a different quality (eg the highest quality is exported to the US). In order to improve profits, HB first of all needs to identify which product markets are the most profitable, and deal with them in a suitable way. Different strategies might be suggested for different market niches to ensure profit streams.

Furthermore, the firm needs to undertake a programme of market research to find out what its customers (both retailers such as the New York department store, and the end-consumer or user) think about HB, and how it can better satisfy their needs.

Product

'Made in Sheffield' goods enable the firm to charge a premium price. The firm should concentrate on exploiting the international luxury market for high quality 'designer' goods. For example, scotch whisky is exported to Japan, and HB can channel its R&D towards producing a variety of innovative designs that can combine premium prices at the high end of the market.

At the same time, it needs to enhance the profits earned from the UK market, where it is facing cheap generic competition. It has little scope for cutting prices, and so it might be a good idea to maintain its position, but at a lower price. It could set up, therefore, a brand of cheap imported cutlery, to compete with BQ and the other importers. This would release resources to concentrate on higher quality premium-priced products which could still have the 'Made in Sheffield' tag. HB can, therefore, set up two brands. There are obviously profits to be earned from the generic end of the market, and HB still has the opportunity to deliver.

Many firms sell low and high-quality versions of a product under different brand names. It is not so much the company that has to be positioned appropriately in the market, as its brands.

The firm could also use its expertise in quality metal work to expand its product range (using Ansoff's product development strategy) into the same market. Suggestions might include:

- Related products such as silver (soup tureens, trays, silver goblets)
- Less plausibly, perhaps, ornaments, jewellery, even cufflinks

Price

The price element of the mix is implicit in the product. To increase its profitability, HB is to manufacture premium products at premium prices. This is in order to increase the ROCE: the New York business earns a gross margin of 45%.

Under a different brand name, HB is to import cheap generic products from Pacific Rim or cheaper countries, and use its existing networks to take on the competition. This will hopefully generate more profits, or at least cover costs, as the expensive manufacturing capability will be directed elsewhere. HB will be able to compete more effectively.

Place

The distribution system is an important element of the marketing mix. HB has obviously no problem in the UK, but perhaps it needs to consider whether it is as effective and efficient as it could be. We are told little about HB's existing distribution and logistics systems.

However, the twin pronged strategy does require some new expertise.

(a) If the company is importing its generic products from overseas, it will need to have suitable warehousing and storage facilities, and to have systems which can predict likely demand, so customers do not have to wait too long.

(b) It is hoped that many of the premium priced products will be exported. The US department store is a model for strategies that can be adopted in other countries in the EU and all over the world. HB will need assistance, perhaps from one of the UK government's export advisory services, to find distributors for its product. The distributors will inevitably have a significant say in how the goods are to be positioned and sold. In a market such as Japan, HB will need a suitable partner to negotiate the thickets of the distribution system; in a country that uses chopsticks, demand for cutlery will be limited, but it can be sold as a luxury item.

However, the main markets would be the US, where further expansion is obviously possible, and the EU.

The company might consider offering an enhanced service to customers, for example, a just-in-time delivery system.

Promotion

Promotional strategies will be an essential feature of HB's repositioning itself as a premium priced quality product. This means finding a suitable advertising agency, and researching the communications messages the company wishes to pursue. It might mean advertising in media it has not used before (eg magazines promoting luxury goods, or lifestyle magazines such as *The World of Interiors*).

Finally, the firm needs to promote itself to another audience: investors, who have to be convinced that the new strategy will work. At the moment they are critical, and will sell to a bidder. To keep their jobs, the existing managers must work to convince investors that the company's existing and potential strengths can be better exploited in future.

Answer to Self-test question 3

Part (a)

In traditional marketing media, such as advertising and direct mail, the marketing message is initiated by the **supplier sending out a message** to potential customers. However, there is limited interaction with the customer. In electronic media, **the customer plays a much more active role**, for example visiting a website to find out information about a course or seminar.

Interactivity – Interactivity is a key feature of electronic media, creating a dialogue between supplier and customer. Usually this dialogue is through email exchanges. For example, IAT could use emails to provide customers with information about courses which may be of interest to them.

However, in order to do this, IAT **needs to know the email address** of potential customers, and the courses they could be interested in. At the moment, IAT only collects personal information about people who wish to download study material; there isn't a facility on the website for **potential customers to register their interest** in a particular course, so that IAT can then send them further details about the course, and any special deals available to encourage them to book on the course.

In this respect, the functionality of IAT's website is more characteristic of traditional media (that is, sending out generic messages) rather than encouraging the interactivity which is characteristic of electronic media.

Individualisation – Another characteristic of electronic media is that they allow marketing messages to be **tailored to specific market segments**, whereas with traditional media, a single message is sent to all market segments.

For example, some of IAT's courses are for non-qualified candidates preparing for their professional exams, while others are for qualified accountants fulfilling their CPD requirements. At the moment, IAT has a single website for all students. However, students could be asked to indicate which courses they are interested in (professional exams, or CPD) when they first visit the website, and then the **information could be filtered** so that only the parts relevant to them are displayed on the screen, or they are taken to different screens, depending on their interest.

The interactivity noted above also promotes individualisation. Once students have registered an interest in a particular course, or for a course in a particular location, subsequently emails individually relevant to them can be sent out, advertising courses for related subjects in the nearest centre to them.

Intelligence – Since advertisers using traditional media do not engage in any dialogue with potential customers, they cannot use their marketing to find out anything about customers' requirements, and also which products or services are meeting them most effectively.

However, website software allows web owners to **record information every time a user clicks on a page**. For IAT, this would be useful to see which pages on its website (ie which courses) potential customers view most frequently. It would also be useful for IAT to see how the number of visitors to a web page translates into them signing up for a course of for study material.

If the **conversion rate from hits (visits) to sales** is low for particular products, it suggests there is either a problem with the web page promoting that product (for example, it is not clear to follow), or with the underlying product itself (for example, potential customers are put off by the price of a course).

IAT could possibly even get more customer intelligence by including a **short survey on its website**, asking visitors to the site for their feedback, on either the site itself, or the products IAT is offering.

Integration – Advertisers can use the intelligence which they gather from customers to add value to their products or services, by sharing the intelligence with other people across their company.

For example, at the moment only 10% of people who view IAT's downloadable study material proceed to purchase it. The online marketing team should discuss this low conversion rate with other areas of the business to assess whether there is anything that could be done to make the material more attractive to potential customers. These discussions could be with the authors of the material, to discuss if it could be made more student-friendly; or with the finance department, to see if any discounts or incentives could be offered to make the price more attractive.

Independence of location – By its nature, internet marketing has a global reach and so allows advertisers to access potential customers who were outside the reach of traditional media. Moreover, the internet is also accessible 24 hours a day, 7 days a week, so it allows potential customers to find information about a company's products and services outside normal office hours.

The ability to communicate globally may be more useful to IAT for selling study material than selling courses. Although IAT has eight worldwide centres, it is only likely to be practical for students to attend these centres if they live relatively close to them. However, study materials can be sent to students wherever they live.

There are some practical considerations here though, which we will consider further in part (b). The procedures for booking courses do not support the 'global' aspect of the electronic media, for example, because customers cannot book a course online.

Part (b)

Electronic marketing offers a number of new opportunities which are not readily available, or affordable, using traditional marketing methods. We can evaluate how IAT can take advantage of them by looking at how they relate to some of the key elements of the marketing mix: product, price, promotion, place and process.

Product

IAT offers three different products for sale through its website: training courses for professional qualifications, training manuals for professional examinations; and CPD training courses.

Sample products – The website allows customers to **see a sample of the training manuals before they buy a product**, so that they can see first-hand the quality of the product they are buying.

At the moment, there is no similar way of assessing the quality of the courses in advance of purchasing them, not least because of their intangible nature. However, IAT could include some **video clips or web-casts** from previous courses on the website to give potential customers a flavour of the training provided. They could also include some **quotes from students** who have been on the most recent courses to endorse the quality of the courses.

Online courses – At the moment, the courses are only run from eight centres worldwide (three for CPD courses). This is likely to restrict the number of students who can attend courses to those who live relatively near to the course locations. IAT should consider whether the courses can be offered online through **web seminars** and **web casts**, supported by a **virtual learning environment** and **online tutors**. Even so, IAT may not be able to access a truly global audience, because customers will need **fast broadband access** to make these web seminars practical, but this option may allow IAT to increase its student numbers internationally.

Product size – At the moment, students pay a fixed fee of CU180, which gives them access to a complete set of manuals for all the professional examinations. However, some students may not which to purchase all the manuals at the same time. Therefore, IAT should consider allowing candidates to buy individual manuals as an alternative to buying the whole set. In part (a) we talked about customer intelligence. This is an area where IAT could benefit from customer research, to understand whether students would prefer to buy individuals manuals or to buy the whole set at once.

Product updates – It is likely that a number of IAT's training manuals will need updating each year to reflect syllabus changes or changes in legislation. IAT can use the website to publicise any such changes. Moreover, if it had a database of email address for students who had registered an interest in the material which was affected, IAT could send a message to the student telling them the new, updated version was available.

Price

Bulk discounts – In the section on price, above, we mentioned the option of allowing students to buy individual manuals rather than having to buy the whole set. However, if IAT takes up this option it could still offer a discounted fee for buying the whole set in one go.

Pay per access – At the moment, students pay a one-off fee to download the material, regardless of how much of it they want to use. An alternative approach may be allow students to pay 'on demand'. For example, they would only be charged when they access the material, and the level of the charge would depend on how many pages they access. The pricing structure could be explained on the website.

Price transparency – The internet allows potential customers to compare IAT's prices to its competitors very easily. Therefore, IAT needs to make sure its prices are competitive in the marketplace.

However, this price transparency could also be problematic for IAT because it makes it harder to offer **differential pricing**. Candidates in poorer countries are going to be less able to afford the standard prices than candidates in richer countries.

IAT could consider **developing local websites for different countries** (with local domain names), translating the prices into local currency and possibly adjusting prices to reflect the income levels in the countries. If the content of the website was also translated into the local language, this, in conjunction with the local domain name would make it harder for people from other countries to compare prices internationally.

Dynamic pricing – It is much quicker and easier to change the price of products advertised on a website than it would be for prices advertised through traditional media. IAT could take advantage of this to vary the prices of its courses over time, in the same way that budget airlines do. For example, when a course first becomes available its price could be relatively cheap, to encourage people to sign up. Then as the course becomes more fully booked, the prices could rise. However, if there remain a number of empty spaces on a course shortly before it is due to run, the price could be reduced to try to encourage late bookings.

Promotion

One of the main differences between electronic media and traditional media is the interactivity of the customer in seeking out information. Potential customers now use the internet to search for information about possible products.

Search engine optimisation – IAT needs to ensure that if potential customers enter a web search for accountancy manuals or courses, then IAT's product offerings come near the top of the resulting listings. The way IAT's website is constructed will affect the likelihood of it appearing on the first page of search engine listings.

Click throughs – IAT should also investigate the possibility of building links to its website from other sites. For example, where it offers professional qualifications, it may be able to build a link from the qualification provider's website. Although IAT will have to pay a commission for the number of visitors who come to its site via the link, it should still prove a beneficial marketing tactic, because it will increase the number of visitors to IAT's website, as well as improving its search engine ranking.

Currently, IAT's website appears to be a standalone site, with no links to any other sites.

Banner advertising – IAT should also publicise its products and services through banner adverts. Although the logic behind these is no different to traditional press adverts, the more places IAT advertises itself the more it will increase customer awareness about its products and services.

Place

Global reach – Although the internet allows IAT to communicate globally, in practice, this global reach is likely to be more useful in selling the downloadable manuals than the training courses. Customers can download and print of the training manuals wherever they live.

However, there are currently only eight training centres worldwide, and of these, only three offer CPD courses. Therefore, IAT's **training courses are only likely to be attractive to people who live relatively close to the centres**.

If IAT wants to maximise the global reach electronic media offer, it will either need to consider opening new centres, or, as we have discussed earlier, provide courses and tutorials online.

Process

Website functionality – At the moment, IAT's website is predominantly only an information site; for example, students can find information about courses on the site, but **cannot book and pay for their course online**.

One of the features of the internet as an advertising medium is that it operates 24 hours a day, 7 days a week. However, because course students have to contact an administrator to process their booking and payment details, this 24/7 flexibility is likely to be lost.

Interestingly, the website does allow students to pay for the downloadable material online, but IAT should consider adding the functionality to allow them to book and pay for their courses online.

Online queries – There is also no evidence that students can register any queries online. This is another feature which the marketing manager should consider adding to improve the consistency of the overall marketing mix.

Answer to Self-test question 4

Part (a)

Competitive market – The high number of branded coffee shops in Teeland suggests that the market there is likely to be competitive, because customers will have a high degree of choice about where to buy their coffee.

In this respect, branding, and the loyalty card scheme, could be valuable to CFE if it encourages customers to keep returning to CFE shops to buy their coffee, rather than going to rival shops.

Customer loyalty – By creating customer loyalty, a strong brand identity is a way of increasing or maintaining sales; for example, by improving customer retention rates and encouraging repeat purchases. This is the logic behind the loyalty cards being proposed by the marketing director.

However, whilst increasing sales will allow CFE to increase its profits overall, it may not, by itself, have as much impact as the marketing director might hope.

Importantly, CFE currently generates more revenue per shop than the market leader, although its profit margins are significantly lower.

Comparison of financial performance –

	CFE	*Market leader*
Revenue per shop ($'000)	1,434.5	1,384.6
Gross margin (%)	64.5%	68.9%
Gross margin per shop ($'000)	925.0	953.8
Operating profit margin (%)	9.77%	12.50%

In this respect, it seems that CFE's cost structure and its product mix may have a greater impact on performance than brand awareness. For example, CFE makes the highest profit margins on coffee sales, so if it could sell relatively more coffee drinks compared to food and snacks, this would improve its profit margins. The loyalty card scheme could help here, by encouraging customers to buy hot drinks so that they qualify for their free drink. (Obviously, though, margins will then be reduced by the 'free' seventh drink.)

Product mix –

	Coffee	*Other drinks*	*Food & snacks*
% of total revenue	34.0%	9.7%	56.3%
Gross margin (%) earned per product	80.7%	52.4%	56.8%

However, although there appear to be more important factors affecting CFE's performance than its company profile, branding could still have a positive impact on its performance.

Brand awareness – Brand awareness would be an indicator of CFE's position in the coffee shop market, and would indicate whether customers or potential customers do actually differentiate CFE from its customers, for example as offering higher quality products and service. If customers don't associate CFE's products as being higher quality than the competitors, then the money spent on higher quality ingredients and service staff is effectively being wasted.

Quality and trust – One of the key attributes of a successful brand is that it conveys a sense of quality and trust to potential customers, thereby encouraging them to buy the product or service in question in preference to a rival product.

Quality seems to be very important to CFE: it uses high quality ingredients for its food and drinks, and seeks to ensure customer receive a high standard of service (by paying its staff wages above the industry average).

Differentiation – In this respect, CFE appears to be trying to differentiate itself from its competitors on grounds of quality. If it can ensure that its brand becomes synonymous with quality, then this will help CFE compete successfully with other branded coffee shops.

Premium price – Branding messages are usually qualitative rather than focusing, and therefore reduce the importance of price differentials between a product and its rivals. This could be very important for CFE. Customers do not appear to be price sensitive, yet CFE is charging broadly the same prices as its competitors.

If CFE is able to strengthen its brand, by focusing on quality and service, this may, in turn, allow it charge a higher price for its products. This could be crucial for CFE's profitability, because it could allow CFE to reverse the current situation in which its gross margin percentages are lower than its competitors'.

Part (b)

Demand for the product – When deciding whether or not to increase the price of its coffee products, CFE needs to consider what impact the changes in price are likely to have on customer demand for them. Therefore, market research will be important to assess how demand (and consequently revenue) will be affected by any change in price.

It seems that CFE's customers are not particularly price sensitive, which should increase the chances of the finance director's proposal. However, CFE should still research their reaction to any change before implementing it.

In this respect, it would also be useful for CFE to gauge the strength of any brand loyalty towards it.

Amount of increase – Equally, market research will give CFE an insight into what price customers are willing to pay for their coffee. CFE's competitive strategy (of differentiation based around quality) might enable it to charge higher prices than its customers to an extent and still retain its customers. However, if CFE increases its prices too much, it is unlikely that the customers will remain loyal to it, even if it offers higher quality coffee and service that its competitors.

Competitors' pricing policies – Currently, CFE's are largely the same as those charged by the multi-national competitors. However, these competitors might also be planning to change their prices. For example, if CFE's competitors increase their prices, that could give CFE greater scope to increase its prices.

Competitors' plans – Currently, CFE seems to serve a higher proportion of 'Fair Trade' products than its competitors, and this might help it justify its higher prices. However, if its competitors are also planning to use more 'Fair Trade' coffee, or increase the quality of other ingredients, this would reduce the basis of differentiation between CFE and its competitors. In this respect, any insights which CFE could gain into its competitors' plans, before it changed its prices, would be useful.

Input prices – The finance director's suggestion is designed to help CFE increase margins. However, if the price of coffee beans rises, it might need to increase prices in order to maintain its current margins.

Equally, if costs, such as the rents CFE has to pay for its premises, rise, these may also increase the pressure on CFE to increase its prices in order to maintain its profit margins.

CHAPTER 6

Corporate governance

Introduction

Topic List

1. Principles of governance
2. Stakeholders
3. Role of boards
4. Organisational structures and strategies
5. Legal framework of governance

Summary and Self-test

Technical reference

Answers to Interactive questions

Answers to Self-test

Introduction

Learning objectives

	Tick off
• Assess the nature of governance and explain the characteristics and principles of good governance in a variety of scenarios	☐
• Assess the interests and impact of organisational stakeholders in determining strategy and the consequences for stakeholders of strategic choices	☐
• Evaluate the impact of governance mechanisms on a range of stakeholders	☐
• Assess and advise on appropriate corporate governance mechanisms and evaluate stakeholder management	☐
• Explain the role of boards in monitoring corporate performance and risk, and assess the role of assurance procedures in this context	☐
• Analyse and evaluate the strengths and weaknesses of corporate governance mechanisms and processes	☐
• Evaluate the suitability of corporate governance and organisational structures for implementing strategy	☐
• Explain the nature, and assess the consequences of, the legal framework within which businesses, assurance and governance systems operate	☐

Knowledge brought forward and syllabus links

Corporate governance was covered briefly in Business Strategy and is also covered in-depth in Corporate Reporting. However, this chapter focuses on the effectiveness of governance by firstly looking at what governance is trying to achieve and the problems it is trying to address. We have already discussed the importance and general concerns of stakeholders in Chapter 1 and in this chapter, we look at how important they are in the context of governance. The role of the board and whether the board appears to be operating effectively (or is able to operate effectively) is central to this chapter. Whether the organisational structure can effectively support the achievement of governance objectives is the other important issue.

The chapter ends with what is mainly a recap of law issues covered in other material, that have been included to set governance in its legal context. We also discuss the importance of the organisation having structures and procedures in place to ensure compliance.

Examination context

The learning objectives of assessing and advising on corporate governance mechanisms and evaluating their strengths and weaknesses, indicate that you will have to make judgements about how strong and appropriate governance mechanisms are, and highlight key weaknesses that may undermine their effectiveness.

1 Principles of governance

Section overview

- Good corporate governance involves risk management and internal control, accountability to stakeholders and other shareholders, and conducting business in an ethical and effective way.

Definitions

Corporate governance: The system by which companies are directed and controlled.

Corporate governance: The set of processes, customs, policies, laws and institutions affecting the way in which an entity is directed, administered or controlled. Corporate governance serves the needs of shareholders, and other stakeholders, by directing and controlling management activities towards good business practices, objectivity and integrity in order to satisfy the objectives of the entity.

The purpose of corporate governance is to facilitate effective, entrepreneurial and prudent management that can deliver the long-term success of the entity in achieving its objectives.

Although mostly discussed in relation to large quoted companies, governance is an issue for all corporate bodies, both commercial and not for profit.

There are a number of elements in corporate governance:

(a) The **management and reduction of risk** is fundamental in all definitions of good governance.

(b) The notion that overall performance **enhanced by good supervision and management**, within set best practice guidelines, underpins most definitions.

(c) Good governance provides a framework for an organisation to **pursue its strategy in an ethical and effective way** from the perspective of all stakeholder groups affected, and offers safeguards against misuse of resources, physical or intellectual.

(d) Good governance is not just about externally established codes, it also requires a **willingness to apply the spirit**, as well as the letter, of the rules.

(e) **Accountability** is generally a major theme in all governance frameworks.

1.1 Reasons for governance developments

Corporate governance issues came to prominence in the USA during the 1970s and in the UK and Europe from the late 1980s. The main, but not the only, drivers associated with the increasing demand for the development of governance were:

(a) **Increasing internationalisation and globalisation** meant that investors, and institutional investors in particular, began to invest outside their home countries. The King report in South Africa highlights the role of the free movement of capital, commenting that investors are promoting governance in their own self-interest.

(b) The **differential treatment of domestic and foreign investors**, both in terms of reporting and associated rights/dividends caused many investors to call for parity of treatment.

(c) Issues concerning **financial reporting** were raised by many investors and were the focus of much debate and litigation.

(d) The **characteristics of individual countries** may have a significant influence over the way corporate governance has developed. The King report emphasises the importance of qualities that are fundamental to South African culture such as collectiveness, consensus, helpfulness, fairness, consultation and religious faith in the development of best practice.

(e) An increasing number of **high profile corporate scandals and collapses**, including Polly Peck International, BCCI, and Maxwell Communications Corporation prompted the development of governance codes in the early 1990s. However, other scandals since then have raised questions about further measures that may be necessary and damaged public confidence in the way that companies are run. The worldwide scandals over the last 25 years have highlighted the need for guidance to tackle the various risks and problems that can arise in organisations' systems of governance.

1.2 The board of directors

Boards that have failed to manage companies effectively have been a very significant aspect of governance scandals. Different scandals have highlighted certain key weaknesses.

1.2.1 Domination by a single individual

A feature of many corporate governance scandals has been boards dominated by a single senior executive, with other board members merely acting as a rubber stamp. Sometimes, the single individual may bypass the board to action his own interests.

Even if an organisation is not dominated by a single individual, there may be other weaknesses. The organisation may be run by a small group centred round the chief executive and chief financial officer, and appointments may be made by personal recommendation, rather than a formal, objective process.

1.2.2 Lack of involvement of board

Boards that meet irregularly or fail to consider systematically the organisation's activities and risks, are clearly weak. Sometimes, the failure to carry out proper oversight is due to a lack of information being provided, or the directors lacking the knowledge or skills necessary to contribute effectively.

1.2.3 Lack of supervision

Employees who are not properly supervised by the board can create large losses for the organisation through their own incompetence, negligence or fraudulent activity. The behaviour of Nick Leeson, the employee who caused the collapse of Barings Bank was not challenged, because he appeared to be successful. He was, however, using unauthorised accounts to cover up his large trading losses. Leeson was able to do this because he was in charge of dealing and settlement, a systems weakness or lack of segregation of key roles that has featured in other financial frauds.

1.3 Directors' remuneration

Complaints over directors' remuneration levels have been a common feature of corporate governance debates. Complaints have not only focused on remuneration levels, but on the unwillingness of those who can challenge remuneration packages effectively (non-executive directors, institutional shareholders) to do so. Various problems have been highlighted:

(a) Remuneration levels that are **excessive** per se, and are not justified by the contribution directors have made.

(b) Directors being **rewarded for failure,** for example, receiving bonuses when their companies have performed poorly and receiving significant compensation payments when they lose office.

(c) Remuneration arrangements providing **incentives for directors** to allow risk-taking beyond levels that would be deemed acceptable by many shareholders.

1.4 Accounts and audit

Inevitably, many companies involved in scandals have had glaring weaknesses in internal control – weaknesses that have not been picked up by those monitoring control.

1.4.1 Lack of adequate control function

An obvious weakness is a lack of internal audit. Another important control is lack of adequate technical knowledge in key roles, for example, in the audit committee or in senior compliance positions. A rapid turnover of staff involved in accounting or control may suggest inadequate resourcing, and will make control more difficult because of lack of continuity.

1.4.2 Lack of independent scrutiny

External auditors may not carry out the necessary questioning of senior management because of fears of losing the audit. Often corporate collapses are followed by criticisms of external auditors, such as the Barlow Clowes affair, where poorly planned and focused audit work failed to identify illegal use of client monies.

1.4.3 Misleading accounts and information

Often misleading figures are symptomatic of other problems but clearly, poor quality accounting information is a major problem if markets are trying to make a fair assessment of a company's value. Giving out misleading information was a major issue in the UK's Equitable Life scandal where the company gave contradictory information to savers, independent advisers, media and regulators.

Clearly, the ultimate risk is of the organisation making such large losses that bankruptcy becomes inevitable. The organisation may also be closed down as a result of serious regulatory breaches, for example, misapplying investors' monies.

1.5 Perspectives on governance

Debates about the place of governance are founded on three differing views associated with the ownership and management of organisations.

1.5.1 Stewardship theory

Some approaches to good governance view the management of an organisation as the **stewards of its assets,** charged with asset employment and deployment in ways consistent with the overall strategy of the organisation. Technically, shareholders or member/owners have the right to dismiss their stewards if they are dissatisfied by their stewardship, via a vote at an annual general meeting.

Fundamentally though, governance is undermined if shareholders do not take an active interest in the organisation, and do not exercise their right to vote. Good governance thus often needs active participation on the part of owners.

1.5.2 Agency theory

Another approach to governance is enshrined in agency theory. This is the view that, rather than acting as stewards, management will act in an agency capacity, seeking to service their own self-interest and looking after the performance of the company only where its goals are co-incident with their own.

This approach is based on a very negative, short term/tactical stance, but is one that has been used in some elements of the frameworks. The development of performance related remuneration and incentive schemes, such as Long Term Incentive Plans (LTIPs) and executive share option schemes, are rooted in an agency theory approach, aiming to direct management towards achieving the long-term goals of the company.

1.5.3 Stakeholder theory

The stakeholder approach takes a much more 'organic' view of the organisation, imbuing it with a 'life' of its own, in keeping with the notion of a separate legal person. Effectively, stakeholder theory is a development of the notion of stewardship, stating that management has a **duty of care,** not just to the owners of the company in terms of maximising shareholder value, but also to the wider community of interest, or stakeholders. We shall examine the role of stakeholders in governance later in this chapter.

1.6 Governance principles

Most corporate governance codes are based on a set of principles founded upon ideas of what corporate governance is meant to achieve. This list is based on a number of reports.

(a) Ensure **adherence to, and satisfaction of the strategic objectives** of, the organisation, thus aiding effective management.

(b) **Convey and reinforce the requirements relating to governance** in local statute and listing rules

(c) **Minimise risk**, especially financial, legal and reputational risks, by ensuring appropriate systems of financial control are in place; also systems for monitoring risk and compliance with the law.

(d) **Promote integrity**, that is, straightforward dealing and completeness.

(e) **Fulfil responsibilities to all stakeholders** and minimise potential conflicts of interest between the owners, managers and wider stakeholder community.

(f) **Establish clear accountability** at senior levels within an organisation. However, one danger may be that boards become too closely involved with day-to-day issues and do not delegate responsibility to management.

(g) **Maintain the independence** of those who scrutinise the behaviour of the organisation and its senior executive managers. Independence is particularly important for non-executive directors and internal and external auditors.

(h) **Provide accurate and timely reporting** of trustworthy/independent financial and operational data to both the management and owners/members of the organisation, in order to give them a true and balanced picture of what is happening in the organisation.

(i) **Encourage more proactive involvement of owners/members** in the effective management of the organisation through recognising their responsibilities of oversight and input to decision making processes via voting or other mechanisms.

(j) **Direct behaviour.** Many detailed requirements within codes are based on the perceived need for boards to take specific actions.

2 Stakeholders

Section overview

- Directors and managers have to be aware of the interests of stakeholders in governance.
- Governance reports have emphasised the role of institutional investors (pension funds, insurance companies) in directing companies towards good corporate governance.

We discussed in Chapter 1 the impact of stakeholders on an organisation's strategic decision-making, but this section focuses on the interests and claims of stakeholders in the context of corporate governance.

The Organisation for Economic Co-operation and Development (OECD) principles of corporate governance stress the importance of protecting the rights of stakeholders. This includes giving stakeholders access to information on a regular and timely basis. Stakeholders, including employees, should be able to communicate their concerns about illegal or unethical relationships to the board.

2.1 Directors

The powers of directors to run the company are set out in the company's constitution or articles.

Under corporate governance best practice, there is a distinction between the role of **executive directors,** who are involved full-time in managing the company, and **non-executive directors**, who primarily focus on monitoring. However, under company law in most jurisdictions, the legal duties of directors and responsibility for performance, controls, compliance and behaviour apply to both executive and non-executive directors.

The role of directors in corporate governance is obviously central, and we shall consider the role of the board in the next section.

2.2 Company secretary

The company secretary is an important figure in ensuring compliance with legal and other regulatory frameworks. Legislation in many regimes refers to the specific duties of the company secretary. The most important duties, however, will generally be in the following areas:

(a) Arranging meetings of shareholders and the board of directors

(b) Signing, authentication and maintenance of documents and registers

(c) General administrative duties, including ensuring compliance with the company's constitution and other statutory and regulatory requirements such as the listing rules

2.2.1 Statement of best practice

ICSA, the Institute of Chartered Secretaries and Administrators, has published a statement of best practice on reporting lines for the company secretary.

(a) The company secretary is **responsible to the board, and should be accountable to the board** through the chairman on all matters relating to his duties as an officer of the company (the core duties).

(b) If the company secretary has other executive or administrative duties beyond the core duties, he or she should **report to the chief executive** or such other director to whom responsibility for the matter has been delegated.

(c) The company secretary's **salary, share options and benefits should be settled by the board or remuneration committee** on the recommendation of the chairman or chief executive.

ICSA has highlighted the following contributions that a secretary can make.

(a) **Probity of the secretary**

A company secretary is responsible for protecting the probity of a company. He or she is a guard against the directors acting in their own interests, rather than those of the company. An important aspect of the role is to remind directors of their responsibilities. The secretary also acts to protect the interests of third party shareholders and other stakeholders, and is also responsible for interpreting the decisions of the board and ensuring they are implemented throughout the company.

(b) **Legal compliance**

Under companies' legislation, the secretary (as an officer of the company) is held responsible for numerous breaches of law. Directors' priorities and areas of expertise may not be in the areas of governance and compliance.

(c) **Governance**

ICSA argues that if a secretary is appointed when a company is formed, this should mean that the principles of compliance and good governance are embedded in the company's procedures from the start. These aspects will be of critical importance as the company grows towards listing.

2.3 Sub-board management

The interests of managers are similar to the directors in many respects, and they may be concerned with corporate governance from the viewpoint of being potential main board directors. They will also be interested in how corporate governance decisions impact on their current position (how much decision-making will be delegated to them and in what areas? What parameters will they be obliged to follow?).

Although sub-board management does not have ultimate responsibility for decision-making within a company, its role in corporate governance is vital. In order to function effectively, the board needs to be supported by a strong senior management team, responsible for implementing strategy and controlling and co-ordinating activities. The management team will be responsible for:

- Helping to set the tone of the company
- Supervising the implementation of control and risk management procedures
- Providing information that directors need to make decisions about strategy, risk management and control

Shortcomings in any of these areas could seriously undermine the effectiveness of governance.

2.4 Employees

Employees need to comply with the corporate governance systems in place.

Employees will focus on how the company is performing and how the company's performance will impact on their pay and working conditions. Company law requires the directors to have regard for the interests of the company's employees in general, as well as the interests of its members.

Employees also have information requirements. Surveys suggest that the most interesting information for employees is information concerned with the immediate work environment and that which is future-orientated. There are a number of ways in which this information can be provided:

- An organisation-wide employee report
- Organisation-wide information on financial results, information on personnel or sales at a unit level
- Including statements by managers on their individual activities
- Producing separate inserts about each division

Employees' contribution to corporate governance is to implement risk management and control procedures. The company's culture will impact significantly on this, so that if enforcement measures are lax or employees do not have the skills or knowledge necessary to implement procedures, governance will be undermined.

Employees also have a role in giving regular feedback to management and of whistleblowing serious concerns. Again, poor communication, perhaps because employees are scared to raise issues or management won't listen, will impact adversely on governance. The OECD principles recommend that performance-enhancing mechanisms for employee participation should be permitted to develop.

2.5 External auditors

The external audit is, of course, one of the most important corporate governance procedures. It enables investors to have much greater confidence in the information that their agents, the directors/managers, are supplying. As you know, the main focus of the external audit is on giving assurance that the accounts give a true and fair view. However, external auditors can provide other audit services, such as social and environmental audits, and can also highlight governance and reporting issues of concern to investors.

External auditors are employed to scrutinise the activities of managers, who are the shareholders' agents. Their audit fees can be seen as an agency cost. This means that external auditors are also the shareholders' agents. A balance is thus required between working constructively with company management and at the same time, serving the interests of shareholders.

2.6 Regulators

Definition

Regulation: Any form of interference with the operation of the free market. This could involve regulating demand, supply, price, profit, quantity, quality, entry, exit, information, technology, or any other aspect of production and consumption in the market.

Regulators include government bodies, such as health and safety executives, and specific regulators such as the financial services authorities, utility regulators and charity commissioners, amongst many others relevant to specific types of industry.

2.6.1 Methods of regulation

Legislators and regulators affect organisations' governance and risk management. They establish **rules and standards** that provide the impetus for management to ensure that risk management and control systems meet minimum requirements. They also **conduct inspections and audits** that provide useful information and recommendations regarding possible improvements. Regulators will be particularly interested in maintaining shareholder-stakeholder confidence in the information with which they are being provided. Regulation can only be effective if it is properly monitored and enforced. Direct costs of enforcement include the setting up and running of the regulatory agencies – employing specialist staff, monitoring behaviour, prosecuting offenders (or otherwise ensuring actions are modified in line with regulations). Indirect costs are those incurred by the regulated (eg the firms in the industry) in conforming to the restrictions.

2.6.2 Regulation and stakeholders

Where privatisation has perpetuated monopolies over natural resources, industry regulatory authorities are responsible for ensuring that consumers' interests are not subordinated to those of other stakeholders, such as employees, shareholders and tax authorities. The regulator's role may be 'advisory' rather than statutory. It may extend only to a part of a company's business, necessitating a fair allocation of costs across different activities of the company.

Case example: Reasons for regulation

Benston (2000) provides six reasons for the regulation imposed to protect consumers of banking, securities and insurance services. Regulations are imposed to:

- Maintain consumer confidence in the financial system
- Assure that a supplier on whom consumers (eg of a major utility) rely does not fail
- Assure that consumers receive sufficient information to make 'good' decisions; and are dealt with fairly
- Assure fair pricing of financial services
- Protect consumers from fraud and misrepresentation
- Prevent invidious discrimination against individuals

2.6.3 Regulation and corporate governance

Regulators will also be concerned with how corporate governance guidance affects the way organisations deal with changing circumstances.

Case example: Regulation in the financial sector

A good example of a major change requiring a different approach to regulation has been the liberalisation of the activities by financial institutions in many countries. The traditional separation of financial institutions into banks, insurance companies, brokers and investment companies has been abolished and financial institutions now engage in all these activities. The risks to which a multi-product financial institution is exposed can be significantly different to the risks that each of the individual component parts, eg the banking division, are exposed.

In practice, the task of keeping regulation up-to-date and relevant is made more challenging by the pace of innovation in financial products, the development of financial markets and institutions, and by globalisation.

The question that arises is: How much regulation should there be? And is there perhaps an optimal level of regulation?

According to McMenamin in *Financial Management – An Introduction*, 'regulation is essentially a question of balance …. too little or ineffective regulation leaves the markets open to abuse, too much regulation makes markets rigid, costly to operate and uncompetitive'.

As a result of the problems in the banking sector over the last few years, the distinction between regulation of banks' retail activities (operations concerned with customer deposits, business lending and the transmission of money) and investment activities has been much debated.

2.7 Government

Most governments do not have a direct economic/financial interest in companies (except for those in which they hold shares). However, governments often have a strong indirect interest in companies' affairs, hence the way they are run and the information that is provided about them:

(a) Governments raise **taxes** on sales and profits and on shareholders' dividends. They also expect companies to act as tax collectors for income tax and sales tax. The tax structure might influence investors' preferences for either dividends or capital growth. Economic policies such as deregulation may be influenced by the desire for economic growth and increased efficiency.

(b) Governments pass and enforce laws as well as establish and determine the **overall regulatory and control climate** in a country. This involves exertion of fiscal pressure, and other methods of state intervention. Governments also determine whether the regulatory framework is **principles or rules based** (discussed later in the text).

(c) Governments may **provide funds** towards the cost of some investment projects. They may also encourage private investment by offering tax incentives.

(d) In Bangladesh, the government has made some attempts to encourage more private individuals to become company shareholders, by means of:

  (i) Attractive **privatisation** issues (such as in the electricity, gas and telecommunications industries)

  (ii) **Tax incentives**, such as Income from dividend amounting to Tk. 25,000 received from a publicly traded company is tax emempted.

(e) Governments also influence companies, and the relationships between companies, their directors, shareholders and other stakeholders.

2.8 Stock exchanges

Stock exchanges provide a means for companies to **raise money**; and investors, to **transfer their shares** easily. They also provide information about company value, derived from the supply of, and demand for, the shares that they trade. Stock exchanges list companies whose shares can be held by the general public (called public companies in many jurisdictions). Many such companies have a clear separation between ownership and management.

Stock exchanges are important because they provide **regulatory frameworks** in principles-based jurisdictions. In most countries, listing rules apply to companies whose shares are listed on the stock exchange. Stock exchange regulation can therefore have a significant impact on the way corporate governance is implemented; and companies report. Bangladesh is a good example of this, with the 'comply or explain' approach being consistent with the tendency toward self-regulation adopted by many entities. In America by contrast, a more legalistic and rules-based approach has been adopted, in line with the regulatory approach that is already in place.

2.9 Institutional investors

Institutional investors have large amounts of money to invest. They are covered by fewer protective regulations, on the grounds that they are knowledgeable and able to protect themselves. They include investors managing funds invested by individuals and agents employed on the investors' behalf.

Institutional investors are now the biggest investors in many stock markets but they might also invest venture capital, or lend directly to companies. Bangladesh trends show that institutional investors can wield great powers over the companies in which they invest.

The major institutional investors in Bangladesh are:

- Investment Corporation of Bangladesh (ICB)
- Scheduled banks
- Merchant banks
- Bangladesh Development Bank Limited (BDBL)
- Non-bank financial institutions (NBFIs)
- Insurance companies
- Leasing companies
- Pension funds and provident funds
- Postal savings schemes
- Postal life insurance
- Co-operative land mortgage banks
- Pension and provident funds
- Employees insurance funds and Security deposits.

Their funds will be managed by a fund manager who aims to benefit investors in the funds or pension or policy holders. Although fund managers will use lots of different sources of information, their agency costs will be high because they have to track the performance of all the investments that the fund makes.

2.9.1 Advantages and disadvantages of institutional investment

In some respects, the **institutional investor** fulfils a desirable role. People should ideally be in pensionable employment or have personal pension plans. The funds from which their pensions will be payable should be held separately from the companies by whom they are employed. Similarly, investors should have the opportunity to invest through the medium of insurance companies, unit trusts and investment trusts.

However, the dominance of the equity markets by institutional investors has possibly undesirable consequences as well.

(a) **Excessive market influence**

For capital markets to be truly competitive, there should be no investors who are of such size that they can influence prices. In the UK, transactions by the largest institutions are now on such a massive scale that considerable price movements can result.

(b) **Playing safe**

Many institutions tend to avoid shares which are seen as speculative, as they feel that they have a duty to their 'customers' to invest only in 'blue chip' shares (ie those of leading commercially sound companies). As a result, the shares of such companies tend to be relatively expensive.

(c) **Short-term speculation**

Fund managers are sometimes accused of 'short-termism' in that they will tend to seek short-term speculative gains or simply sell their shares and invest elsewhere if they feel that there are management shortcomings. Pension fund trustees are also accused of being over-influenced by short-term results because of the lack of time they have to go into the company's performance in detail.

(d) **Lack of power of investors**

Investors in investment and pension funds cannot directly influence the policy of the companies in which their funds invest, since they do not hold shares themselves and cannot hold the company accountable at general meetings.

2.9.2 Role of institutional investors

UK guidance has placed significant emphasis on the role of institutional investors in promoting good corporate governance. The UK Corporate Governance Code states that shareholders should enter into a dialogue with companies based on the mutual understanding of objectives, taking into account the size and complexity of the companies and the risks they face. Their representatives should attend company annual general meetings and make considered use of their votes.

UK guidance stresses that institutional investors should consider, in particular, companies' governance arrangements that relate to board structure and composition. They should enter a dialogue about departures from the Code if they do not accept the companies' position.

2.9.3 Stewardship Code

The UK Corporate Governance Code refers to guidance in the UK Stewardship Code, published in July 2010. The Stewardship Code states that institutional investors should:

(a) Disclose how they will discharge their responsibilities.

(b) Operate a clearly disclosed policy for managing conflicts of interest.

(c) Monitor performance of investee companies – to gain assurance on the operation of the board and its committees by attending meetings of the board and the AGM. They should be particularly concerned with departures from the UK Corporate Governance Code, and also seek to identify threats to shareholder value at an early stage.

(d) Establish clear guidelines on when they will actively intervene, when they are concerned about strategy and performance, governance or approach to risk.

(e) Be willing to act collectively with other investors, particularly at times of significant stress or when the company's existence appears to be threatened.

(f) Operate a clear policy on voting and disclosure of voting activity. They should not necessarily support the board.

(g) Report to their clients on their stewardship and voting activities. They should consider obtaining an independent audit opinion on their engagement and voting processes.

2.9.4 Means of exercising institutional investors' influence

A number of different methods may be effective.

(a) **One-to-one meetings**

These discuss strategy, whether objectives are being achieved, how the company is achieving its objectives, the quality of management. However, new information cannot be divulged to any single analyst or investor in these meetings, as it would give that investor an information advantage over others.

(b) **Voting**

Generally, institutional investors would prefer to work behind-the-scenes and to avoid voting against the board, if possible. If they are intending to oppose a resolution, they should normally state their intention in advance. Most corporate governance reports emphasise the importance of institutional investors exercising their votes regularly and responsibly.

(c) **Focus list**

This means putting companies' names on a list of underperforming companies. Such companies' boards may face challenges.

(d) **Contributing to corporate governance rating systems**

These measure key corporate governance performance indicators, such as the number of non-executive directors, role of the board and the transparency of the company.

2.9.5 Intervention by institutional investors

In extreme circumstances, the institutional shareholders may intervene more actively, by for example, calling a company meeting in an attempt to unseat the board. The UK Institutional Shareholders' Committee has identified a number of reasons why institutional investors might intervene:

- Fundamental concerns about the strategy being pursued in terms of products, markets and investments.
- Poor operational performance, particularly if one or more key segments has persistently underperformed.
- Management being dominated by a small group of executive directors, with the non-executive directors failing to hold management to account.
- Major failures in internal controls, particularly in sensitive areas such as health and safety, pollution or quality.
- Failure to comply with laws and regulations or governance codes.
- Excessive levels of directors' remuneration.
- Poor attitudes towards corporate social responsibility.

2.10 Small investors

Small investors include shareholders who hold small numbers of shares in companies, trusts and funds. They may not have the same ease of access to information that institutional investors possess, or the level of understanding of experts employed by institutional investors. Their portfolios are likely to be narrower and they may be less able to diversify risk away. These problems can handicap their position.

The OECD suggests that a key principle of corporate governance is that all shareholders should be treated **equally**. However, if institutional investors become more influential, they may be treated better by company managers.

The OECD guidelines stress the importance of achieving shareholder protection by enforcing the **basic rights of shareholders**. These include the right to secure methods of ownership registration, convey or transfer shares, obtain relevant and material information, participate and vote in general meetings and share in the profits of the company. Under the OECD guidelines, shareholders should also have the right to participate in, and be sufficiently informed on, decisions concerning fundamental changes, such as amendments to the company's constitution.

3 Role of boards

Section overview

- The effectiveness of the board as a mechanism for governance depends on the composition and organisation of the board, the steps the board takes to maintain and improve its effectiveness and the roles played by the chairman and chief executive, non-executive directors and board committees.
- The most important areas in which the board must operate effectively are strategy setting, risk management and performance monitoring.

3.1 Role of board

The South African King report provides a good summary of the role of the board:

> *To define the purpose of the company and the values by which the company will perform its daily existence and to identify the stakeholders relevant to the business of the company. The board must then develop a strategy combining all three factors and ensure management implements that strategy.*

The King report stresses that the board is responsible for assets and for ensuring the company follows its strategic plan. For management to be held properly responsible, there must be a system in place that allows for **corrective action** and **penalising mismanagement**. Responsible management should do, when necessary, whatever it takes to set the company on the right path. King also stresses the importance of doing business ethically and building sustainable businesses.

Bangladesh Security and Exchange Commission (BSEC) Corporate Governance Guideline states that the board's role is to provide **entrepreneurial leadership** of the company within a framework of prudent and effective controls that enable risk to be assessed and managed. The board should set the company's strategic aims, ensure that the necessary financial and human resources are in place for the company to meet its objectives and review management performance.

Case example: Good boards

Corporate governance expert, Professor Richard Leblanc, commented that good boards, 'are independent, competent, transparent, constructively challenge management and set the ethical tone and culture for the entire organisation.' In organisations where there were corporate misdeeds or ethical failures, there were generally also board problems. Common defects included 'undue influence, bullying, poor design, lack of industry knowledge and directors who are not engaged.'

Case example: Enron

The most significant scandal in America in the last 15 years has been the Enron scandal, when one of the country's biggest companies filed for bankruptcy. The scandal also resulted in the disappearance of Arthur Andersen, one of the Big Five accountancy firms who had audited Enron's accounts.

Enquiries into the scandal exposed a number of weaknesses in the company's governance. The company's management team was criticised for being arrogant and over ambitious. *The Economist* suggested that Enron's Chief Executive Officer, Kenneth Lay, was like a cult leader, with his staff and employees fawning over his every word and following him slavishly. The non-executive directors were weak, and there were conflicts of interest. The chair of the audit committee was Wendy Gramm. Her husband, Senator Phil Gramm, received substantial political donations from Enron.

3.2 Set-up of board

Worldwide there are a variety of governance models, based on different ways of formalising the distinction between those who manage a company (executives) and those who monitor the managers (non-executives).

3.2.1 Unitary boards

BSEC corporate governance is based on the idea of a unitary board, consisting of a mix of executive and non-executive directors. All directors have the right to **participate in board decision-making**. All participants in the single board have **legal responsibility** for management of the company and strategic performance.

3.2.2 Multi-tier boards – Germany

Institutional arrangements in German companies are based on a **dual board**.

(a) **Supervisory board**

A **supervisory board** has workers' representatives and stakeholders' management representatives, including banks' representatives. The board has no executive function, although it does review the company's direction and strategy and is responsible for **safeguarding stakeholders' interests**. It must receive formal reports of the state of the company's affairs and finance. It approves the accounts and may appoint committees and undertake investigations. The board should be composed of members who, as a whole, have the required **knowledge, abilities and expert experience** to complete their tasks properly and are sufficiently independent.

(b) **Management board**

A **management or executive board**, composed entirely of managers, will be responsible for the day-to-day **running** of the business. The supervisory board appoints the management board. Membership of the two boards is entirely separate.

3.2.3 Multi-tier boards – Japan

In Japan there are three different types of board of director.

- **Policy boards** – Concerned with long-term strategic issues
- **Functional boards** – Made up of the main senior executives with a functional role
- **Monocratic boards** – With few responsibilities and having a more symbolic role

Perhaps unsurprisingly, one of the main features of this structure is that decision-making is **generally thorough** but slow. This has been considered as acceptable in a culture where the stress is on long-term decisions. Directors are supposed to continue to promote the interests of employees once they join the board, in line with corporate culture. Entry of executives onto the board is **controlled** by the chairman, who may seek the advice of others (frequently bankers).

3.2.4 Advantages of unitary boards

(a) **Common legal responsibility**

This implies a **more active approach** by those directors who are not executive directors and therefore act in an independent and 'supervisory' capacity.

(b) **Inclusion in decision-making**

If all the directors attend the same meetings, the **independent directors** are **less likely** to be **excluded from decision-making and given restricted access to information**. Boards that take all views into account in decision-making may end up making better decisions.

(c) **Questioning**

The **presence of non-executive directors**, with different viewpoints to question the actions and decisions of executive directors as they are taking place, **should lead to better decisions being made**.

(d) **Maintenance of better relationships**

The **relationship** between **different types of directors** may be **better**, as a single board promotes easier co-operation.

3.2.5 Disadvantages of unitary boards

(a) **Objectivity of monitoring**

Non-executive directors' primary role is to monitor decision-making by executive directors. They may find it very difficult to monitor objectively if they are also **significantly involved in decision-making** themselves.

(b) **Time requirements**

The time requirements on non-executive directors may be **onerous,** both in terms of the time spent in board meetings and the commitment required to **obtain sufficient knowledge** about the company to properly fulfil their monitoring role.

(c) **Entrenchment of divisions with employees**

In some jurisdictions, for example the UK, the unitary board can be seen as emphasising a **division between directors and employees**, who are not represented on the board.

(d) **Relationships with shareholders**

Similarly, the unitary board also **emphasises the divide between the shareholders and the directors.** Shareholder representatives cannot be included on the board, other than as directors. However, if shareholder representatives are appointed as directors, it means that they may face a conflict between promoting the interests of the shareholder group they represent, and acting in the interests of the company as a whole. If shareholder representatives are not on the board, then **the general meeting** may be the only time when shareholder grievances or concerns can be raised effectively.

3.2.6 Advantages of multi-tier boards

(a) **Separation of duties**

The main argument in favour of multi-tier boards is the **clear and formal separation** between the monitors and the executive directors being monitored.

(b) **Guarding role**

The supervisory/policy board has the **capacity** to be an **effective guard** against management inefficiency or worse. Indeed, its very existence may be a **deterrent** to fraud or irregularity in a similar way to the independent audit.

(c) **Interests of stakeholders**

The supervisory/policy board should **take account of the needs of stakeholders** other than shareholders, specifically **employees**, who are clearly important stakeholders in practice. The system actively **encourages transparency within the company**, between the boards and, through the supervisory board, to the employees and the shareholders. It also **involves the shareholders and employees** in the supervision and appointment of directors.

(d) **Role of strategic board**

If the split of the board is on strategic/operational lines, a small strategic board may be able to act more **quickly and decisively** than a larger board that includes everyone with operational responsibilities.

3.2.7 Disadvantages of multi-tier boards

(a) **Lack of clarity**

Confusion over authority and therefore, a **lack of accountability** can arise with multi-tier boards. This criticism has been particularly levelled at Japanese companies, where the consequence is allegedly often over-secretive procedures.

(b) **Ineffectiveness of supervisory board**

In practice, the supervisory/policy board may not be as effective as it seems in theory. The **executive management board may restrict the information passed on** to the supervisory board and the boards may only liaise infrequently.

(c) **Lack of independence**

The supervisory board may not be as **independent** as would be wished, depending on how rigorous the appointment procedures are. In addition, members of the supervisory board can be, indeed are likely to be, shareholder representatives. This could detract from legal requirements that shareholders don't instruct executive directors on how to manage if the supervisory board was particularly strong.

(d) **Limitations of strategic board**

Exclusion of board members, particularly those with operational responsibilities from important strategic discussions, may result in decisions that do not take full account of all the important factors. Directors who are not consulted may not support the decisions, particularly if they regard them as **unworkable**.

3.3 Qualities and effectiveness of board

The Australian code of corporate governance summarises what a board must do:

- Properly understand current and emerging issues in business
- Exercise independent judgement
- Encourage enhanced performance of company
- Effectively review and challenge the performance of management

3.3.1 Board effectiveness

Guidance on board effectiveness, published by the UK Financial Reporting Council (FRC) in 2011, stresses that an effective board:

'develops and promotes its collective vision of the company's purpose, its culture, its values and the behaviours it wishes to promote in conducting its business.'

Key aspects include providing direction for management, creating a performance culture that drives value creation without exposing the company to excessive risk of value destruction, and making well-informed and high-quality decisions based on a clear line of sight into the business. This underlines the aspects of conformance and performance. Board effectiveness cannot just be seen in terms of promoting performance – controlling risk is also vital. The recent banking crisis emphasised possible conflict between the two.

The guidance stresses that an effective board should not necessarily be a comfortable place, with challenge, as well as teamwork, being an essential feature.

The FRC's guidance stresses the importance of well-informed and high-quality **decision-making,** with many of the factors leading to poor decision-making being predictable and preventable by boards taking the time to design effective decision-making policies and processes.

The guidance lists factors that can facilitate good decision-making:

- High-quality board documentation
- Obtaining expert opinions if necessary
- Allowing time for debate and challenge, especially for complex, contentious or business-critical issues
- Achieving timely closure
- Providing clarity on the actions required; and timescales and responsibilities

The guidance also stresses that boards need to be aware of factors that can limit effective decision-making, such as:

- A dominant personality or group of directors in the board, inhibiting contribution from other directors
- Insufficient attention to risk, treating risk as a compliance issue, rather than as part of the decision-making process

- Failing to recognise the value implications of running the business on the basis of self-interest and other poor ethical standards
- Reluctance to involve non-executive directors, or matters being brought to the board for sign-off, rather than debate
- Complacent or intransigent attitudes
- Weak organisational culture
- Inadequate information or analysis

3.3.2 Board size

A large board provides significant opportunities for **varied views** to be put forward. However, a large board can make it difficult to achieve ease of operation and coherence of decision-making.

A large board will mean that directors are not overloaded, for example by committee work, which may be a particular risk for non-executive directors with limited time. A complex company operating in a complicated environment may need a bigger board to have access to a wide range of skills and experience. On the other hand, a company operating in a fast-moving environment where rapid decision-making is required may be better served by a smaller board. Evidence suggests that small boards are typically more effective than large boards.

3.3.3 Director attributes

In order to carry out their roles effectively, directors need to have **relevant expertise** in industry, company, functional area and governance. The board as a whole, needs to contain a **mix of expertise** and show a **balance** between **executive management** and **independent non-executive directors**.

Case example: Director attributes

The South African King report lists five moral attributes that individual directors should have:

- **Conscience** – Acting with intellectual honesty and independence of mind in the best interests of the company and its stakeholders, avoiding conflicts of interest
- **Inclusivity** – Taking into account the legitimate interests and expectations of stakeholders
- **Competence** – Having the knowledge and skills required to govern a company effectively
- **Commitment** – Diligently performing duties and devoting enough time to company affairs
- **Courage** – Having the courage to take the necessary risks; and to act with integrity

Case example: Board composition grid

Guidance, published by PwC and the Institute of Internal Auditors Research Foundation, highlights the use of a grid to help a board analyse what skills and experience it needs. The grid lists the skills, experience and attributes required, and which directors possess them, and decides whether there are any areas in which the board is lacking. The example grid given lists the following:

- Financial literacy
- Financial expertise
- Industry expertise
- International expertise
- Operational experience
- Technology expertise
- Governmental/regulatory experience
- Social/environmental expertise
- Marketing expertise
- Gender diversity
- Ethnic diversity

3.3.4 Independence

Definition

Independence: The avoidance of being unduly influenced by vested interests and being free from any constraints that would prevent a correct course of action being taken. It is an ability to stand apart from inappropriate influences and be free of managerial capture, to be able to make the correct and uncontaminated decision on a given issue.

Independence, in particular freedom from conflict of interests, is important for all directors. In governance, it is particularly important in the context of **independent non-executive directors** – directors who are not primarily employed by the company and who have very strictly-controlled links with it. They have important roles in promoting the interests of shareholders and other stakeholders and carrying out effective monitoring. However, as we shall discuss further below, non-executive directors also play a key role in challenging the direction of the company's strategy.

Non-executive directors' lack of links and limits on the time that they serve as non-executive directors should promote avoidance of managerial capture – accepting executive managers' views on trust without analysing and questioning them.

3.3.5 Diversity

The UK Corporate Governance Code states that when directors are appointed, the board should have due regard for the benefits of diversity on the board, including gender diversity. In its 2011 green paper, the European Commission stated that a diversity of expertise and backgrounds is essential if the board is to function efficiently. The commission highlighted a variety of professional backgrounds, national or regional backgrounds and gender diversity as the most significant considerations when assessing diversity.

An earlier UK report, the 2003 Tyson report on the recruitment and development of non-executive directors, highlighted the benefits that diversity can bring.

(a) **Talent**

A company committed to diversity has the best chance of **finding and employing the best available talent**, rather than artificially limiting itself.

(b) **Broad range of knowledge**

No one individual director can be **knowledgeable and informed about all aspects of business**, given the information and expertise necessary for boards to govern listed companies effectively. Management literature suggests that groups make better decisions if the available information is more diverse, provided the group understands who knows what and takes advantage of the knowledge. One example is having foreign nationals on the board, which should enhance knowledge of the global environment within which most listed companies operate. Diverse boards should avoid the 'group-think' that can occur when boards have similar backgrounds.

(c) **Greater range of constituencies**

Diverse boards can **reach out more effectively to a broader range of constituencies** to help them deal with problems. They can also send **positive signals** to different stakeholder groups and contribute to a better understanding of the stakeholder groups that underpin commercial success.

(d) **Independence and judgement**

A board with a broad range of experience is more likely to develop **independence of mind** and a probing attitude. It can also enhance corporate decision-making by having sensitivity to a wider range of risks to its reputation.

(e) **Corporate citizen**

Greater diversity can **enhance a company's reputation as a corporate citizen** that understands its community. Following on from that, a company can have the objective that its board reflects the make-up of the society within which it operates, in order to maximise its **strategic fit** with the community. Fairly reflecting the community can also be seen as **strengthening the social contract** between a company and its stakeholders.

However, some studies have found that diversity can result in lower cohesion and trust, unless members are trained to work together and boards are effectively led.

3.3.6 Matters the board must consider

Most codes emphasise that the board should have a **formal schedule of matters** specifically reserved to it for decision at board meetings. Some would be decisions, such as **mergers and takeovers**, that are **fundamental** to the business and hence, should not be taken solely by executive managers. Other decisions include **acquisitions and disposals of assets of the company** or its subsidiaries, that are material to the company, **investments, capital projects, bank borrowing** facilities, **loans**, foreign currency transactions, all **above a set size** (to be determined by the board).

Case example: Board agenda

The Guidelines of Corporate Governance for Bangladesh provides a fuller list than many others, identifying the range of matters a board must consider. This list partly reflects local concerns:

- Annual operating plans and budgets, together with updated long term plans
- Capital budgets, manpower, and overhead budgets
- Quarterly results for the company as a whole and its operating divisions or business segments
- Internal audit reports, including specific, material cases of theft and misconduct
- Cause, demand, and prosecution notices received from revenue authorities
- Fatal or serious accidents and any effluent or pollution problems
- Default in payment of interest or principal on any public deposit, secured creditor, or financial institution
- Any possible public or product liability which is material and estimable
- Details of any joint venture or collaboration agreement
- Recruitment and remuneration of senior officers just below board level, including appointment or removal of the company secretary and most senior financial officers
- Any labour issues and their proposed resolution

3.3.7 Board meetings

To be effective, boards must **meet frequently** and as warranted by circumstances. Companies should amend their constitutions to provide for telephonic and video conference meetings. The International Corporate Governance Network (ICGN) Governance guidelines emphasise the importance of the non-executive directors meeting in the absence of the executive directors as often as required and on a regular basis. Boards should operate a **no-surprises** approach. The board should not hear about a major issue or be given a major issue for approval at a board meeting – materials sent out, or contacts before the meeting, should inform directors.

Directors should have **sufficient time** to fulfil their responsibilities. The UK Corporate Governance Code states that the board should not agree to a full-time executive director taking on more than one non-executive directorship in a FTSE 100 company, nor the chairmanship of such a company. The time commitment for non-executive directors should be set out when they are appointed, and they should undertake to have sufficient time to discharge their role.

3.3.8 Board appraisal

Appraisal of the board's performance and effectiveness is an important control over it, aimed at **improving board effectiveness, maximising strengths and tackling weaknesses**. It should be seen as an essential part of the **feedback** process within the company and may prompt the board to change its **methods** and/or **objectives**. The UK Corporate Governance Code recommends that **performance of the board, its committees and individual directors**, should be formally **assessed once a year.** Ideally, the assessment should be by an external third party who can bring **objectivity** to the process.

In order to be conducted effectively, the appraisal of the whole board will need to include:

- A review of the board's systems (conduct of meetings, work of committees, quality of written documentation).

- Performance measurement in terms of the standards it has established, financial criteria, and non-financial criteria relating to individual directors.
- Assessment of the board's role in the organisation (dealing with problems, communicating with stakeholders).

If the review is carried out internally, board members may be asked to assess performance using a questionnaire based on the best practice of an effective board. The questionnaire may be supplemented by interviews.

Parker suggests that a key aspect of board appraisal is whether the board focuses on long-term issues and vision, or spends too much time on day-to-day management matters.

Case example: Board effectiveness

Corporate governance – A practical guide, published by the London Stock Exchange and the accountants, RSM Robson Rhodes, suggests that board evaluation needs to be assessed in terms of clear objectives. Boards ought to be learning lessons from specific decisions they have taken (Did they receive adequate information? Did they address the main issues well?).

Considering how the board is working as a team is also important. This includes issues such as encouragement of criticism, existence of factions, whether dominant players are restricting the contribution of others. The guidance suggests involving an external facilitator to help discover key issues.

The guide also compares the working of an effective board with other types of board and suggests that boards should consider which unsuccessful elements they demonstrate.

Type of board	Strengths	Weaknesses
Effective board	• Clear strategy aligned to capabilities • Vigorous implementation of strategy • Key performance drivers monitored • Effective risk management • Focus on views of City and other stakeholders • Regular evaluation of board performance	
The rubber stamp	• Makes clear decisions • Listens to in-house expertise • Ensures decisions are implemented	• Fails to consider alternatives • Dominated by executives • Relies on fed information • Focuses on supporting evidence • Does not listen to criticism • Role of non-executives limited
The talking shop	• All opinions given equal weight • All options considered	• No effective decision-making process • Lack of direction from chairman • Failure to focus on critical issues • No evaluation of previous decisions

Type of board	Strengths	Weaknesses
The number crunchers	• Short-term needs of investors considered • Prudent decision-making	• Excessive focus on financial impact • Lack of long-term, wider awareness • Lack of diversity of board members • Impact of social and environmental issues ignored • Risk averse
The dreamers	• Strong long-term focus • Long-term strategies • Consider social and environmental implications	• Insufficient current focus • Fail to identify or manage key risks • Excessively optimistic
The adrenalin junkies	• Clear decisions • Decisions implemented	• Lurch from crisis to crisis • Excessive focus on short-term • Lack of strategic direction • Internal focus • Tendency to micro-manage
The semi-detached	• Strong focus on external environment • Intellectually challenging	• Out of touch with the company • Little attempt to implement decisions • Poor monitoring of decision-making

3.4 Chairman and chief executive

The most important point in the leadership of a company is that there are two roles at its head:

- **Chairman** – Leader of the board of directors
- **Chief executive (CEO) –** Leader of the executive management team at, or below, board level

3.4.1 Role of chairman

The chairman's most important tasks include ensuring that the board **focuses on strategic matters** and **takes account of the key issues and concerns of all board members.** He should allow sufficient time for discussion of critical issues and promote a culture of openness and debate.

Other significant roles include ensuring the board receives **accurate and timely information,** ensuring **effective communication with shareholders** and taking the lead in **board development**.

3.4.2 Role of chief executive

The CEO is responsible for **running the organisation's business** and for **proposing and developing the group's strategy** and **overall commercial objectives**, in consultation with the directors and the board. The CEO shapes the values, principles and major operating policies on which the internal control systems are based. The CEO will examine major investments, capital expenditure, acquisitions and disposals and be responsible for identifying new initiatives. The CEO **manages the risk profile and control systems of the organisation**.

The CEO is also responsible for **implementing the decisions of the board** and its committees, **developing the main policy statements** and **reviewing** the business's **organisational structure and operational performance**.

The CEO is the senior executive in charge of the management team and is answerable to the board for its performance. He will have to formalise the roles and responsibilities of the management team, including determining the degree of delegation.

3.4.3 Division of responsibilities

One of the most controversial areas of corporate governance has been whether the roles of chairman and chief executive can be held by the same person.

All governance reports acknowledge the importance of having a division of responsibilities at the head of an organisation to avoid the situation where one individual has **unfettered control** of the decision-making process. This can be achieved by the roles of **chairman** and **CEO** being held by two different people, which has the following advantages.

(a) **Demands of roles**

It reflects the reality that both jobs are **demanding roles** and ultimately, the idea that no one person would be able to do both jobs well. The CEO can then run the company. The chairman can run the board and take the lead in liaising with shareholders.

(b) **Authority**

There is an important difference between the authority of the chairman and the authority of the chief executive, which having the roles taken by different people, will clarify. The chairman **carries the authority of the board**, whereas the chief executive has the authority that is **delegated by the board.** Separating the roles emphasises that the chairman is acting on behalf of the board, whereas the chief executive has the authority given in his **terms of appointment.** Having the same person in both roles means that **unfettered power** is concentrated into one pair of hands. The board may be ineffective in controlling the chief executive, if it is led by the chief executive.

(c) **Conflicts of interest**

The separation of roles avoids the risk of **conflicts of interest**. The Chairman can concentrate on representing the interests of shareholders.

(d) **Accountability**

The board cannot make the CEO **truly accountable** for management if it is led by the CEO.

(e) **Board opinions**

Separation of the roles means that the board is more able to **express its concerns effectively** by providing a point of reporting (the chairman) for the non-executive directors.

(f) **Control over information**

The chairman is responsible for obtaining the information that other directors require to **exercise proper oversight and monitor the organisation effectively**. If the chairman is also chief executive, then directors may not be sure that the information they are getting is sufficient and objective enough to support their work. The chairman should ensure that the board is receiving sufficient information to make **informed decisions**, and should put pressure on the chief executive if the chairman believes that the chief executive is not providing adequate information.

(g) **Compliance**

Separation enables compliance with governance best practice and hence, reassures shareholders.

That said, there are arguments in favour of the two roles being held by the same person:

(a) **Creation of unity**

Having a single leader **creates unity** within the company. Having two leaders that disagree can create deadlock.

(b) **Acquisition of knowledge**

The holders of both posts need **considerable knowledge** of the company. A non-executive chairman may struggle to acquire this knowledge due to constraints on his time.

For a split role to work effectively, both board leaders need to understand and be happy with their roles. They need to have a consistent strategic vision, communicate frankly with each other and avoid giving differing messages to other board members.

3.5 Non-executive directors

Definition

Non-executive directors: Directors who have no executive (managerial) responsibilities.

Under the UK unitary board system there is no legal distinction between executive and non-executive directors. Non-executive directors have the same legal duties, responsibilities and potential liabilities as executive directors , even though they are not expected to give the same continuous attention to the company's business. Statutory requirements giving rise to personal civil and criminal liability are increasing and directors of listed companies face fines and public criticism for contravening the Listing Rules and other regulations.

The Walker committee that reviewed governance in banks in 2009 argued for less emphasis on complying strictly with independence requirements, and more emphasis on 'the quality of independence of mind and spirit, of character and judgement', along with relevant financial experience.

Guidance published by ICAS on the role of a non-executive director in a private company provides practical help for non-executive directors (NEDs) on fulfilling the legal duties of directors set out in the Companies Act 2006.

Legal duties	Practical considerations
Act in accordance with the company's constitution and only exercising powers for proper purpose	NEDs need to read and understand relevant documents including articles, shareholder agreements and bank facility agreements.
Act to promote success of company for benefit of members as a whole whilst giving appropriate consideration to wider stakeholders	Board minutes should reflect discussions and the reasons why decisions were made. NEDs should not represent particular interests.
Exercise independent judgement	NEDs should operate in independent and professional manner and should seek independent professional assistance if it's helpful.
Exercise care, skill and diligence of reasonably diligent person	A NED who is knowledgeable on a particular subject is expected to provide higher level of expertise and will have higher degree of responsibility and potential liability. NEDs with financial or legal qualifications must use knowledge they have to make the board aware of their responsibilities.
Avoid conflicts of interest	These may include other directorships, employments or shareholdings or appointment by particular stakeholder groups. Declare conflicts before meetings and directors should leave meetings if necessary.
Don't accept benefits from third parties unless clearly don't give rise to conflicts of interest	Critical factors are scale of benefit and external perceptions of whether they might influence the directors' behaviour.
Declare nature and extent of personal interest in company transactions	Generally NEDs should not have loans, credit transactions or substantial transactions.

Non-executive directors should provide a **balancing influence**, and play a key role in **reducing conflicts of interest** between management (including executive directors) and shareholders. They should provide **reassurance** to shareholders, particularly institutional shareholders, that management is acting in the interests of the organisation.

The UK's Higgs report provides a useful summary of the role of non-executive directors.

(a) **Strategy**

Non-executive directors should contribute to, and challenge the direction of, strategy. They should use their own business experience to reinforce their contribution.

(b) **Scrutiny**

Non-executive directors should scrutinise the performance of executive management in meeting goals and objectives, and monitor the reporting of performance. They should represent the shareholders' interests to ensure agency issues don't arise to reduce shareholder value.

(c) **Risk**

Non-executive directors should satisfy themselves that financial information is accurate and that financial controls and systems of risk management are robust. (These may include industry-specific systems, such as in the chemical industry.)

(d) **People**

Non-executive directors are responsible for determining appropriate levels of remuneration for executives, and are key figures in the appointment and removal of senior managers, and in succession planning.

3.5.1 Contribution of non-executive directors

Non-executive directors can bring a number of advantages to a board of directors.

(a) **Experience and knowledge**

They may have **external experience and knowledge which executive directors do not possess.** The experience they bring can be in many different fields. They may be executive directors of other companies and have experience of different ways of approaching corporate governance, internal controls or performance assessment. They can also bring knowledge of markets within which the company operates.

(b) **Perspective**

Non-executive directors can provide a **wider perspective** than executive directors, who may be more involved in detailed operations.

(c) **Reassurance**

Good non-executive directors are often a **comfort factor** for third parties, such as investors or creditors.

(d) **Contribution**

The English businessman, Sir John Harvey-Jones, pointed out that there are **certain roles** non-executive directors are well-suited to play. These include 'father-confessor' (being a confidant for the chairman and other directors), 'oil-can' (intervening to make the board run more effectively) and acting as 'high sheriff' (if necessary, taking steps to remove the chairman or chief executive).

(e) **Dual roles**

The most important advantage perhaps lies in the dual nature of the non-executive director's role. Non-executive directors are **full board members** who are expected to have the level of knowledge that full board membership implies.

At the same time, they are meant to provide the so-called **strong, independent element** on the board. This should imply that they have the knowledge and detachment to be able to **monitor the company's strategy and affairs effectively**. In particular, they should be able to assess fairly the remuneration of executive directors when serving on the remuneration committee, be able to discuss knowledgeably with auditors the affairs of the company on the audit committee, and be able to **scrutinise strategies for excessive risks**.

3.5.2 Number of non-executive directors

The UK Corporate Governance Code suggests that at least half the members of boards of listed companies should be independent non-executive directors.

Interactive question 1: Recruitment of non-executives [Difficulty level: Intermediate]

QP is a major quoted company that manufactures industrial chemicals. The company's board comprises a chief executive and five other executive directors, a non-executive chairman and four non-executive directors.

Two of the non-executive directors have served on QP's board for five years. The company has a policy of asking non-executive directors to stand down after six years and so the chairman has established a nominations committee to start the process of selecting replacements.

Three replacements have been suggested to the nominations committee. The nominees are:

- Adrian, who is on the main board of City Pensions, an investment institution which owns 6% of QP's equity. Adrian has worked for City Pensions for 15 years and has always worked in the management of the company's investments, initially as an analyst and more recently, as director in charge of investments. Before working for City Pensions, Adrian was an investment analyst with an insurance company for 15 years.

- Nicole, who is an ICAB member, is about to retire from full-time work. Nicole has had a varied career, including acting as a management accountant with an engineering company and finally, as a senior accountant with a commercial bank. Nicole was promoted to the bank's board and has been finance director for seven years.

- Helen, who is a former politician. After a brief career as a journalist, Helen became a member of parliament at the age of 40. After spending 20 years as a politician, including several years as a government minister, Helen has recently retired from politics at the age of 60. Helen already holds two other non-executive directorships in companies that do not compete with, and are not in any way connected to QP.

Requirement

Evaluate the suitability of each of the three nominees. Your answer should include arguments for and against each of the nominees.

See **Answer** at the end of this chapter.

3.6 Board committees

Many companies operate a series of board sub-committees responsible for supervising specific aspects of governance. Operation of a committee system does not absolve the main board of its responsibilities for the areas covered by the board committees. A survey by the Financial Reporting Council in 2011 on boards and risk found that board committees focused on ensuring that the Board received good quality and advice and information, to enhance the quality of oversight.

For a committee structure to work effectively, there needs to be effective relationships between different committees and with the full Board, good information exchanges and perhaps members in common on different committees. Major decisions need to be discussed with the full board.

The FRC's survey suggested that for many companies the **complexity of the business** and **the nature of the company's product** were the determining factors in selecting a committee structure. However separate committees were more common in sectors where there was exposure to significant safety, environmental and regulatory risks such as pharmaceuticals and the extractive industries. Examples included compliance committees dealing with risks associated with product regulation and corporate responsibility committees dealing with ethical, environmental and safety issues.

3.6.1 Nomination committee

The main task of the nomination committee is to recommend new appointments to the board. A very important consideration is whether the current board has the **skills, knowledge and experience** necessary to take sound strategic decisions and to run the company effectively. This must be balanced against wider factors such as the executive-non-executive balance, continuity and succession planning, and size and diversity of the board.

The nomination committee may also take the lead in ensuring that each committee has members with the right skills and experience, and that board members understand their role(s) within the board structure.

3.6.2 Audit committee

The audit committee is responsible for liaising with external audit, supervising internal audit and reviewing the annual accounts and controls.

The audit committee's responsibilities in relation to risk management will depend on whether there is a separate risk committee. Particularly if there is no risk committee, the audit committee should play an important role in reviewing risk. This includes confirming that there is a **formal policy** in place for **risk management** and that the policy is backed and regularly monitored by the board. The committee should also **review** the **arrangements**, including training, for ensuring that managers and staff are aware of their responsibilities. Committee members should use their own knowledge of the business to confirm that risk management is updated to **reflect current positions and strategy**.

Guidance from COSO points out that the audit committee, along with a strong internal audit function, is often in the best position, due to its independence, to take the necessary actions when senior management overrides controls or deviates from expected standards of conduct.

COSO's guidance highlights the need for the audit committee to oversee the work of internal audit and ensure its work **supports the company's strategic objectives** and the **compliance** needs of the company. The exact involvement of the audit committee will depend on the role of internal audit. In some companies internal audit is viewed as an arm of management, with its work designed to achieve important insights into the functioning of control processes. In other companies internal audit is designed to be a function independent of management with primary responsibility to the board or audit committee.

Internal audit normally reports to the audit committee for the following reasons.

(a) **Independence**

The fact that internal audit is reporting to a committee of independent non-executive directors, itself **helps guarantee internal audit's independence**. As they are not involved in day-to-day management, committee members will have no self-interest in diverting internal audit's attention away from their area of the business. The audit committee should be able to take steps to ensure internal audit remains **independent** and its work is not compromised by pressure from operational management. This particularly applies if internal audit needs to review higher-level strategic matters which are likely to be the responsibility of very senior management.

(b) **Strategic oversight**

Having internal audit report to the audit committee makes clear the responsibility the committee has for **determining the strategy** adopted by internal audit. The committee should help internal audit fulfil its objectives, including being responsive to the views and needs of different stakeholders. The committee also needs to take decisions about the level of **resources** available to internal audit and where these resources should be employed. This is a subsidiary part of its general responsibility to look at whether internal controls are **effective**, internal audit being a control just like any other.

(c) **Authority**

Internal audit needs to have whatever **access** is necessary to people and documents. There should be no no-go areas. The backing of the audit committee should reinforce the authority that internal audit has to enforce its demands.

(d) **Role of audit committee**

Internal audit provides the evidence that **informs the reviews** of financial statements, internal control and risk management that the audit committee undertakes.

(e) **Monitoring of internal audit**

Monitoring the role of internal audit forms part of the audit committee's involvement in the overall monitoring process carried out by the board, discussed earlier in this chapter. Annual review of internal audit will be a key part of this monitoring process.

(f) **Ensuring action taken**

The audit committee should provide a forum for internal audit's conclusions to be **considered fairly**. It can also follow up the reports of internal audit by obtaining evidence of whether its recommendations have been implemented. It has the **authority** to hold managers accountable if they have failed to take action.

The audit committee will also be responsible for assessing the **independence and objectivity** of external audit and the effectiveness of the external audit process. It will carry out the following specific tasks.

(a) Being responsible for the **appointment or removal of the external auditors**, as well as fixing their remuneration.

(b) Considering whether there are **any other threats to external auditor independence.** In particular, the committee should consider **non-audit services** provided by the external auditors, paying particular attention to whether there may be a **conflict of interest**.

(c) **Discussing the scope of the external audit** prior to the start of the audit. This should include consideration of whether external audit's coverage of all areas and locations of the business is fair, and how much external audit will rely on the work of internal audit.

(d) Acting as a **forum for liaison** between the external auditors, the internal auditors and the finance director.

(e) **Helping the external auditors to obtain the information** they require, and in resolving any problems they may encounter.

(f) **Making themselves available** to the external auditors for consultation, with or without the presence of the company's management.

(g) Dealing with any **serious reservations** which the external auditors may express either about the accounts, the records or the quality of the company's management.

The South African King report stresses the role of the audit committee in bringing all the strands of assurance together, ensuring that a combined assurance model is applied to provide a co-ordinated approach to all assurance activities, and to optimise the assurance coverage obtained from management, and internal and external assurance providers. External assurance providers include not just the external auditors, but also the regulatory inspectorate, sustainability assurance providers, actuaries and geologists.

Case example: Audit committees

A 2012 survey of audit committees, carried out by the FRC, ICAS and the Institute of Chartered Accountants in Australia found that a balancing act was integral to the role of the audit committee, dealing effectively with oversight functions whilst maintaining the collegiality and relationships that are expected of board directors. Audit committee members need to be integrated with the board but must ensure there is open debate and effective questioning. Overall board behaviour and culture has a bigger influence on how effective the audit (and other committees) are rather than regulatory requirements.

The respondents to the survey stressed that diversity of skills and experience was essential. Audit committee members needed sound commercial and financial knowledge but not necessarily deep accounting knowledge. Committee members need to understand a company's risk and business profile. A strong chairman was essential for the audit committee's effective functioning.

A two-way flow of information – with the board ensuring that the audit committee was informed of all transactions that may affect its work, and the audit committee reporting all the significant risks and value judgements that it considered to the main board – was also considered necessary for the relationship between board and audit committee to work effectively.

Interactive question 2: Audit committee [Difficulty level: Intermediate]

KPN is a major hotel group that will shortly be seeking a flotation on the stock market. At present, the company does not have any non-executive directors or an audit committee. One of KPN's most significant local competitors, NN has recently collapsed; some of the competitor's shareholders have raised issues about the ineffectiveness of the non-executive directors and in particular, the failure of the audit committee to deal with major accounting problems. As this news story is topical, the directors of KPN want to understand why NN's non-executive directors might have failed to exercise sufficient supervision, and how the audit committee that KPN will be required to establish can function effectively.

Requirements

(a) Explain the limitations of depending on non-executive directors to improve corporate governance.
(b) Explain how the effectiveness of audit committees can be enhanced.

See **Answer** at the end of this chapter.

3.6.3 Remuneration committee

The remuneration committee is responsible for advising on executive director remuneration policy and the specific package for each director.

The remuneration packages and policies that the committee establishes need to be **consistent** with the business's strategies. Guidance from CIMA in a 2010 discussion paper stresses the need for executive pay policies to be aligned with a clear link to business strategy, with proportionate bonuses linked to performance and risk. This implies the need for clear determination of business objectives (discussed further in Chapter 5) and careful design of packages. There should be a match between long-term business objectives and remuneration methods, such as share incentive plans, and short-term objectives and remuneration, particularly bonuses.

Of course, one strategic objective may be maintaining reputation as a good corporate citizen. This may lead companies to be cautious about the **maximum levels of remuneration** directors are given, or be particularly concerned about headline-grabbing elements of directors' packages, for example bonuses.

The Financial Stability Forum stresses the importance of packages reflecting the risks companies face. The Forum suggests that compensation must be **symmetric with risk outcomes,** meaning that the bonus component should be as variable downwards, in response to poor performance; as it is upwards, in response to good performance. It must reflect risk time horizons, with payments not being made over the short-term when risks are realised over the longer-term. The Forum suggests that the mix of different elements within the package must be consistent with risk alignment, and will vary by director and employee.

The remuneration committee's influence can be particularly important here. The committee should be able to review what directors are **doing to achieve the targets** they have been set, and be able to penalise directors if it has evidence that they are taking excessive risks to achieve their targets.

3.6.4 Risk committee

The risk committee is responsible for **overseeing the organisation's risk response and management strategies.** It is not a compulsory committee under most governance regimes. However, companies that are subject to significant financial market risk will often have a risk committee. The potential for large losses through misuse of derivatives was demonstrated by the Barings Bank scandal. A risk committee can help provide the supervision required. Clearly though, to be effective, the members collectively will need a high level of financial expertise.

We shall examine the risk committee's work further in the next chapter.

Case example: Unilever

Unilever has established a number of board committees

- **Audit committee**
- **Nominating and corporate governance committee**
- **Compensation management and resources committee** – Reviews remuneration of directors and tier of management directly below the board and responsibility for executive share-based incentive plans
- **Corporate responsibility committee** – Oversight of Unilever's conduct with regard to its corporate and societal obligations and its reputation as a responsible corporate citizen. This includes reviewing external developments that impact upon Unilever's reputation and conduct as a corporate citizen. An important task is to ensure that the Code of Business Principles is up-to-date and reflects the best practice of business. The committee also focuses on sustainability and health and safety matters.
- **Disclosure committee** – Helping the board ensure that financial and other information that ought to be disclosed publicly by Unilever is disclosed in a timely manner and that the information disclosed is complete and accurate. The committee oversees the establishment and maintenance of disclosure controls and procedures and the appropriateness of the disclosures made. The committee also identifies inside information and monitors compliance with the Preventing Insider Dealing Code Policy, and reviews compliance with the s302 certifications and s404 assertion required by the Sarbanes-Oxley legislation.
- **Global Code and policy committee** – Ensuring the content of the Code remains relevant and approving and reviewing the effectiveness of operating model for Code compliance. The committee also considers training requirements. In addition the Committee reviews company performance in preventing, detecting and responding to breaches and oversees the investigation of sensitive breaches.

- **Routine business committee** – Set up to conduct routine business as and when the boards consider they are necessary. This includes allotment and administration of shares, appointment of representatives and signing of documents.

3.7 Strategy setting

CIMA and IFAC published a joint report in 2004, *Enterprise Governance; Getting the Balance Right,* stressing the need for balance between:

- **Conformance** – Basically corporate governance
- **Performance** – Strategic decisions, use of resources, value-adding activities. Analysis of these will help the board develop strategy, consider what levels of risk it is prepared to tolerate and utilise appropriate performance measures

The report highlights a number of key features of success.

- Choice and clarity of strategy
- Effective strategy execution
- Competence in mergers and acquisitions
- Responsiveness to information flows

3.7.1 Role of board

Although boards are responsible ultimately for strategy, they can manage strategic development in different ways.

- Boards can be actively involved with executive management in strategic development. However, non-executive directors, in particular, may have problems committing enough time to contribute effectively. Also for non-executive directors, there is the issue that their primary role is to **monitor decision-making** by executive directors. They may find it very difficult to monitor effectively if they are also significantly involved in decision-making.
- Boards adopt more of a **stewardship role** – Directors approve strategic plans but strategic management and development is the responsibility of the executive team. Here, the danger is that the board is too permissive and allows the executive team to act in their own interests, rather than protecting the interests of shareholders and other stakeholders.

3.7.2 Leadership of strategic development

Michael Porter emphasises the importance of a **clear strategic leader** who owns strategic development and is accountable for its success or failure. The obvious leader is the chief executive. However, if strategies are largely identified with chief executives, organisations may respond to strategic difficulties by changing their chief executives, rather than examining the reasons for failure thoroughly. In addition, if chief executives are successful initially and are allowed to continue without significant checks, they may become overambitious.

In theory, other executive managers, in particular, directors with executive responsibilities, should be able to assist the chief executive by providing the benefit of their own experience and knowledge. However, they may find it difficult to constrain a determined chief executive. The operational responsibilities that they have may cause them to focus particularly on their areas, for example, the sales director focusing on sales. Below board level, the executives may have been appointed by the chief executive and lack the independence to challenge the CEO. There is also the possibility that the management team will focus on agreeing and avoiding conflict, and develop a mindset where there is a lack of effective challenge.

3.7.3 Prioritisation of strategy-setting

Boards need to ensure that they spend sufficient time on development of strategy. Surveys taken over the last ten years identify strategic planning as the activity to which directors would like to devote more time. Boards may decide to tackle specific strategic decisions at regular board meetings, but have special meetings to look at general strategic direction.

3.7.4 Information required

When analysing strategy, boards need to understand the key factors in the business environment, and industry and market trends. They should take into account financial position, and the situation and behaviour of suppliers and customers.

In particular, boards need to be aware of the likely actions of competitors and take seriously the potential threats that they pose. It may be difficult, however, to anticipate what competitors will do; in particular, the actions of new competitors.

Boards also need to have available data about all the strategic choices that they are reviewing. This includes:

- **Assumptions** on which plans and forecasts are based, including assumptions about key financial indicators and non-financial factors such as information technology.
- **Major risks** that could prevent the achievement of strategic aims and how risks will be analysed and managed; and also best, worst and most likely scenarios.
- **Resources and capacity required**, including capital, financial, people, technology and how major investment in resources would be financed.
- **Strategic alliances and acquisitions required,** such as joint ventures, with an indication of the terms involved in entering them.
- **Targets** including pricing, revenues and profit margins; again analysing best, worst and most likely scenarios.

3.7.5 Focus of discussions

Discussions need to focus on the key customer, supply and resourcing issues. As well as discussing the proposed strategy, boards may want to discuss the strategies that were rejected, if a process of strategic development took place outside board meetings. Boards also need to understand how difficult it will be to achieve strategies, given current operations and resources, and how well new strategies fit with the existing culture.

3.7.6 Implementation of strategy

Once the strategy has been decided, the board then needs to ensure that plans are in place to implement strategy effectively. These plans should specify:

- Alignment of company resources, infrastructures and processes
- Use of technology
- Human resource management
- Knowledge management
- Risk management
- Action plans and timescales
- Accountability

3.8 Risk management

3.8.1 Board responsibilities

The board's role in managing risk is one of its most important. The 2012 BSEC Corporate Governance Code emphasises the importance of the board's responsibility for determining the **nature** and **extent** of the significant risks it is willing to take.

COSO published a paper, *Strengthening Enterprise Risk Management for Strategic Advantage*, to enhance the board's risk management capabilities.

(a) **Discuss risk management philosophy and risk appetite**

The board and senior management have to understand the level of risk that they want their organisation to take, including whether it is consistent with stakeholder expectations. Risk appetite should be a key element in objective setting and strategy selection, and will also determine risk management processes.

The guidance suggests that as a starting point, management should consider the strategies that they would not be interested in pursuing, due to the **level of risk** involved or the **inadequacy of returns** for the risks incurred. It should also consider risk appetite for each of the main categories of risk. The guidance suggests a series of questions that can be used to help determine risk appetite:

- Do shareholders want us to pursue high risk/high return businesses, or do they prefer a more conservative, predictable business profile?
- What is our desired risk rating?
- What is our desired confidence level for paying dividends?
- How much of our budget can we subject to potential loss?
- How much earnings volatility are we prepared to accept?
- Are there specific risks that we are not prepared to accept?
- What is our willingness to consider growth through acquisitions?
- To what extent are we willing to expand our product, customer or geographic coverage?
- What amount of risk are we willing to accept on new initiatives to achieve a specified target?

(b) **Understand risk management practices**

It can be difficult for boards to gain a complete view of risk if risk, management is adhoc, informal and implicit. Sometimes, risk management processes are left to the **discretion of risk specialists or operational managers** with the result that risks are identified, assessed, managed and communicated separately. Boards need to ensure that risk management permeates through the organisation, that it is applied by managers and staff throughout the organisation and, in particular, is applied in strategy-setting, with top risk exposures and key strategies and objectives being linked.

(c) **Review portfolio risks in relation to risk appetite**

Boards need to **understand the portfolio of risk exposures** so that they can determine whether it is in line with stakeholders' tolerance of risk. A portfolio view also helps the board identify concentration of risks affecting specific strategies or overlapping risk exposures.

(d) **Be appraised of the most significant risks and related responses**

Since risks are continuously evolving, risk management processes need to ensure that timely and robust information about risks is provided. Boards need to understand how risks may affect the enterprise and how management is correlating them. Board members need to have sufficient experience, training and knowledge of the business to discuss properly the risks that the business faces. The board needs to be able to rely on key risk indicators that provide a clear view of risks, allow for comparisons over time and between units, and provide opportunities to assess the performance of risk owners.

3.8.2 Review of risk

The board should consider on a **regular basis:**

- The nature and extent of the risks facing the company
- The extent and categories of acceptable risks
- The likelihood of the risks materialising
- The company's ability to reduce the incidence and impact of risks that do materialise
- The costs of operating particular controls, versus their benefits

The board should focus on serious risks, whether they are long-term or short-term; and strategic or operational. Although the board will spend a lot of time on risks associated with strategy, it must gain assurance that serious operational risks are being appropriately managed. That said, too great a focus on immediate issues may mean longer-term trends, such as technological developments associated with serious strategic risks, may be neglected.

3.8.3 Monitoring of risk

Boards should review risks and internal control as a regular part of their agenda. A key aspect for the directors to consider is the **frequency of monitoring of risks**. Some risks may need to be monitored daily; others, much less frequently.

The UK Turnbull report emphasises that the board cannot just rely on the management monitoring processes to discharge its responsibilities. It should **regularly receive and review reports on internal control** to ensure that management has implemented an effective monitoring system. It should also carry out an annual assessment that forms the basis of its report on internal controls.

Although the board need not understand the details of every management procedure, it should focus on controls performed directly by senior management, and controls designed to prevent or detect senior management override.

COSO has published guidance covering how boards should monitor risks and controls. The guidance states that **ineffective** monitoring results in control breakdowns, and materially impacts on the organisation's ability to achieve its objectives. **Inefficient** monitoring leads to a lack of focus on the areas of greatest need.

The **size of the organisation** and the **complexity of its operations and controls** will be key determinants of the scale of monitoring.

Case example: Purchasing function

The practical example given in the COSO guidance is a distinction between the purchase function in a large and small company. A company that has 20 people processing invoices, one of whom is not properly trained, may be able to operate for some time without material error. Senior management would not therefore be concerned. A company with only one person processing invoices cannot afford that person to be inadequately trained. Senior management, monitoring on a day-to-day basis, may be required.

The COSO guidance stresses the need for effective organisational support for monitoring. This includes tone at the top, giving monitoring roles to people with appropriate capabilities, objectivity and authority, and a baseline of known effective control from which evaluations can be developed.

The COSO guidance stresses that the business's overall risk assessment process will influence the scope of monitoring. Key factors will include the **size and complexity of the organisation**, the **nature of the organisation's operations**, the **purpose for which monitoring is being conducted** and the **relative importance of the underlying controls**.

To ensure monitoring has an appropriate risk-based focus, the organisation should establish a structure that firstly ensures that internal control is effective in a given area and focuses monitoring attention on areas of change. This structure will have the following elements:

Control baseline	Heading
Change identification process	Identifying changes in processes or risks that indicate controls should have changed. Monitoring should focus on the ability of the risk assessment procedures to identify changes in processes, or risks that should result in changes in controls. Monitoring should also assess whether indicators of change in control design and operation are effective.
Change management process	Verifying that the internal control systems have managed changes in controls effectively.

The results of monitoring need to be reported to the right people and corrective action taken. Weaknesses in internal controls should be reported to the person **responsible for the control's operation** and **to someone else at least one level higher.** The weaknesses need to be assessed in the same terms as risks, the **likelihood** that a control will fail to detect or prevent a risk's occurrence and the **significance** of the potential impact of the risk.

Where control weaknesses are potentially significant, additional monitoring procedures may be needed during the correction period to protect against errors.

In order to be able to carry out an effective review, boards should regularly receive and review reports and information on internal control, concentrating on:

(a) What the **risks** are, and strategies for **identifying**, **evaluating** and **managing** them

(b) The **effectiveness** of the management and internal control systems in the management of risk; in particular, how risks are **monitored** and **how** any **weaknesses** have been dealt with

(c) Whether **actions** are being taken to **reduce** the risks found

(d) Whether the results indicate that **internal control** should be **monitored more extensively**

Interactive question 3: Internal control review [Difficulty level: Intermediate]

(a) What sort of information would help the board carry out an effective review of internal control?

(b) What sort of employee attitudes would help or hinder an effective review of internal control?

See **Answer** at the end of this chapter.

In an appendix Turnbull provides more detailed guidance on what should be assessed as part of the regular review of internal controls:

Risk assessment	• Does the organisation have clear objectives and have they been communicated to provide direction to employees (examples include performance targets)? • Are significant risks identified and assessed on an ongoing basis? • Do managers and employees have a clear understanding of what risks are acceptable?
Control environment and control activities	• Does the board have a risk management policy and strategies for dealing with significant risks? • Do the company's culture, code of conduct, human resource policies and performance reward systems support the business objectives and risk management and control systems? • Does senior management demonstrate commitment to competence, integrity and fostering a climate of trust? • Are authority, responsibility and accountability defined clearly? • Are the decisions and actions of different parts of the company appropriately co-ordinated? • Does the company communicate to its employees what is expected of them and the scope of their freedom to act? • Do company employees have the knowledge, skills and tools necessary to support the company's objectives and manage risks effectively? • How are processes and controls adjusted to reflect new or changing risks or operational deficiencies?
Information and communication	• Do managers receive timely, relevant and reliable reports on progress against business objectives and risks to provide the information needed for decision-making and review processes? • Are information needs and systems reassessed as objectives and related risks change, or reporting deficiencies are identified? • Do reporting procedures communicate a balanced and understandable account of the company's position and prospects? • Are there communication channels for individuals to report suspected breaches of law, or regulations or other improprieties?
Monitoring	• Are there ongoing embedded processes for monitoring the effective application of the policies, processes and activities relating to internal control and risk management? • Do these processes monitor the company's ability to re-evaluate risks and adjust controls effectively in response to changes in objectives, business and environment? • Are there effective follow-up procedures to ensure action is taken in response to changes in risk and control assessments? • Are there specific arrangements for management monitoring and reporting to the board matters of particular importance (including fraud or illegal acts)?

3.8.4 Role of assurance procedures

To carry out its reviews effectively, the board is likely to have to rely on internal audit work on the risk management and control systems. In addition, the board has to consider the need for risk management procedures to have the **credibility** that assurance work provides. Stakeholders, particularly investors, need assurance that the risks taken by the company are acceptable to them and that their returns are consistent with the risks taken.

Internal auditors will again be concerned to see that managers have made **adequate responses to risks**, have **designed robust risk management processes and internal control systems**, and that these risk management processes and controls **operate to mitigate the risks.**

Case example: Political risk

An example given in the PwC guide, *Internal audit 2012*, highlights a number of areas of political risk:

- For a company's new or existing investments or operations, and for sales or supply chains in international markets, monitoring rapid economic growth, instability or deterioration, increasing levels of foreign investment and significant changes in political leadership.
- Reviewing potential changes in regulations or trade agreements; also any indications of social unrest or other looming security issues.

Having taken an overall view earlier in the audit, internal auditors will concentrate on the **adequacy of risk management processes** and **controls** for each area to be covered, determine whether these processes are operating as intended, and seek to promote improvements where processes are inadequate or not operating as required.

Internal auditors will assess the **operation and effectiveness** of the **risk management processes** and the **internal controls** in operation to **limit risks.** A comprehensive risk audit will extend to the risk management and control **culture**.

Internal auditors' work on controls would include:

- Identifying controls at an entity and operational level
- Reviewing the completeness of documentation
- Testing controls
- Advising on the contents of the statement on the internal control system and the disclosure of material weaknesses

3.8.5 Annual review of controls

When directors are considering annually the disclosures they are required to make about internal controls, the UK Turnbull report states they should conduct an **annual review** of internal control. This should be wider-ranging than the regular review. In particular, it should cover:

(a) The **changes** since the last **assessment** in **risks** faced, and the company's **ability** to **respond** to **changes** in its business environment

(b) The **scope** and **quality** of management's monitoring of risk and internal control, and of the work of internal audit, or consideration of the need for internal audit if the company does not have it

(c) The **extent** and **frequency** of reports to the board

(d) **Significant controls**, **failings** and **weaknesses** with material impacts upon the accounts

(e) The **effectiveness** of the **public reporting** processes

In America, Section 404 of the Sarbanes-Oxley Act states that annual reports should contain **internal control reports** that outline the responsibility of management for establishing and maintaining **adequate internal control over financial reporting.** Annual reports should contain an **assessment** of the **effectiveness** of the **internal control over financial reporting**, and a statement identifying the framework used by management to evaluate the effectiveness of the company's internal control over financial reporting. External auditors should report on this assessment, having carried out independent testing of the control system.

Under the SEC rules, the UK Turnbull guidance provides an acceptable framework for the assessment of internal controls over financial monitoring. The UK Financial Reporting Council has issued further guidance on the use of Turnbull:

- Although Turnbull is an acceptable framework for Section 404 purposes, the company must comply with SEC rules and US security laws, in particular, the requirements for appropriate documentation of processes and testing.
- Responsibility for compliance strictly under Section 404 lies with company management, whereas under Turnbull, it lies with the board.
- Turnbull was written in the context of the UK 'comply or explain' framework. However, if companies are using Turnbull as a framework in the US, they must comply with all the provisions.

3.9 Performance monitoring

Boards should keep the performance metrics they use under review. What they use will be influenced by what analysts typically use, but boards also should look at other broader indicators. A key aspect of the review will be to look out for signs of forthcoming problems, but sometimes directors may need to anticipate problems – by the time the metrics give an unambiguous indication of problems, it may be too late to take effective action.

3.9.1 Choice of metrics

We shall discuss data analysis and choice of metrics in Chapter 8, but as a general principle, directors need to ensure that metrics link to the key **value drivers** of the business that relate to its strategy. For example, sales growth should be linked to new product sales or repeat business; margin, to return on sales or product cycle time reduction.

Identification of **leading indicators** that can predict future difficulties is particularly important. Falling customer satisfaction can result in future falls in revenue and a decline of the company's brand. Much of the financial information the board receives will be historic, and so will often be a **lagging indicator –** a measure of problems that have already occurred.

Some **non-financial matters**, for example customer and staff satisfaction, will be as important as financial matters. Many boards will adopt the balanced scorecard approach, grouping indicators under a series of headers. This may involve compromising between measures that, in total, give a sufficiently wide-ranging view of the business on one hand, and not being overloaded by too much information, on the other.

Directors need to be **selective** in the information they obtain from operational management and regularly consider whether they are receiving too much information on certain areas. The board may not see or see only rarely a lot of metrics that operational management use. Boards may be tempted to receive information about areas that have caused difficulties in the past, even though these areas are no longer a problem.

3.9.2 Setting targets

Having identified the metrics, the board must then decide the **targets** for those metrics. There needs to be a **mix of short and long-term targets** and the targets may need to change if there are significant changes in external circumstances. Boards also need to be aware of investors' and analysts' views on what targets they expect companies to meet. A consistent failure to meet targets should trigger board action before investors exert pressure.

The board may consider the following issues when deciding whether to investigate further or take action:

(a) **Materiality** – **Small variations in a single period** are bound to occur and **are unlikely to be significant**. Obtaining an 'explanation' is likely to be time-consuming and irritating for the manager concerned. The explanation will often be 'chance', which is not particularly helpful.

(b) **Controllability** – Controllability must also influence the decision of whether to investigate further. If there is a general worldwide price increase in the price of an important raw material, there is **nothing that can be done internally** to control the effect of this.

(c) **Variance trend** – If, say, an efficiency **variance** is £1,000 adverse in month 1, the obvious conclusion is that the process is **out of control** and that corrective action must be taken. This may be correct, but what if the same variance is £1,000 adverse every month? The **trend** indicates that the process is **in control** and the standard has been wrongly set.

3.9.3 Analysing information about metrics

Directors need to obtain assurance from management that the metrics that are being reported are based on reliable data. Internal audit work may also provide assurance. Even if this assurance is obtained, directors should analyse the information critically, comparing it with their own knowledge of the company and external sources of information.

3.9.4 Other sources of information

Directors need to reinforce their understanding of the business that the performance metrics provide by obtaining information from the following sources:

- **Directors' observations** – Regular visits by directors to operations may yield valuable insights
- **Reports from subordinates** – As well as providing performance indicators, other reports from subordinates may yield valuable insights
- **Reports from control functions** – These may provide leading indicators, for example, the human resources functions reporting on staff dissatisfaction
- **Feedback from staff** – Staff surveys may provide useful information and also staff raising concerns about specific issues
- **External sources** – Particularly important are external sources that are tied in with value drivers

4 Organisational structures and strategies

Section overview

- The effectiveness of governance arrangements may significantly depend on how well organisational structure matches with strategic and governance aims. We discussed business structure in-depth in Chapter 3, and the issues discussed there are relevant, particularly the section on choosing a structure. In this section, we are interested in the relationship of structure to governance implementation, planning and control systems.

4.1 Organisational structure

For governance purposes, developing an appropriate structure involves consideration of three areas:

- **Organisational configuration** – The primary groupings of staff into departments or divisions.
- **Centralisation/Decentralisation** – Where the responsibility for decision making lies.
- **Management systems** – The make-up of the senior management team, eg the corporate board, and the methods they use to govern the organisation. This also includes the processes used to monitor financial results, to arrive at strategic decisions and to manage risk.

4.1.1 Hierarchy

A key aspect of the control environment of a business is its organisational structure and its methods of assigning authority and responsibility.

Within the organisation's hierarchy, there will be lines of authority or **chains of command**, running from senior management vertically downwards through the organisation, connecting the various levels of managers.

The chain of command not only represents the **decision making hierarchy**; it also provides a **defined channel for formal communication up and down the organisation**.

Decisions on chains of command must also take into account the following issues.

- Communications can become **distorted** as more layers are added to the chain of command.
- Long chains of command will increase the amount of time taken for **information to reach the relevant decision makers**.
- Long chains of command **distance junior managers** from thinking and decision making at the top, and limit development into a general management role. Managers may therefore become **frustrated** and **de-motivated**, and may leave the organisation in search of flatter organisations and greater opportunities for responsibility.

Tall and flat organisations

A **tall organisation** is one which, in relation to its size, has a large number of management levels. A **flat organisation** is one which, in relation to its size, has a smaller number of hierarchical levels.

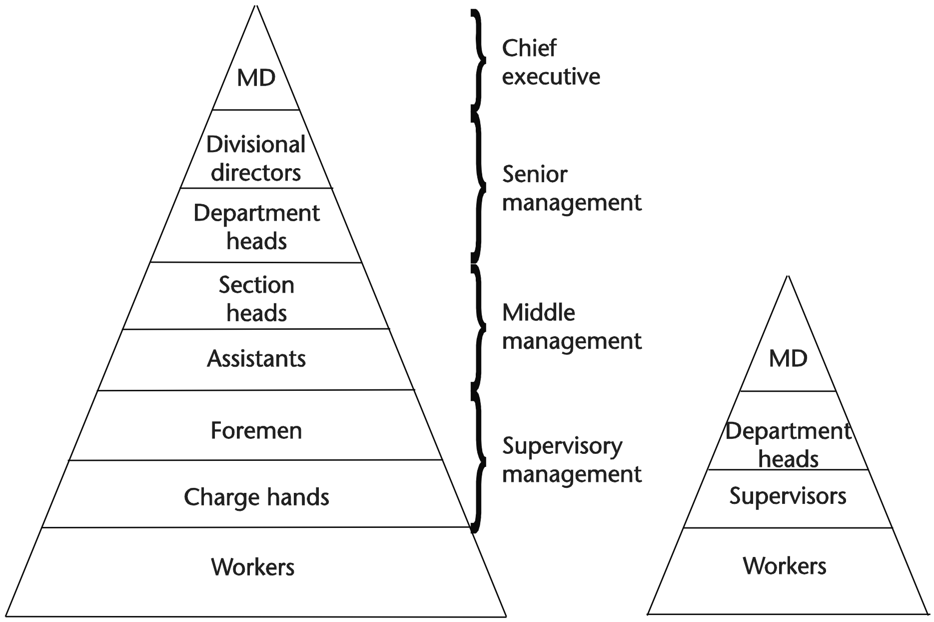


Figure 6.1: Tall and flat organisations

A tall organisation structure might be inefficient, despite the advantages of a narrow span of control and the possibility of graduated promotions. Tall structures can impose rigid supervision and control and therefore, block initiative and ruin the motivation of subordinates.

Flat organisations have become more common as a result of the current fashion for **delayering and empowerment**.

4.1.2 Empowerment

Empowerment means making workers (and particularly work teams) responsible for achieving, and even setting, work targets, with the freedom to make decisions about how they are to be achieved.

Empowerment goes hand in hand with the following developments.

- **Flexibility**, since giving responsibility for strategic development to the people closest to the products and customer, encourages responsiveness and informed decision-making.
- **Increased business education** means that operational managers are more informed about strategic issues and keen to be involved in strategic development.
- **New technology**, since there are more 'knowledge workers'. Such people need less supervision, being better able to identify and control the means to clearly understood ends. Operational workers close to the knowledge workers are in a better position than remote top managers.

Establishing control in an empowered culture can be achieved perhaps through:

- **Standardisation of processes**, with clear guidelines (eg bank lending)
- **Cultural control**, so that everyone accepts the responsibilities that come with empowerment
- **Team working**

4.2 Structure and strategy

Which then comes first, strategy or structure?

- The **top-down approach** says that management decides the strategic goals first and then designs strategies to reach them. It is possible to separate the planning and selection of strategies from the implementation of strategies. They then build or revise organisational structure to implement it.

- The **bottom-up view** is that the strategy a firm follows emerges from, or depends on, its structure or that the structure limits the choice of strategy. It is usually associated with managers of divisions being granted significant autonomy. Managers are empowered to develop and adopt strategies as circumstances change, and opportunities and threats arise. Strategic choice and implementation happen concurrently.

In practice, structure and strategy will feed off each other. Restructuring will be required to implement new strategies, and structures may develop more informally in response to environmental challenges. Restructuring may also involve new possibilities and business initiatives.

4.2.1 Centralisation and decentralisation of organisations

Centralisation and decentralisation refer to the degree to which authority is delegated in an organisation, and therefore, the level at which decisions are taken in the management hierarchy. There are several issues.

- In some businesses, authority is **centralised** and **decisions are taken at the top**. In a small business, the owner-manager may take all the decisions. However, in a hospital environment, 'life or death' decisions are taken at 'operations level'.
- **Operations** might be **decentralised**, but standards might be set centrally and distributed throughout the organisation.

Goold and Campbell conducted a study of a large number of high profile diversified companies to examine **how different companies cope with the problem of managing diversity**. They discovered three main philosophies and three corresponding styles of strategic management.

Philosophy	Example	Style of management
Core businesses	'The company commits itself to a few industries and sets out to win big in those industries.'	Strategic planning style
Diverse businesses	'The centre seeks to build a portfolio that spreads risk across industries and geographic areas as well as ensuring that the portfolio is balanced in terms of growth, profitability and cash flow.'	Strategic control style
Manageable businesses	'The emphasis is on selecting businesses for the portfolio which can be effectively managed using short-term financial controls...' The businesses have few linkages with each other, should be in relatively stable competitive environments and should not involve large or long-term investment decisions.	Financial control style

Goold and Campbell describe the features of the different styles of central management in terms of their management structures.

Style of central management	Features
Strategic planning	Entails the centre **participating in**, and **influencing**, **the strategies** of the **core businesses**. The centre establishes a planning process and contributes to strategic thinking. Rather less emphasis is placed on financial controls, and performance targets are set flexibly and reviewed within the context of long-term progress.
Strategic control	Concerned with the plans of its business units but believes in **autonomy for business unit managers**. Plans are, therefore, made locally but reviewed in a formal planning process to upgrade the quality of the thinking. The centre does not advocate strategies or interfere with major decisions but maintains control through financial targets and strategic objectives.
Financial control	As the name suggests, **focuses on annual profit targets**. There are no long-term planning documents and no strategy documents. The role of the centre is limited to approving budgets and monitoring performance.

4.3 Strategic planning

You covered strategic planning in Business Strategy but we shall revise the main points here.

A business's strategic plan or corporate plan provides the long-term framework for its activities, whatever the responsibilities for strategy of differing levels of management. However, if business strategies are to be implemented successfully, the corporate plan needs to be supported by shorter-term business plans, typically over one year. These short-term plans:

- **Co-ordinate** the roles of different functions so that they are consistent with strategic objectives
- Give **confidence** to stakeholders such as finance providers or important customers
- Help to ensure the **accountability** of operational managers

The planning of implementation should include **resource** planning, **operations** planning, and **organisation** structure and control systems.

4.3.1 Features of strategic planning systems

Key features of a strategic planning system include the following:

(a) A **system to collect strategic information** should be established. This would have dedicated human resources (which might be as little as a few hours per week for one or more individuals) and information systems to support them.

(b) A **strategic planning committee** or team formed at the strategic apex, but with staff support and advice from subordinate managers. Such a team should meet regularly to direct information-gathering, consider reports and liaise with consultants. It would also have the task of debating and agreeing future strategy.

(c) A **system to implement and control the chosen strategy** might include a written summary plan, live or video presentations to stakeholders, detailed plans and budgets developed to support the overall plan and the establishment of financial and non-financial targets for managers and staff. Suitable reports should be made and control action taken.

It would also be necessary to renew existing strategy regularly as a kind of **double loop control**, checking that current objectives, methods and plans were still relevant.

4.3.2 Advantages of strategic planning

The advantages of a formal system of strategic planning are as follows:

Advantages	Comment
Identifies risks	Planning helps in managing these risks.
Forces managers to think	Planning can encourage creativity and initiative by tapping the ideas of the management team.
Forces decision-making	Businesses cannot remain static – they have to cope with changes in the environment. A business plan draws attention to the need to change and adapt, not just to 'stand still' and survive.
Better control	Management control can be better exercised if targets are explicit.
Enforces consistency at all levels	Long-term, medium-term and short-term objectives, plans and controls can be made consistent with one another. Otherwise, strategies can be rendered ineffective by budgeting systems and performance measures which have no strategic content.
Public knowledge	Drucker has argued that an entrepreneur who builds a long-lasting business has 'a theory of the business' which informs his or her business decisions. In large organisations, that theory of the business has to become public knowledge, as decisions cannot be taken only by one person.
Time horizon	Some plans are needed for the long term.
Co-ordinates	Activities of different business functions need to be directed towards a common goal.
Clarifies objectives	Managers are forced to define what they want to achieve.
Allocates responsibility	A plan shows people where they fit in.

4.3.3 Disadvantages of strategic planning

There are disadvantages of planning for strategy implementation in a structured way. Mintzberg, in his book, *The Rise and Fall of Strategic Planning*, made a number of criticisms of a structured approach to planning the implementation of strategy, and these are worth revisiting.

Problem	Comments
Practical failure	Empirical studies have not proved that formal planning processes contribute to success.
Routine and regular	Strategic planning often occurs in an annual cycle. But a firm 'cannot allow itself to wait every year for the month of February to address its problems.'
Reduces initiative	Formal planning discourages strategic thinking. Once a plan is locked in place, people are unwilling to question it.
Internal politics	The assumption of 'objectivity' in evaluation ignores political battles between different managers and departments.
Exaggerates power	Managers are not all-knowing, and there are limits to the extent to which they can control the behaviour of the organisation.

4.4 Role of control systems

As well as overall approach to management, the strategies chosen also have an impact on elements of control systems that are important parts of governance.

Robert Simons conducted a study that examined the effects of strategy on management control systems and vice versa.

Simons looked at two companies competing in the same industry. One followed a 'cost leadership' strategy; the other, a 'differentiation' strategy. He found that there were significant differences in the way that the two companies used basically similar control systems.

Top management control systems	Cost leadership strategy	Differentiation strategy
Strategic planning review	Sporadic. Last update two years ago. Does not motivate a lot of discussion in the company.	Intensive annual process. Business managers prepare strategic plans for debate by top management committee.
Financial goals	Set by top management and communicated down through organisation.	Established by each business unit and rolled up after a series of review and challenge meetings.
Budget preparation and review	Budgets prepared to meet financial goals. Budgets co-ordinated by finance dept and presented to top management when assured that goals will be met.	Market segment prepares budgets with focus on strategy and tactics. Intensive debate at presentations to top management committee.
Budget revisions and updates	Not revised during budget year.	Business units rebudget from lowest expense three times during year with action plans to deal with changes.
Programme reviews	Intensive monitoring of product and process-related programmes. Programmes cut across organisational boundaries and affect all layers of company.	Programmes limited to R&D which is delegated to local operating companies.
Evaluation and reward	Percentage of bonus based on contribution to generating profit in excess of plan, based on personal goals (usually quantified).	Bonus based on subjective evaluation of effort, MBO system used throughout organisation.

Simons explains these differences in terms of how and why top managers choose to monitor certain management control systems personally. **He identifies** four factors **that have a bearing on this**.

Factor	Detail
Limited attention	'Managers have neither the time nor the capacity to process all the information available to them.'
Strategic uncertainties	These are 'uncertainties that top managers believe they must monitor personally to ensure that the goals of the firm are achieved'. Which uncertainties are chosen is strongly dependent on the strategy of the firm.
Interactive management control	This is actively monitoring and intervening in the activities of subordinates using planning and control procedures, as opposed to programmed controls which rely on staff specialists. Top managers make a management control system interactive if it collects information about strategic uncertainties.
Organisational learning	This is how the organisation adjusts to fit its environment. Since management control is made 'interactive' in the area of strategic uncertainties, the ensuing review and discussion of the control process gives rise to new ideas and new strategies.

The argument, in summary, is that **management control plays a key role in the process of interacting with the competitive environment to achieve organisation goals**.

4.4.1 Types of control systems

Simons went on to identify four types of control system used by top managers.

Type of control system	Detail
Beliefs systems	Determine purpose from such [documents] as mission statements or statements of purpose, and guide or limit the search for opportunities.
Boundary systems	Define limits. These vary from codes of conduct to operational guidelines, but include strategic planning systems and capital expenditure authorisation systems which define the limits of areas in which the search for opportunities can be conducted.
Diagnostic control systems	Monitor operations against preset standards of performance – typically budgeting systems and operating statements.
Interactive control systems	Typically profit-planning systems, project and brand management systems, budget formulation and planning – focusing on forecast information and possible opportunities.

4.5 Influence of operational managers

There are other practical reasons why operational managers may be able to influence strategic development and implementation:

(a) Operational managers who are in charge of strategically important divisions will have the vital **knowledge** that must be accessed if strategic development is to be successful. They must also be brought on board if their support will be necessary for effective implementation. Generally, the important roles will be those that deal with external stakeholders, such as sales and marketing.

(b) If the organisation has **strong internal networks**, operational managers can easily draw on the experience of others to inform their own contributions. Networks can also be a powerful force in enforcing strategic initiatives.

If strategic discussions are a regular feature of strategic decision-making, an organisation can involve operational managers in strategic development during training days or in strategic projects or workshops.

5 Legal framework of governance

Section overview

- Boards must have regard to the wide variety of laws and regulations that affect the organisation, with company law having a particular impact upon governance arrangements.

5.1 Legal requirements relating to the company

Companies are increasingly subject to laws and regulations with which they must comply. Some examples are given in Figure 6.2.

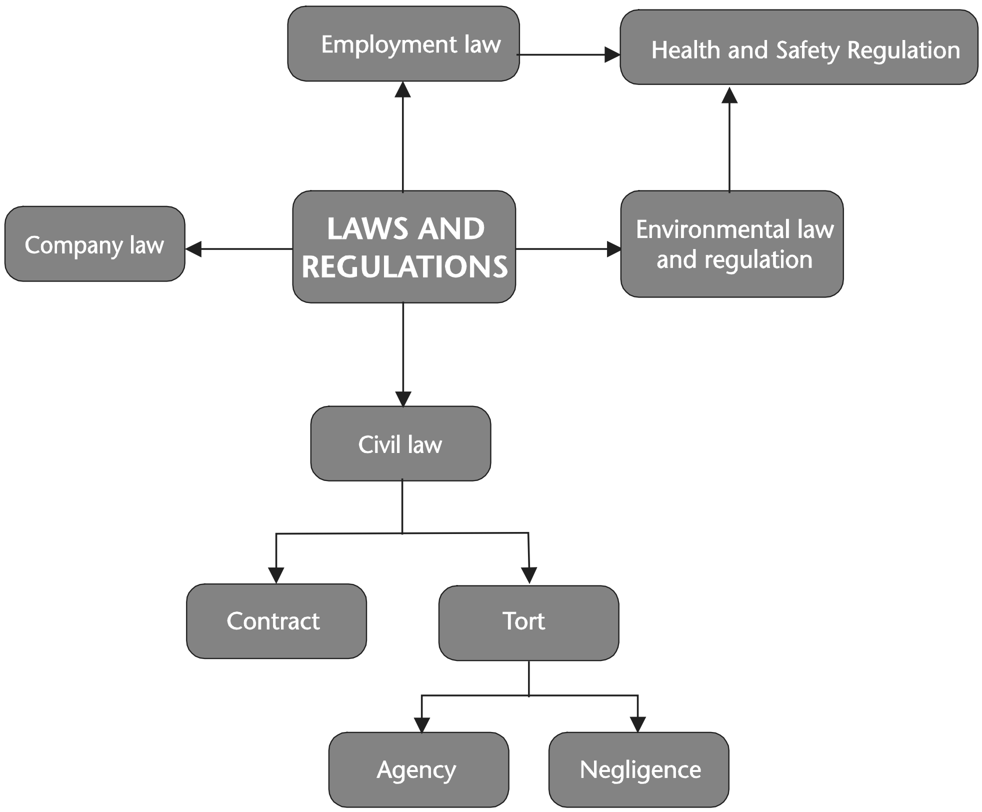


Figure 6.2: Laws and regulations affecting organisations

Much of the discussion in this section relates to governance. It is, however, just one example of a governance regime and legal aspects of governance will vary according to the jurisdiction.

5.1.1 Company law

Company laws are obviously amongst the most significant laws with which an organisation must comply. The following table summarises a number of major areas:

Areas	Provisions
Legal rights	Directors are entitled to fees and expenses as directors according to the company's constitution, and emoluments and compensation for loss of office in line with their service contracts.
Legal responsibilities	Directors have a duty of care to show reasonable competence and may have to indemnify the company against loss caused by their negligence. Directors are also said to be in a fiduciary position in relation to the company. They must act honestly in what they consider to be the best interest of the company and in good faith.

Areas	Provisions
	The Companies Act 1994 sets out seven statutory duties of directors: • Act within their powers • Promote the success of the company • Exercise independent judgement • Exercise reasonable skill, care and diligence • Avoid conflicts of interest • Not accept benefits from third parties • Declare an interest in a proposed transaction or arrangement
Duty to act within powers	The directors owe a duty to act in accordance with the company's constitution, and only to exercise powers for the purposes for which they were conferred. They have a fiduciary duty to the company to exercise their powers *bona fide* in what they honestly consider to be the interests of the company. In exercising the powers given to them by the articles, the directors have a fiduciary duty not only to act *bona fide* but also only to use their powers for a proper purpose. The powers are restricted to the purposes for which they were given. They also should act in accordance with decisions reached at board and company meetings and in compliance with the law.
Duty to promote success of company	This principle means that the law should encourage a long-term outlook and regard for all stakeholders by directors and that stakeholder interests should be pursued in an enlightened and inclusive way. The Companies Act 1994 provides directors with a list of issues to keep in mind. When exercising this duty, directors should consider: • The consequences of decisions in the long term • The interests of their employees • The need to develop good relationships with customers and suppliers • The impact of the company on the local community and the environment • The desirability of maintaining high standards of business conduct and a good reputation • The need to act fairly as between all members of the company This list identifies areas of particular importance and modern day expectations of responsible business behaviour, for example, the interests of the company's employees and the impact of the company's operations on the community and the environment. The Companies Act does not define what should be regarded as the success of a company. This is down to a director's judgement in good faith. This is important as it ensures that business decisions are for the directors rather than the courts. No guidance is given for what the correct course of action would be where the various duties are in conflict.
Duty to exercise independent judgement	Directors should not delegate their powers of decision-making or be swayed by the influence of others. Directors may delegate their functions to others, but they must continue to make independent decisions.
Duty to exercise reasonable skill, care and diligence	The Companies Act 1994 states that a director owes a duty to his company to exercise the same standard of 'care, skill and diligence that would be exercised by a reasonably diligent person with: (a) The general knowledge, skill and experience that may reasonably be expected of a person carrying out the functions carried out by the director in relation to the company; and

Areas	Provisions
	(b) The general knowledge, skill and experience that the director has.' There is, therefore, a reasonableness test consisting of two parts: (a) Did the director act in a manner reasonably expected of a person performing the same role? (b) Did the director act in accordance with the skill, knowledge and experience that the director actually has? The duty to be competent extends to non-executive directors, who may be liable if they fail in their duty.
Duty to avoid conflict of interest	A conflict of interest in the context of directors' duties most often means a situation where directors face influences that tempt them not to act in the best interests of the company. As agents, directors have a general duty to try to avoid a conflict of interest. In particular: (a) The directors must retain their freedom of action and not fetter their discretion by agreeing to vote as some other person may direct. (b) The directors owe a fiduciary duty to avoid a conflict of duty and personal interest. (c) The directors must not obtain any personal advantage from their position as directors without the consent of the company for whatever gain or profit they have obtained. The company's constitution may not allow directors to have any contracts with the company. If it allows contracts, then directors are likely to have to disclose their interest to the rest of the board. Legal provisions may reinforce or be stricter than the constitution, prohibiting certain transactions (for example, loans to directors) and only allowing some transactions if they are ratified by a shareholder vote (transactions above a certain size). Directors of listed companies may face stricter legal requirements. Directors are required to disclose to the other directors the nature and extent of any interest, direct or indirect, that they have in relation to a proposed transaction or arrangement with the company.
Duty not to accept benefits from third parties	This duty prohibits the acceptance of benefits (including bribes) from third parties conferred by reason of them being a director, or doing (or omitting to do) something as a director.
Departure from office	A director may leave office in the following ways: • Resignation (written notice may be required) • Not offering himself for re-election when his term of office ends • Failing to be re-elected • Death • Dissolution of the company • Being removed from office • Prolonged absence, meaning that director cannot fulfil duties (may be provided in law or by company constitution) • Being disqualified (by virtue of the constitution or by the court) • Agreed departure, possibly with compensation for loss of office

5.1.2 Fraud

Definition

Fraud: An intentional act by one or more individuals among management, those charged with governance (management fraud), employees (employee fraud) or third parties involving the use of deception to obtain an unjust or illegal advantage. Fraud may be perpetrated by an individual, or colluded in with people internal or external to the business.

UK statute has been clarified recently, with the issue of the Fraud Act 2006 which came into force in January 2007. The Act defines three classes of fraud:

- Fraud by false representation
- Fraud by failing to disclose information
- Fraud by abuse of position

An offence has occurred in any of these classes if a person has acted dishonestly and with the intent of making a gain for themselves or for someone else, or of inflicting a loss on someone else.

It is the fact that fraud is a form of deceit that makes its prevention and detection difficult. The perpetrator of the fraud does not want to be detected and will go out of their way to be successful. Fraud should be distinguished from error where the latter arises from a genuine mistake with no intention to deceive.

5.1.3 Bribery

The key points of the UK Bribery Act 2010 are as follows:

- Bribery is an intention to encourage or induce improper performance by any person, in breach of any duty or expectation of trust or impartiality.
- Bribery may amount to an offence for the giver ('active bribery') and the receiver ('passive bribery').
- Improper performance will be judged in accordance with what a reasonable person in the UK would expect. This applies, even if no part of the activity took place in the UK and where local custom is very different.
- Reasonable and proportionate hospitality is not prohibited.
- Facilitation payments (payments to induce officials to perform routine functions they are otherwise obligated to perform) are bribes.
- Bribing a foreign public official is an offence.
- If companies (or partnerships) fail to prevent bribes being paid on their behalf, they have committed an offence punishable by an unlimited fine.
- A defence will be having 'adequate procedures' in place for the prevention of bribery.
- If a bribery offence is committed by a company (or partnership), any director, manager or similar officer will also be guilty of the offence if they consented or were involved with the activity which took place.

Guidance published in 2011 by the Ministry of Justice highlighted five areas where the risk of bribery and corruption may be high:

- **Country.** Countries with high levels of corruption, lacking anti-bribery legislation and which fail to promote transparent procurement and investment policies.
- **Sectoral.** Higher risk sectors include the extractive and large-scale infrastructure sectors.
- **Transaction.** Risky transactions include charitable and political contributions, licences and permits, and transactions relating to public procurement.
- **Business opportunity.** Potentially risky projects include high-value projects, projects involving many contractors or intermediaries, and projects not apparently undertaken at market price or which lack a clear business objective.
- **Business partnership risk.** Risky situations could include the use of intermediaries in transactions with foreign public officials, involvement with consortia or joint venture partners and relationships with politically exposed persons.

The guidance also highlights various internal failings that could add to risk:

- Deficiencies in employee training, skills and knowledge
- Bonus culture that rewards excessive risk taking
- Lack of clarity in the organisation's policies on, and procedures for, hospitality and promotional expenditure and political or charitable contributions
- Lack of clear financial controls
- Lack of clear anti-bribery message from top-level management

5.1.4 Insider dealing

For directors, an obvious example of insider dealing would be using the advance knowledge they have of the company's results to make gains before the information is released to the market. Rules in many countries therefore include prohibition in directors dealing in shares during a **close period,** defined as a specific period (60 days, for example) before the publication of annual or period results.

As well as being a criminal offence in most regimes, it is also an abuse of directors' roles as agents, a clear instance of directors using the superior information they have for their benefit, rather than putting shareholders' interests first. It also undermines capital markets by deterring investors who do not have access to privileged information and feel therefore, that market distortions will result in insufficient returns for the risks that they face.

5.1.5 Money laundering

Money laundering is a form of fraud. It is essentially a process where the perpetrator attempts to legitimise the proceeds of any crime (dirty money made good). Proceeds of crime can include activities such as drug trafficking, terrorism, shoplifting, theft, tax evasion and other financial criminal activity. As a form of fraud, the emphasis is on concealing the illegal source of the money, which makes it difficult to detect, especially given that the transactions are rarely linked to one country.

The three principal money laundering offences as per the Proceeds of Crime Act are:

Section 327 – An offence is committed if a person conceals, disguises, converts, transfers or removes from the jurisdiction property which is, or represents, the proceeds of crime which the person knows or suspects represents the proceeds of crime.

Section 328 – An offence is committed when a person enters into or becomes concerned in an arrangement which he knows or suspects will facilitate another person to acquire, retain, use or control criminal property and the person knows or suspects that the property is criminal property.

Section 329 – An offence is committed when a person acquires, uses or has possession of property which he knows or suspects represents the proceeds of crime.

Affected companies must assess the risk of money laundering in their business and take necessary action to alleviate this risk.

Assessing risk – the risk-based approach

The risk-based approach consists of a number of steps.

- Identifying the money laundering risks that are relevant to the business
- Carrying out a detailed risk assessment on such areas as customer behaviour and delivery channels
- Designing and implementing controls to manage and reduce any identified risks
- Monitoring the effectiveness of these controls and make improvements where necessary
- Maintaining records of actions taken and reasons for these actions

Assessing customer base

Businesses with certain types of customers are more at risk of money laundering activities and will therefore, be required to take more stringent action to protect themselves. Types of customers that pose a risk include the following.

- New customers carrying out large, one-off transactions
- Customers who have been introduced by a third party who may not have assessed their risk potential thoroughly

- Customers who aren't local
- Customers whose businesses handle large amounts of cash

Other customers who might pose a risk include those who are unwilling to provide identification and who enter into transactions that do not make commercial sense. Before companies commence business dealings with a customer, they should conduct suitable customer due diligence.

Customer due diligence

In practice, the best and easiest way to do this is to ask for official identification such as a passport or driving licence, together with utility bills and bank statements.

If customers are acting on behalf of a third party, it is important to identify who the third party is.

Ongoing monitoring of your business

There needs to be an effective system of internal controls to protect your business from being used for money laundering. Staff should be suitably trained in the implementation of these internal controls and be alert to any potential issues. A specific member of staff should be nominated as the person to whom any suspicious activities should be reported.

Full documentation of anti-money laundering policies and procedures should be kept and updated as appropriate. Staff should be kept fully informed of any changes.

Maintaining full and up to date records

Businesses are generally required to keep full and up to date records for financial reporting and auditing purposes but these can also be used to demonstrate compliance with money laundering regulations. Such records will include receipts, invoices and customer correspondence.

5.1.6 Civil law

Areas of commercial law which may impact upon businesses include:

- Carriage by land and sea
- Marine, fire, life and accident assurance
- Bills of exchange
- Manufacture and sale of consumer goods

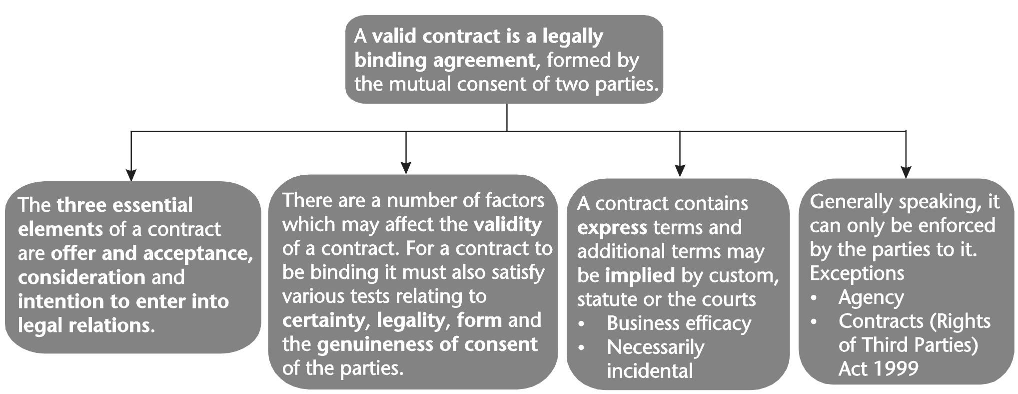
Businesses may also be affected by various aspects of property law including:

- Possession and rights over land
- Transfer of property
- Landlord and tenant law
- Manufacture and sale of consumer goods

5.1.7 Contract law

Contract law will have a significant impact on a business. Contracts may be made with suppliers, customers, landlords and so on.

You will have covered the detail of these elements in detail in your law studies. The following diagram is a summary of the key points:



It is almost invariably the case that the two parties to a contract bring with them differing levels of bargaining power. A contract may be made between a large retail company and an individual, for example. In such cases, the agreement is likely to be in the form of a standard form contract, prepared by the dominant party and which the other party has no choice but to take or leave. Alternatively, the parties to the contract will negotiate the terms between them.

Risks

Having entered into a contract, a business faces the following risks:

- The contract is unenforceable

  A contract will be unenforceable where it is not in the correct **form.** Generally speaking, a contract may be made orally or in writing and an oral agreement will be just as binding as a written contract. However, in certain cases, the law may stipulate that an oral contract will not be sufficient, for example, agreements for the transfer of land and consumer credit agreements (that are regulated by the Consumer Credit Act 1974, as amended by the Consumer Credit Act 2006, must be in writing. Note that, increasingly, contracts are made electronically and an electronic signature can be used as evidence of the validity of a contract in the same way as a written signature (Section 8 Electronic Communications Act 2000).

- The contract is void or voidable

  A contract may be void or voidable in the following situations:

  – Lack of capacity
  – Absence of free will
  – Illegality
  – Mistake
  – Misrepresentation

  The consequences of a contract being rendered void or voidable are as follows:

Void	A **void contract** is not a contract at all. The parties are not bound by it and if they transfer property under it, they can generally recover their goods, even from a third party.
Voidable	A **voidable contract** is a contract which one party may set aside. Property transferred before avoidance is usually irrecoverable from a third party.

- The contract is not discharged

  A contract is normally discharged by performance. Where a party does not perform his contractual obligation sufficiently, he is said to be in **breach of contract**, unless the contract has been discharged by frustration or he has some other **lawful excuse**. A lawful excuse may apply in the following circumstances:

  – Where he has tendered performance but this has been **rejected**
  – Where the **other party** has made it **impossible** for him to perform
  – Where the parties have, by **agreement**, permitted **non-performance**

The majority of contractual disputes will not reach the courts and may be resolved by negotiation, arbitration or some other means such as mediation, adjudication or expert determination. However where this is not possible, the court may award one of the following remedies:

- Damages (designed to compensate the claimant by putting him in the position he would have been in, if the contract had been performed)

- Specific performance (where damages are not an adequate remedy)

- Injunction (ie the defendant is directed to take positive steps to undo something he has already done in breach of contract)

Damages are the most common form of remedy to be awarded by the courts. A company in breach of contract may need to recognise a provision for damages or disclose a contingent liability, depending on the specific nature of the situation and the assessment of the likely outcome of the court proceedings.

5.1.8 Agency

Agency is a very important feature of modern commercial life and describes the relationship that exists where one party, the agent, acts on behalf of another, the principal. In practice, there are many examples of agency relationships to which you are probably accustomed, such as estate agents and travel agents. However, you should appreciate, in particular, how a director may be held to be an agent of the company and bind the company by his acts, and also how a partner is an agent of the partnership and may bind the firm by his acts.

Agency by consent

An agency can be expressly created either orally or in writing. There is only one exception to this, which is that if the agent is to execute a deed on the principal's behalf (for example, a conveyance of land or a lease exceeding three years) then the agency must be created by deed. Essentially, this means that the agent is given a power of attorney. In **commercial transactions**, it is usual (but not essential) to appoint an agent **in writing**, so that the terms and extent of the relationship are set down to avoid misunderstanding. In the case of a director, the agency would be created by the contract of employment.

Agency by estoppel

Agency by estoppel arises by operation of law and is no less effective than an agency expressly created. It arises in the following situation:

- When the words or **conduct of the principal** give to a **third party** the **impression** that the person who purports to contract with the third party **is the agent** of the principal, and
- The **third party**, as a result, **acts upon this**.

The principal is 'estopped', or prevented, from denying the existence of the agency. For example, where a business presents an employee to customers and other entities it is in business with as a director, he will be treated in law as such (shadow director), even if he is not officially registered at Companies House as a director of the company.

The law implies the following duties into any contract of agency:

Duties	Explanation
Accountability	An agent must provide full information to his principal of his agency transactions and account to him for all monies arising from them. If he accepts from the other party any commission or reward as an inducement to make the contract with him, it is considered to be a bribe and the contract is fraudulent. The principal who discovers that his agent has accepted a bribe may dismiss the agent and recover the amount of the bribe from him.
No conflict of interest	The agent owes to his principal a duty not to put himself in a situation where his own interests conflict with those of the principal.
Performance	The agent who agrees to act as agent for reward has a contractual obligation to perform his agreed task. (An unpaid agent is not bound to carry out his agreed duties unless there is other consideration.) Any agent may refuse to perform an illegal act.
Obedience	The agent must act strictly in accordance with his principal's instructions insofar as these are lawful and reasonable. Even if he believes disobedience to be in his principal's best interests, he may not disobey instructions (unless he is asked to commit an illegal or unreasonable act).
Skill	An agent undertakes to maintain the standard of skill and care to be expected of a person in his profession.
Personal performance	The agent is usually selected because of his personal qualities and owes a duty to perform his task himself and not to delegate it to another. (However, he may delegate in certain circumstances; for example, a solicitor acting for a client would be obliged to instruct a stockbroker to buy or sell listed securities on the Stock Exchange.)
Confidence	The agent must keep in confidence what he knows of his principal's affairs, even after the agency relationship has ceased.

Conversely, an agent has the following **rights** (or duties owed by the principal):

Rights of the agent	Explanation
Indemnity	The agent is entitled to be repaid his expenses and to be indemnified by his principal against losses and liabilities, provided his acts are done properly within the limits of his authority. He may recover expenses properly paid, even if he was not legally bound to pay; for example, a solicitor who pays counsel's fees (which the counsel cannot recover at law) may reclaim this expense from his client.
Remuneration	The agent is also entitled to be paid any agreed remuneration for his services by his principal. The entitlement to remuneration may have been expressly agreed or may be inferred from the circumstances; for example, by reference to trade or professional practice. If it is agreed that the agent is to be remunerated but the amount has not been fixed, the agent is entitled to a reasonable amount.
Lien	The agent has the right to exercise a lien over property owned by the principal, ie a right to retain and hold goods pending payment of sums owed to him.

5.1.9 Negligence

Negligence is the most important modern tort. To succeed in an action for negligence, the burden of proof is on the claimant to prove, on **a balance of probabilities**, that:

- The defendant owed **a duty of care** to the claimant to avoid causing injury, damage or loss
- There was **a breach of that duty** by the defendant
- *In consequence* the claimant suffered **injury, damage or loss**

Duty of care

It is not possible to give a clear statement of the law as to when a duty of care exists for the purposes of negligence, since the law has evolved over many years as it has had to be applied to extremely varied situations and many factors have influenced the courts' decisions. Whether or not a duty of care exists will be assessed on the basis of some or all of the following four tests. These were formulated by the House of Lords in *The Nicholas H* (*Marc Rich & Co v Bishops Rock Marine*) *1995* case.

Test	Meaning
1 Reasonably foreseeable	Was the damage reasonably foreseeable by the defendant as damage to the claimant at the time of the negligent act or omission?
2 Proximity	Is there sufficient proximity, or neighbourhood, between the parties?
3 Fair, just and reasonable	Is it fair, just and reasonable that the law should impose a duty on the defendant on the facts of the case?
4 Public policy	Is there a matter of public policy that requires that no duty of care should exist?

In applying these tests, the court is essentially looking at the relationship between the claimant and the defendant in the context of the damage suffered. *The Nicholas H* case was concerned with economic loss, but the court held that the requirements would be equally applicable in cases of physical damage to property.

Breach of duty

Whether or not there has been a breach of duty is a question of fact. In certain circumstances, where the reason for the damage is not known, but it can fairly be said that it would not have occurred without the defendant's lack of care, the claimant can argue *res ipsa loquitur* ('the facts speak for themselves') and the court will infer that the defendant was in breach of the duty of care. It will be necessary for the claimant to show that the thing which caused the damage was under the management and control of the defendant. In such cases, it will then be for the defendant to prove that the cause of the injury was **not** his negligence.

The standard of care needed to satisfy the duty of care is a question of law. Broadly speaking, it is the standard of 'a reasonable man, guided upon those considerations which ordinarily regulate the conduct of human affairs' (*Blyth v Birmingham Waterworks Co 1856).*

The following principles have been established by case law:

Principle	Explanation
Particular skill	If the defendant professes a **particular skill**, the standard is that of a reasonable person with that skill, ie a reasonable accountant or reasonable electrician.
Lack of skill	**Peculiarities or disabilities** of the defendant are not relevant, so the standard for a learner driver is that of a reasonable driver; and for a trainee accountant, that of a reasonable accountant.
No hindsight	The test is one of **knowledge and general practice existing at the time**, not hindsight or subsequent change of practice.
Body of opinion	In broad terms, a claim against a professional person will fail if he or she can point to a **body of professional opinion that supports the approach** taken and which the court considers to be reasonable.
Advantage and risk	In deciding what is reasonable care, the balance must be struck between **advantage and risk.** (For example, a driver of a fire engine may exceed the normal speed on his way to the fire but not on the way back.)
Emergency	If a defendant acts negligently in an **emergency situation**, this will be taken into account – the test is that of a reasonable man in the defendant's situation.
Vulnerability	If A owes a duty of care to B, and A knows that B is unusually vulnerable, a higher standard of care is expected.

Loss caused by breach

A person will only be compensated if he has suffered actual loss, injury, damage or harm **as a consequence** of another's actions. As a general rule, loss is represented by personal injury or damage to property, or financial loss directly connected to such injury (for example, loss of earnings) or property damage. Such *consequential* economic loss that is related in this way, is more readily recoverable than *pure* economic loss.

5.1.10 Employment and health and safety regulations

An entity which employs individuals has a number of responsibilities under the terms of the employment contract in common law and in statute. One of the key distinctions that a business needs to be able to make, therefore, is between an employee and a contractor. An employee is someone who is employed under a **'contract of service',** ie a contract of employment. An independent contractor is someone who works under a **contract for services** and is also described as 'self-employed'.

There are three essential elements, or conditions, that **must** be present in order for the contract of service (and thus the employer/ employee relationship) to exist, namely:

Condition	Explanation
Personal service	The employee must have agreed to provide his own work and skill in the performance of a service for his employer. However, the fact that an employee is able to delegate that performance in limited circumstances (for example when he is sick or only with permission) will not mean that this condition is not met.
Control	There must be some element of control exercisable by the employer over the employee.
Mutuality of obligations	There must be an obligation on the employer to provide work and an obligation on the employee to do that work. Thus a 'casual worker' who works as and when required, even if in preference to others, cannot be an employee because there is no 'mutuality of obligations'.

If these factors are not present, there can be no contract of service. The fact that they are present, however, does not mean that there *will* be a contract of service. The level of service and degree of control will be taken into account, along with a number of other factors.

There are several other **practical reasons** why the distinction between a contract of service (employed) and a contract for services (self-employed) is important.

Significance of the distinction		
	Employee	**Self-employed**
Wrongful dismissal	Can claim wrongful dismissal.	Cannot claim wrongful dismissal.
Employment protection	There is legislation that confers protection and benefits upon employees under a contract of service, including: • Minimum periods of notice • Entitlement to statutory redundancy payment • Remedies for unfair dismissal • Health and safety protection (Sometimes the protection is subject to the employee having completed a certain amount of continuous service.)	Note that increasingly, employment protection is given to 'workers' rather than 'employees'. 'Workers' is more widely defined and will often include those normally regarded as independent contractors as well as employees. It is important to note which term the legislation applies to, for example, statutory protection against unfair dismissal applies to 'employees', but working time protection applies to 'workers'. Note too that statutory health and safety obligations on employers often relate to both employees and independent contractors.
Insolvency	In liquidation, an employee has preferential rights as a creditor for payment of outstanding salary and redundancy payments, up to certain limits.	Self-employed contractors only have the normal, non-preferential rights of any creditor, in the event of insolvency.
Implied terms	There are rights and duties implied in an employment contract by common law and statute, for example a mutual duty of trust and confidence.	These implied rights and duties do not generally apply to a contract for services.
Tortious acts	Employer is generally vicariously liable for tortious acts of employees, committed in the course of employment.	Liability of person hiring an independent contractor for contractor's acts severely limited unless there is strict liability.
Taxation	Deductions for income tax must be made by an employer under Tax Withholding from salary paid to employee.	The self-employed are directly responsible to Commissioner of Taxes for tax due.
VAT		An independent contractor may have to register for, and charge, VAT.

With the current trend in increasingly flexible working practices, in some cases this distinction is becoming more difficult to make. There is an increased risk that an entity has responsibilities for individuals under employment law which it is not aware of. This could increase the risk of penalties.

Employer's implied duties

The employer owes the following duties at common law:

To pay reasonable remuneration	This duty is subject to any express provision, for example, to pay a rate fixed by the parties, or to pay nothing during a lay-off.
To indemnify employees	To **indemnify the employee** against expenses and losses incurred in the course of employment.
Health and safety	This is normally expressed as a duty to protect the employee against reasonably foreseeable risks to his **health, safety** and welfare at work. Health and safety obligations are also imposed by statute. This common law duty is three-fold and incorporates the obligations to provide: • Safe plant and appliances • A safe system of work • Reasonably competent fellow-employees.

To provide work	Generally speaking, an employer will not be liable for failing to provide work, as long as he continues to pay wages (so liability is more likely to arise where someone is paid on a commission basis).
To provide accurate reference (where one is provided)	An employer does not have a duty to provide a reference (but if he does provide one, he must exercise reasonable care and skill to ensure that the information contained in it is accurate and gives a fair impression of the employee). In particular, an employer cannot divulge information that is not known to the employee (for example, customers' complaints against the employee).
Not to disclose confidential information	The employer must not divulge confidential information about the employee to a third party without the employee's consent.
To maintain mutual trust and confidence	The employer must treat the employee with due respect and consideration. He must not, for example, conduct his business in a disreputable fashion, thereby damaging the employee's reputation and future employment prospects.

Legislation also imposes a number of implied duties on employers, often implementing European Directives on employment law issues. Many of these duties are concerned with 'family-friendly' employment and the 'work-life balance', for example provisions regarding maternity and paternity rights, flexible working arrangements and time off work. The principal duties implied by statute are as follows:

Subject	Duty
Pay	Under legislation protecting equal pay, contractual employment terms such as sick pay, holiday pay and working hours should be as favourable as those given to an employee of the opposite sex who is performing equal work or work of equal value, unless a 'genuine material factor' exists that justifies the discrepancy (for example, employees in London receiving a higher hourly rate than employees in Aberystwyth).
Health and safety	The Health and Safety at Work Act 1974 imposes general duties on employers, including a duty to ensure the continuing good health, safety and welfare of his employees, as far as is practicable. This general duty includes the following obligations: • Provide and maintain plant and systems of work that are safe and without risk • Make arrangements to ensure safe use, handling, storage and transport of articles/substances • Provide adequate information, instruction, training and supervision • Maintain safe places of work and ensure that there is adequate access in and out • Provide a safe and healthy working environment Certain additional duties are imposed on employers in particular categories; for example, designers and manufacturers who must ensure that the articles designed or manufactured are safe and that there is adequate testing and examination. There are also extensive health and safety regulations which may be generally applicable, or specifically applicable, to particular hazards or risks. Contravention of the Act is an offence punishable by an unlimited fine and/or up to two years' imprisonment. If an offence is committed by a company, any director or other officer who consented to, or was responsible for, commission of the offence will also be guilty and liable to the penalties mentioned.
Discrimination	Not to discriminate on grounds of race, sex, disability, religion or belief, sexual orientation or age.

Employee's implied duties

Common law implies a number of duties on the part of the employee into any contract of employment:

Duty of faithful service (fidelity)	The employee has a **fundamental duty of faithful service** or fidelity to his employer. Thus, an employee who works for an employer's competitor in his spare time, or who frustrates the commercial objectives of his employer, is in breach of this duty.
To obey lawful and reasonable orders	The employee must show **obedience** to the employer's instructions unless they require him to: • Do an unlawful act, or • Expose himself to personal danger (not inherent in his work), or • Do something outside his contract.
Not to misuse confidential information	This duty will not necessarily cease when the employment ceases. (Note that when someone invents or writes something as part of his employment, the right to the patent or copyright will normally belong to his employer.)
To exercise reasonable care and skill	The employee must demonstrate reasonable **competence, care and skill** in the performance of his work, bearing in mind the degree of skill and experience that the employee professes to have.
Personal service	The contract of employment is a personal one and so the employee may not delegate his duties without the employer's express or implied consent.
Trust and confidence	This is a mutual obligation imposed on both parties and is based on respect and consideration for each other. An employee should not, for example, make unjustifiable complaints or false accusations about his employer.

Further details on employment law are covered in your Law Learning Manual.

5.1.11 Environmental law and regulation

Environmental law and regulation is very complex and comes from a number of sources, including UK and EU legislation. Legislation covers a number of different areas including:

- Air
- Chemicals
- Conservation
- Energy
- Noise and nuisance
- Pesticides and biocides
- Radioactive substances
- Waste
- Water

Within each category, there is a range of legislation. For example, legislation on air quality includes regulations regarding aerosol dispensers, clean air acts, climate change acts and crop residues (burning) legislation. For any business, it is therefore critical that it identifies which regulations are relevant to its business and ensures that it complies with the provisions of these. The company may employ the services of a consultant in order to help it understand and apply the legislation with a view to avoiding any breaches and the potential penalties that may arise as a consequence.

As the BP oil spill in the Gulf of Mexico, discussed in Chapter 7 demonstrates, the consequences of breaches of environmental regulations can have significant consequences, both directly (as a result of the fines) and indirectly (as a result of the bad publicity).

5.2 Compliance with laws and regulations

Most codes stress the importance of businesses having procedures in place to help ensure compliance with applicable laws and regulations.

Case example: Compliance framework

The South African King report sets out the principles underlying the framework that should ensure compliance.

1 **The board should ensure that the company complies with applicable laws and considers adherence to non-binding rules, codes and standards**

Compliance is an ethical imperative, which should be understood not only in terms of the obligations that laws create, but the rights and protection that they afford. The board should consider adherence to non-binding rules, codes and standards if it would constitute good governance practice. Compliance should be systematically managed and should be a regular item on a board's agenda.

2 **The board and each individual director should have a working understanding of the effect of the applicable laws, rules, codes and standards**

Directors have a duty to familiarise themselves with the general content of laws and regulations, to be able to adequately discharge their fiduciary duties in the best interests of the company and their duty of care, skill and diligence. The business should have processes to ensure that the board is continually informed of relevant laws, rules, codes and standards.

3 **Compliance risk should form an integral part of the company's risk management process**

Risks of non-compliance should be managed through the risk management processes. However, this does not imply that compliance is optional, depending on whether the risk assessment warrants it. A compliance function can form part of a broader risk management function.

4 **The board should delegate to management the implementation of an effective compliance framework and processes**

Management should develop and implement the compliance policy, and the board should approve it and monitor compliance. The compliance policy should be aligned with other business efforts and objectives. Compliance should be part of the code of conduct to entrench a culture of compliance. A compliance culture should also be encouraged through leadership, establishing appropriate structures, education and training, communication and measurement of key performance indicators relevant to compliance.

The following aspects of control systems are particularly important.

5.2.1 Establishing culture

Board commitment to compliance with the law is an important overall control. Directors may seek to establish a commitment against breaches of specific laws by a formal statement, setting out a zero tolerance policy and spelling out the consequences for employees or managers who transgress.

As with other areas, **communication** of the organisation's procedures and policies, and **training** in their application, will be very important in helping to establish the culture. Training should include general training on the threat of bribery on induction, and also specific training for those involved in higher risk activities such as purchasing and contracting.

However, whilst establishing the right culture is an important part of taking effective action to combat corruption, a culture that is ambiguous or not enforced may adversely affect the success of other measures. This may occur if managers and staff feel that they are getting mixed messages. They may believe that they are expected to do what it takes to earn sufficient returns in environments where ethical temptations exist, or that ethically dubious conduct will be ignored or implicitly accepted.

5.2.2 Code of conduct

As well as being central to communication with employees, a publicly-communicated code also reassures those doing business with the organisation and can act as a deterrent to misconduct. For example, a code may include provisions about dealing truthfully with suppliers and refraining from seeking or participating in questionable behaviour to secure competitive advantage. However, there may be the problem that staff do not feel the code is relevant to them.

5.2.3 Risk assessment

Identification of circumstances where non-compliance with laws may be a problem, must be built into business risk assessments. Sensitive areas could include hazardous activities for health and safety laws, disputes with staff for employment law, or the activities of intermediaries or agents, or staff within the organisation responsible for hospitality or promotional expenditure for anti-bribery legislation. Risks may change over time (for example, as the business enters new markets) and so may need to be re-assessed. A poor internal control environment may also be a factor that contributes significantly to increased risk.

5.2.4 Operational compliance

A strong tone at the top and the ethical code may be undermined by a lack of detailed guidance on the implementation of procedures to ensure compliance with laws.

However detailed the procedures, they will not be able to give absolute assurance that corrupt activities will not take place. Staff may not understand why operational controls are required, how they should operate and who should be operating them. They may misinterpret the requirements, or may encounter dubious situations not covered by guidance. They may assume that conduct not forbidden by the guidance is legitimate.

There is also the issue that detailed guidance is meant to ensure compliance with the law. However, the law may not be entirely clear.

5.2.5 Whistleblowing

A business's guidance should make it clear that managers and staff should seek guidance about, and disclose, any activities that are questionable. Staff should also have the opportunity to make suggestions for improvement in prevention and compliance procedures.

5.2.6 Monitoring

As part of their regular monitoring of risk management, the board should receive reports on compliance with significant legislation. The board must also consider whether systems need to be improved as the risk environment changes. Events that may result in changes to systems include changes of government, changes in legislation or changes in the activities of the business.

The board's monitoring of compliance may be assisted by compliance audits. These may be carried out by internal auditors, or external specialists for areas in which there is a lack of in-house expertise, or external assurance is required or felt to be desirable.

Summary and Self-test

Summary

Globalisation, the treatment of investors and major corporate scandals have been driving forces behind corporate governance development.

Most governance reports are based around the principles of integrity, accountability, independence and good management. Agency is also very important as often the directors/managers are acting as agents for the owners.

Governance reports have emphasised the roles of institutional investors, but directors and managers also need to be aware of the interests of all significant stakeholders.

The board should be responsible for taking major policy and strategic decisions, monitoring performance and overseeing risk management. Directors should have a mix of skills and their performance should be assessed regularly.

Division of responsibilities at the head of an organisation is best achieved by separating the roles of chairman and chief executive. Independent non-executive directors have a key role to play in governance, including serving on board committees.

Business structure will have a major impact on how effectively governance is implemented, particularly the form planning and control systems take and the amount of responsibility given to operational management.

Boards must introduce a framework including an appropriate culture, code of conduct, compliance procedures and communication channels to ensure their companies comply with the many laws and regulations that they face.

Self-test

Self-test question 1

Corporate governance development

(a) Discuss the main issues that triggered the development of systematised corporate governance in large public companies.

(b) Discuss the main principles underlying global corporate governance reports.

Self-test question 2

Non-executive directors

Discuss the extent to which non-executive directors can contribute to the effectiveness of corporate governance for an unlisted company that may seek a listing in future.

Self-test question 3

GFE

GFE is a registered charity with 150 employees and 350 volunteers, providing in-home care for elderly persons who are unable to fully take care of themselves. The company structure has no shareholders in a practical sense although a small number of issued shares are held by the sponsors who established the charity many years previously. GFE is governed by a seven-member board of directors. The chief executive officer (CEO) chairs the board, which comprises the chief financial officer (CFO) and five independent, unpaid non-executive directors who were appointed by the CEO, based on past business relationships. You are one of the independent members of GFE's board.

The CEO/Chair sets the board agendas, distributes board papers in advance of meetings and briefs board members in relation to each agenda item. At each of its quarterly meetings, the board reviews the financial reports of the charity in some detail and the CFO answers questions. Other issues that regularly appear as agenda items include new government funding initiatives for the client group, and the results of proposals that have been submitted to funding agencies, of which about 35% are successful. There is rarely any discussion of operational matters relating to the charity, as the CEO believes these are outside the directors' experience and the executive management team is more than capable of managing the delivery of the in-home care services.

The board has no separate audit committee but relies on the annual management letter from the external auditors to provide assurance that financial controls are operating effectively. The external auditors were appointed by the CEO many years previously.

GFE's board believes that the company's corporate governance could be improved by following the principles applicable to listed companies.

Requirement

Recommend how GFE's board should be restructured to comply with the principles of good corporate governance.

Technical Reference

A	**Leadership**	
	• Role of the board	Corporate Governance Code A.1
	• Division of responsibilities	Corporate Governance Code A.2
	• The chairman	Corporate Governance Code A.3
	• Non-executive directors	Corporate Governance Code A.4
B	**Effectiveness**	
	• Composition of the Board	Corporate Governance Code B.1
	• Appointments to the Board	Corporate Governance Code B.2
	• Commitment	Corporate Governance Code B.3
	• Re-election	Corporate Governance Code B.7
C	**Accountability**	
	• Risk management and internal control	Corporate Governance Code C.2
	• Audit committee and auditors	Corporate Governance Code C.3
D	**Remuneration**	
	• Level and components	Corporate Governance Code D.1 & Schedule A
E	**Relations with shareholders**	
	• Dialogue with shareholders	Corporate Governance Code E.1
	Institutional shareholders	Stewardship Code

Answers to Interactive questions

Answer to Interactive question 1

<u>Adrian</u>

Arguments for appointment

Knowledge of QP

Adrian has **exceptionally good long-term knowledge** of QP through his involvement with the investment over 15 years. Adrian's knowledge should mean that he can provide expert scrutiny of the performance of executive management.

Knowledge of industry

As a result of Adrian's long experience as investment analyst, he should have **wide knowledge of the industry and economy** as well as of QP, although he has not worked in the manufacturing sector. This should mean that he is able to make an informed contribution to board discussions about strategy, and have the weight of knowledge to be able to challenge effectively the plans of executive directors from the perspective of an institutional investor.

Arguments against appointment

Independence

As the representative of a significant institutional investor in QP, Adrian cannot be regarded as an independent non-executive director under governance best practice such as the UK Corporate Governance Code. Adrian has perhaps been suggested because current board members believe, based on their previous dealings with him, that he will be reluctant to challenge their strategies. Also Adrian does not appear to be stepping down from the City Pensions' board. If he does not do so, his duties to **promote the best interests of City Pensions and QP may conflict**. Other significant investors may consider that Adrian's appointment would give City Pensions a privileged position and demand board representation themselves.

Lack of fresh perspective

Adrian may **not be able to bring a fresh perspective** to the affairs of QP. As City Pensions' representative, Adrian already has had chances to raise concerns about QP's strategies or how QP is being governed. Possibly, Adrian is unlikely to raise new issues if appointed as a director.

Recommendation

Adrian's connections mean that he cannot be regarded as an **independent non-executive director**. This would limit his contribution to the board, as he could not serve on **audit or remuneration committees** under governance best practice. The board would be some way short of fulfilling the requirement of governance best practice that at least half the board should be independent non-executive directors. For this reason, Adrian should not be appointed.

<u>Nicole</u>

Arguments for appointment

ICAB membership

Nicole's membership of ICAB means that she is subject to **ICAB's ethical code**. This should guarantee that she brings to the board essential qualities such as **integrity and objectivity**. Adherence to ICAB's **continuing professional education requirements** will obligate Nicole to make sure that she has the relevant, up-to-date, knowledge needed to contribute effectively as a director.

Wide experience

Nicole can bring a **fresh perspective** to the board, based on experience of a number of different sectors. Her experience as finance director on the bank's board, together with ICAB membership, means that Nicole has the **recent financial knowledge**, highlighted by governance reports as a requirement for the audit committee. Nicole will also bring contacts in the banking sector, which may be useful when QP is dealing with major lenders.

Arguments against appointment

Independence

Nicole is about to retire. We are **not given details of any other sources of income** that Nicole has, although Nicole probably has a pension from the bank.

Nicole's fees as non-executive director may be a **significant proportion of her income** going forward. There is the risk that Nicole may be less willing to challenge and upset other directors and jeopardise this source of income.

Lack of previous involvement in sector

Nicole does not appear to have had **previous involvement** in this specific sector. Nicole will need to have a **more extensive induction programme** than Adrian would.

Recommendation

Nicole should qualify as an independent non-executive director. The benefits that Nicole's ICAB membership and wider experience will bring should mean that Nicole is offered a directorship. Her role should include chairing the audit committee.

<u>**Helen**</u>

Arguments for appointment

Political knowledge

Helen should be able to bring expert knowledge of the **political and legal environment** to the Board, helping the board assess risks in this area. QP may be able to use the political contacts that Helen has, and use her expertise to lobby against damaging changes to legislation.

Other directorships

Helen is currently on **two other boards**. The perspective she gains from serving on these boards may inform her contribution to QP's board. Helen may be able to **benchmark** what QP is doing against practice elsewhere. She should also have gone through an **induction process** at these companies and be aware of responsibilities in law and under governance best practice.

Arguments against appointment

Time

Helen is already a director of two other companies and this may limit the time that can be spent as a director of QP to an **unacceptably low level**.

Lack of previous involvement in sector

Helen does not appear to have had any previous experience in the chemical sector, unlike Adrian. Helen also appears to lack Nicole's financial knowledge.

Recommendation

Helen should be considered for one of the vacant directorships. However, before Helen is appointed, the board should obtain **guarantees that she will spend sufficient time** on QP's affairs.

Answer to Interactive question 2

(a) The effectiveness of non-executive directors may be limited by the following factors.

Having the same perspective as executive directors

The corporate governance reports stress the importance of non-executive directors possessing independent judgement and being appointed by a nomination committee. However, the nomination committee may restrict its search to **directors** who will '**fit in**' with the rest of the board, and may be **unwilling to recruit** from a **diversity of backgrounds,** for example stakeholders such as employees. In addition, many non-executive directors will only agree to serve on the boards of companies if they admire the company's chairman or its way of operating.

Lack of independence

In many companies, non-executive directors have been appointed through business or social contacts with directors. It may be difficult to find **non-executive directors** who **fulfill the independence requirements** of the corporate governance reports or freedom from any relationship that compromises independence.

Lack of business knowledge

This can be the other side of the coin to the problem of lack of independence. Potential non-executive directors who have good knowledge of the business and industry may have gained that knowledge through links with the company in the past.

Lack of human resource management

Limited time may mean that non-executive directors do not have proper **induction** into the company, nor **proper updating and refreshment** of their skills and knowledge of the company. Their **performance may not be appraised** regularly; it should form part of an **annual appraisal** of the **board's activities**.

Limited time

The most knowledgeable and effective non-executive directors are likely to have other significant demands on their time. As directors, they have to fulfil **certain legal requirements.** Apart from their contributions to the main board, they will also probably spend time at **meetings of board committees** such as the audit and remuneration committees. The limited involvement resulting from the lack of time may limit their ability to contribute to board meetings, since they are **unable to obtain** a **broad enough picture** of what is happening throughout the organisation.

Information available

Non-executive directors' contribution will also depend on the information that is readily available to them as directors. This will be influenced by the quality of the **organisation's information systems**, and also the **willingness** of **executive directors** to supply information about their activities.

Role of board

The corporate governance reports stress the importance of non-executive directors being involved in **strategic decisions.** If non-executive directors are involved in formulating strategy, they can fulfil their key role, that of **warning of potential problems** and hence, **preventing trouble**. However, board meetings may focus almost entirely on **current operational matters** and **short-term operational results**. In addition, a focus at board meetings on short-term results may mean that non-executive directors **assess** the **performance** of the organisation using short-term indicators and its management, and do not focus on **longer-term issues**, such as changes in product mix or re-engineering of the organisation's processes.

Inability to resist pressures

Non-executive directors have limited options when faced with a **united group** of **executive directors** who are determined to push through a policy with which the non-executive directors disagree. Their ultimate weapon is **resignation**, but if all or a number of non-executive directors resign, they may precipitate a **crisis of confidence** in the company. Alternatively, they can **remain in office,** but then if serious problems arise, the executive directors may have to depart from the board, leaving the non-executive directors with the responsibility for **'picking up the pieces'**.

(b) The effectiveness of audit committees could be improved in the following ways.

Appointment requirements

Appointments could be **recommended** by a vote at the **annual general meeting**. Alternatively, certain stakeholders, for example, employees could have the right to appoint a member. These measures might improve the independence of committee members.

The **term of office** of committee members could be **limited** to ensure the committee retained a fresh perspective.

When nominating potential members, the selection process could be biased towards **recruiting members** with **financial accounting experience**, or **experience of large control systems**. Members who have accountancy experience will be able to question the judgements that management make when preparing accountancy information.

CHAPTER 6

Expansion of responsibilities

There are various ways in which the committee's remit might be expanded. They could have responsibility for **reviewing compliance** with **laws and regulations** such as environmental legislation or ethical codes. Certain **transactions** could also be **referred automatically** to them for review.

Internal audit

As a major function of many audit committees is to oversee the role of internal audit, it follows that a **more effective internal audit function** will lead to more effective operation of the audit committee, by improving the quality of information that the audit committee review.

Statutory backing

Audit committees may become more effective if their establishment by certain organisations is made **compulsory**. The recommendations of internal audit will also be **reinforced by stricter accounting and auditing standards**.

Improvement in operations

Changes that might improve the way audit committees operate include the following.

(i) Having **clear terms of reference**, agreed by the board

(ii) Establishment of an **annual plan**, giving details of the areas on which the committee will focus

(iii) Establishment of **standards** for the **frequency** of, and **form of reporting** to, the main board

(iv) Regular **review** of the **effectiveness** of the audit committee, including whether its recent work has been correctly focused.

Answer to Interactive question 3

(a) The UK's Institute of Internal Auditors suggests that the board needs to consider the following information in order to carry out an effective review.

(i) The organisation's **code of business conduct**

(ii) Confirmation that line managers are **clear as to their objectives**

(iii) The overall results of a **control self assessment** process by line management or staff

(iv) **Letters of representation** ('comfort letters') on internal control from line management (confirmations about the operation of systems or specific transactions)

(v) A **report** from the audit committee on the **key procedures** that are designed to provide effective internal control

(vi) **Reports from internal audit** on audits performed

(vii) The audit committee's **assessment** of the **effectiveness of internal audit**

(viii) Reports on **special reviews** commissioned by the audit committee from internal audit or others

(ix) Internal audit's **overall summary opinion on internal control**

(x) The **external auditors' report on weaknesses** in the accounting and internal control systems and other matters, including errors, identified during the audit

(xi) **Intelligence** gathered by board members during the year

(xii) A **report on avoidable losses** by the finance director

(xiii) A **report on any material developments** since the reporting date and up to the present

(xiv) The board's proposed wording of **the internal control report** for publication

(b) The following employee attitudes will be relevant.

Response to management behaviour

Employees may not take controls with the **same degree of seriousness** that management does. They will take into account how strictly controls are applied by senior managers, whether senior managers override controls, and whether follow-up action is taken by management if control weaknesses are identified.

Realism of controls

If employees see **controls as unrealistic** because, for example, there is insufficient time to operate them, they may not take management review of controls seriously.

Employee collusion

If employees do collude, the evidence available to management may be **undermined**. Collusion may not necessarily be hiding fraud. It could be a shared intention to thwart what is seen as unnecessary bureaucracy. The fact, for example, that there are two signatures on a document does not necessarily mean that it has been checked properly.

Focus on certain controls

If a **lot of emphasis is placed on certain controls**, reports on which the annual review is based will stress the operation of those controls and provide less detail of other controls that are also significant.

Prioritisation

Many employees may feel that controls are bureaucracy and, as such, interfere with more important day-to-day work. This may mean, for example, that controls are **not operated when they should be**, but some time later, and so the evidence the annual review is relying on may not be as strong as it appears.

Reliance on memory

Some controls may be dependent on **knowledge held in the mind of employees**. The employees concerned may be happy about this because it reinforces their position, but it can lead to a lack of clarity about whether controls have operated; and also inconsistency and misunderstanding, when controls depend on the attitudes of the person operating them.

Answers to Self-test

Answer to Self-test question 1

Corporate governance development

Part (a)

Reasons for emergence of corporate governance

Corporate governance was defined in the Cadbury report as 'the system by which companies are directed and controlled'.

Corporate governance has developed because of a number of developments and events over the last thirty years.

Abuses by individuals

In the UK, a key influence on the development of the Cadbury framework was the financial scandals of the late 1980s and the abuses exposed. A number of provisions have been designed to counter situations where a **single individual** has dominated a company and has abused his position.

Financial reporting

A key problem in many financial scandals has been **misleading financial accounting practices**. Whilst these have resulted in strengthened international financial regulations, they have also impacted on corporate governance regulations because of the perceived **failure of auditors** to address these problems.

Risks and controls

Again, poor controls have been a symptom of poor corporate governance with, for example, **inadequate management control of individuals** such as Nick Leeson. In addition, the development of risk management frameworks such as the COSO guidance, has impacted upon regulations.

Internationalisation

More investors, in particular institutional investors, have begun to **invest outside their home countries**. In order to limit the risks of their investments, they seek to promote a common **international governance framework**.

Cultural reasons

Some corporate governance guidance has been driven by **developments in the business environment** in local economies and the **response of the country's culture** to these. South Africa's King report, in particular, has stressed the influence of corporate governance on qualities that are fundamental to the South African culture. The US has used a strict regulatory approach, embodied in Sarbanes-Oxley, to achieve its ends.

Part (b)

Principles of corporate governance

The requirements of the corporate governance reports can be grouped under a number of headings relating to the principles with which they attempt to comply.

Ensuring integrity

A basic aim of all governance guidance has been to promote **ethical fair dealing by companies**. An important aspect has been stressing the role of directors in influencing the **culture**, **tone and core values** of the company.

Promotion of strategic objectives

Reports have sought to ensure **adherence to**, **and satisfaction of**, **the strategic objectives** of the organisation, thus aiding effective management. CIMA/IFAC guidance has stressed the need for analysis of how strategic decision-making and activities will **enhance performance**. This should be balanced with the **conformance** requirements of corporate governance reports.

Control of companies

Corporate governance regulations can be seen as creating a framework for the **control of multinational companies**, whose interests may not coincide with the national interests. Corporate governance provides a framework for enforcing **compliance with worldwide laws** on this sort of company.

Enhancing risk management

Corporate governance guidelines have promoted **risk management principles**, **especially financial**, **legal and reputation risks**. They have required **compliance with accepted good practice** in the jurisdiction in question, and **ensuring appropriate systems of control** are in place; in particular, systems for monitoring risk, financial control and compliance with the law.

Protection of shareholders

The corporate governance reports aim to **protect shareholders** in the same way that investors are protected who buy any other financial investment product, such as insurance or a pension.

Involvement of shareholders

As well as protecting shareholders, the governance recommendations are designed to **enhance shareholder involvement**, particularly institutional shareholder involvement, in companies. This is achieved by giving them **more details about company activities**, and improving proceedings at annual general meetings by recommending **votes on remuneration policy** and the **report and accounts**.

Protection of stakeholders

Corporate governance reports are also concerned with **fulfilling responsibilities to all stakeholders**. This includes **minimising potential conflicts of interest** between the owners, managers and wider stakeholder community, and **treating each category of stakeholder fairly**.

Establishment of accountability

Governance reports are designed to address the problem of **the over-mighty managing director by emphasising the role of the whole board in major decisions**, and a need for a **clear division of responsibilities** at the head of companies, so that one person does not enjoy unfettered power. It also means the **involvement of non-executive directors** through committees in delicate decisions such as recruitment to the board, and **remuneration** of executive directors.

Maintenance of effective scrutiny

Governance provisions have aimed to **ensure the independence** of those with **primary responsibility** for **scrutinising company activities**. This includes prescribing what constitutes, or what might **jeopardise, the independence** of non-executive directors. It also means **enhancing their position** by prescribing that a **certain number of directors be non-executive**.

Provision of accurate and timely information

Governance reports are designed to **complement developments in financial reporting guidance** by emphasising the need for accounts to present a **true and balanced picture of what is happening in the organisation**. They also emphasise the **importance of timely information** as an aid, enabling directors to supervise company activities better.

Answer to Self-test question 2

Non-executive directors

Business expertise

Non-executive directors can broaden the level of expertise on the board, which may be fairly limited.

Strategy

A non-executive director should be able to bring an independent viewpoint on strategy. A non-executive director may be more inclined to **challenge the strategy** of the board.

Performance scrutiny

A non-executive director can **scrutinise the work done by executive management** and monitor how performance is reported to the board. This will include whether the company is **developing reporting systems** that will be sufficient to provide the reliable information that will be required if it seeks and obtains a listing.

Risk

A non-executive director can also **review the reports on risks and risk management** that derive from the system established by the risk management function. The director will assess whether risks appear to be **adequately managed,** and also that the systems **fulfil the requirements** of **governance best practice** with which the company will have to comply if it obtains a listing.

Directors and management

The non-executive director can assess the performance of directors and managers, and can be responsible for advising on a remuneration structure that **fairly rewards the performance of directors**. He can also advise on what the **concerns of external shareholders** will be if the company seeks a listing and how management will best **demonstrate its accountability** to a new shareholder base.

Answer to Self-test question 3

GFE

Split of role of chairman and chief executive

Governance reports recommend that the roles of chief executive and chairman should be split between different individuals, to avoid there being an excessive concentration of power in the hands of one individual. At present, the chief executive is able to **manipulate the information** the board receives, to protect his position. It seems best for one of the existing NEDs to be appointed as chairman. Splitting the roles emphasises that the two jobs are distinct, with the **chief executive running the charity** and the **chairman running the board**. The chairman can ensure the chief executive is **accountable** for his actions, by for example, ensuring the board **has enough information** to exercise oversight of the chief executive.

Appointment of secretary

The board's functioning would be better if someone acted as company secretary. The secretary could undertake a number of tasks currently undertaken by the CEO, including **distributing board minutes** in advance of meetings and **briefing board members in relation to each agenda item**. This would free up the time of the CEO or chairman. The secretary should be accountable to the board collectively, and should, if necessary, have the **independence** to come into conflict with the CEO if the secretary believes it is in the interest of GFE.

More executive directors

The UK Higgs report commented that there is a greater risk of distortion or withholding of information, or lack of balance in the management contribution, when there is only one, or a very small number, of executives on t he board. GFE should consider appointing one or two more executive directors; for example, an operations director. This would also help with **succession planning**, and lead to a greater emphasis on **risk management** and **operational control** at board level.

Audit committee

Appointing a **separate audit committee** will enable the main board to concentrate more on strategic and operational matters, leaving the audit committee to undertake the **detailed financial review** that is a major part of current board meetings. The audit committee should also be **responsible for the appointment of auditors** and **liaison with them about further work, including a review of controls**. At present, the auditors' ability to exercise independent scrutiny could be questioned, since they have been appointed by the CEO. Governance reports recommend that all members of the committee should have sufficient financial expertise to contribute effectively, and that one member should have **relevant and recent financial experience**. New directors may therefore, need to be recruited to fulfil this requirement or existing members **receive training**.

Nomination committee

A nomination committee of NEDs would **oversee the appointment of the new directors** that GFE's board appears to need. The committee would also review other important issues of board functioning that have not been considered recently, such as:

- The **balance between executives and NEDs**
- Whether there are **gaps between the skills, knowledge and experience** possessed by the current board and what the board ideally should have
- The need to **attract board members from a variety of backgrounds**
- Whether GFE will need to pay **some NEDs** to attract the right candidates

Independent NEDs

Governance reports recommend that at least half the board are **independent NEDs**, without business or financial connections, who face re-election regularly. Independent NEDs will be particularly important for GFE as it is a charity, and stakeholders will rely on NEDs to provide unbiased scrutiny of how the executive directors are conducting its affairs. It is possible that none of the current NEDs can be classed as independent, since they have all been appointed on the basis of previous business connections.

Expert NEDs

NEDs with **experience of the charity sector** need to be appointed. The reason given for not discussing operational matters, that these are outside the directors' experience, indicates that as a body, the NEDs have **insufficient expertise** at present. The CEO's belief that the executive management team is more than capable of managing the delivery of the in-home care services misses the point. NEDs should **scrutinise**, and if necessary **challenge**, the way the CEO is running operations, drawing on their own experience.

Stakeholder representation

There appears to be a **lack of stakeholder representation** on the board; with fund providers, volunteer helpers and users of GFE's services not being represented. Having a user representative on the board would mean that the board received **direct feedback on the effectiveness of the charity's activities**. Stakeholder representatives could also **provide feedback** to the stakeholders they represent on the reasoning behind board decisions and GFE's current strategy.

Changes in board membership

It seems that new NEDs need to be appointed to provide the **expertise and independence** the board is currently lacking. Corporate governance reports recommend that the board should not be so large as to be unwieldy; therefore, some of the new board members may have to replace existing board members.

CHAPTER 7

Business risk management

Introduction

Topic List

1 Business risks

2 Enterprise risk management

3 Risk management responsibilities

4 Stakeholders and risk

5 Risk assessment

6 Risk response

Summary and Self-test

Technical reference

Answers to Interactive questions

Answers to Self-test

Introduction

Learning objectives

	Tick off
• Analyse and evaluate the key types of business risks and assess their implications within a given scenario, for business strategy and corporate reporting disclosures	☐
• Advise on the risks involved in business and organisational plans and show how these risks can be managed by assurance procedures and other forms of risk mitigation	☐
• Assess and explain enterprise risk management, evaluating its framework and its benefits	☐
• Explain the responsibility of those charged with governance for managing risk and assess the role of assurance in risk mitigation	☐
• Assess the impact of risk on a variety of stakeholders	☐
• Explain and assess the various steps involved in constructing a business risk management plan by establishing context, identifying risks and the assessment and quantification of risks	☐
• Using data provided, analyse quantitatively business risks under a range of complex scenarios	☐
• Evaluate and explain the limitations of business risk management	☐

Knowledge brought forward

Business Strategy covered the risk assessment and management process and we revise the main stages briefly in Sections 5 and 6.

Syllabus links

A key point about the enterprise risk management process discussed here is its strong links to the strategy setting process that we have already touched upon in earlier chapters.

Examination context

If you have to analyse business decisions or situations, the assessment may well include identification and evaluation of risks. You may need to make recommendations about risk management, either dealing with specific risks or recommending an overall framework that is appropriate for the business.

1 Business risks

Section overview

- Risk, and internal management's attitude towards it, has a considerable bearing on the way in which different organisations conduct their business – that is, their business strategy.
- The risk of an organisation, whether genuine or perceived, has a direct effect on a firm's cost of capital, the rates of interest it pays on its loans, and therefore, the types of projects it can pursue.

1.1 Risk and uncertainty

Risk and uncertainty must always be taken into account in strategic planning. Many areas of risk and uncertainty are exogenous – that is, outside the control of the organisation.

1.1.1 Risk

Risk is sometimes used to describe situations where outcomes are not known, but their probabilities can be estimated. (This is the underlying principle behind insurance.)

1.1.2 Uncertainty

Uncertainty is present when the outcome cannot be predicted or assigned probabilities. For example, many insurance companies exclude 'war damage, riots and civil commotion' from their insurance cover.

1.2 Risk and business

Risk is bound up with doing business. The basic principle is that 'you have to speculate to accumulate.'

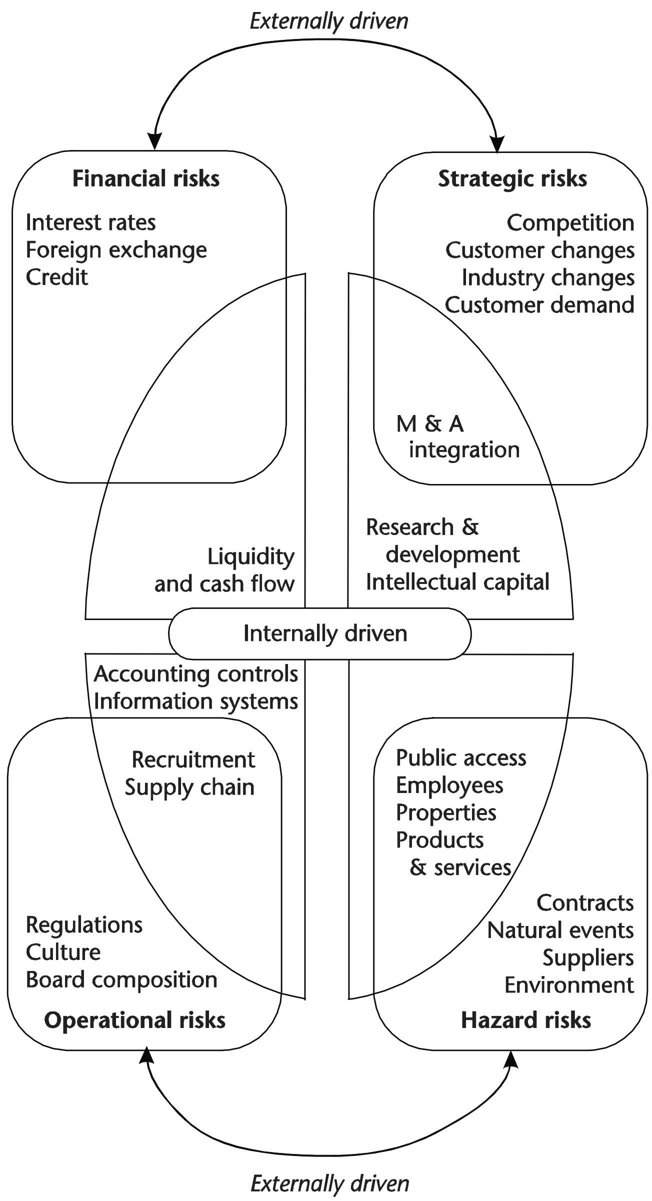
It may not be possible to eliminate risks without undermining the whole basis on which the business operates, or without incurring excessive costs and insurance premiums. Therefore, in many situations, there is likely to be a level of residual risk that is simply not worth eliminating.

There are some benefits to be derived from the management of risk, possibly at the expense of profits such as:

- Predictability of cash flows
- Limitation of the impact of potentially bankrupting events
- Increased confidence of shareholders and other investors

However, boards should not just focus on managing negative risks, they should also seek to limit uncertainty and to manage speculative risks and opportunities in order to maximise positive outcomes and hence, shareholder value.

In its *Risk Management Standard*, the Institute of Risk Management linked key value drivers for a business with major risk categories.



Risk drivers

Figure 7.1: The links between value drivers and risk categories

[Source: Institute of Risk Management – *A Risk Management Standard*]

1.3 Risk and managers

It is worth noting that shareholders and managers have different approaches to risk.

- Shareholders can spread risk over a number of investments.
- Managers' careers tend to be bound up with the success or failure of one particular company, so managers are therefore likely to be more risk-averse than shareholders might be.

1.4 Risk appetite

Since risk management is bound up with strategy, how organisations deal with risk will not only be determined by events and the information available about events, but also by **management perceptions or appetite** to take risk. These factors will also influence risk **culture**, the values and practices that influence how an organisation deals with risk in its day-to-day operations.

1.4.1 Personal views

Surveys suggest that managers acknowledge the **emotional satisfaction** from successful risk-taking, although this is unlikely to be the most important influence on appetite.

1.4.2 Response to shareholder demand

Shareholders demand a level of return that is consistent with taking a certain level of risk. Managers will respond to these expectations by viewing risk-taking as a key part of decision-making.

1.4.3 Organisational influences

Organisational influences may be important, and these are not necessarily just a response to shareholder concerns. Organisational attitudes may be influenced by **significant losses** in the past, **changes in regulation and best practice**, or even **changing views** of the benefits that risk management can bring.

1.4.4 National influences

There is some evidence that national culture influences attitudes towards risk and uncertainty. Surveys suggest that attitudes to risk vary nationally according to how much people are shielded from the consequences of adverse events.

1.4.5 Cultural influences

Adams argued that there are four viewpoints that are key determinants in how risks are viewed.

Viewpoints	Features
Fatalists	Think they have no control over their own lives and hence, risk management is pointless
Hierarchists	Most likely to exist in a bureaucratic organisation, with formal structures and procedures. Will emphasise risk reduction through formal risk management procedures
Individualists	Seek to control their environment rather than let their environment control them. Often found in small, single-person dominated, organisations with less formal structures, and hence, risk management too will be informal, if indeed it is considered at all
Egalitarians	Loyal to groups but have little respect for procedures. Often found in charities and public sector, non-profit making activities, prefer sharing risks as widely as possible, or transfer of risks to those best able to bear them

1.5 Risk appetite and attitudes

Definitions

Risk appetite is the nature and strengths of risk that an organisation is prepared to bear.

Risk attitude is the directors' views on the level of risk that they consider desirable.

Risk capacity describes the nature and strengths of risk that an organisation is able to bear.

Different businesses will have different attitudes towards taking risk.

Risk-averse businesses are **not** businesses that are seeking to avoid risks. They are businesses that are seeking to obtain sufficient returns for the risks they take. Risk-averse businesses may be willing to **tolerate risks up to a point**, provided they receive an **acceptable return**, or if risk is 'two-way' or symmetrical, that it has both positive and negative outcomes. Some risks may be an unavoidable consequence of operating in a particular business sector. However, there will be upper limits to the risks they are prepared to take whatever the level of returns they can earn.

Risk-seeking businesses are likely to focus on maximising returns and may not be worried about the level of risks that have to be taken to maximise returns (indeed, their managers may thrive on taking risks).

Whatever the viewpoint, a business should be concerned with reducing risk where possible and necessary, but not eliminating all risks, whilst managers try to **maximise the returns** that are possible, given the levels of risk. Most risks must be managed to some extent, and some should be eliminated as being outside the business. Risk management under this view is an integral part of **strategy**, and involves analysing what the **key value drivers are** in the organisation's activities, and the risks tied up with those value drivers.

For example, a business in a high-tech industry, such as computing, which evolves rapidly within ever-changing markets and technologies, has to accept high risks in its research and development activities, but should it also be speculating on interest and exchange rates within its treasury activities?

Another issue is that organisations that seek to **avoid risks** (for example, public sector companies and charities) do not need the elaborate and costly control systems that a risk-seeking company may have. However, businesses such as those that trade in derivatives, volatile share funds or venture capital companies, need complex systems in place in order to monitor and manage risk.

1.6 Conformance and performance

The International Federation of Accountants (IFAC) has highlighted two aspects of risk management which can be seen as linking in with risk aversion and risk seeking.

(a) **Conformance** focuses on controlling pure (only downside) strategic risks. It highlights compliance with laws and regulations, best practice governance codes, fiduciary responsibilities, accountability and the provision of assurance to stakeholders in general. It also includes ensuring the effectiveness of the risk analysis, management and reporting processes, and that the organisation is working effectively and efficiently to achieve its goals.

(b) **Performance** focuses on taking advantage of opportunities to increase overall returns within a business. It includes policies and procedures that focus on alignment of opportunities and risks, strategy, value creation and resource utilisation, and guides an organisation's decision-making.

IFAC guidance states that risk management should seek to **reconcile performance and conformance** – the two enhance each other. Case studies and surveys commissioned by IFAC have shown that many people believe that organisations focus too much on compliance, and not enough on strategy and building a business.

Interactive question 1: Nature and extent of risks [Difficulty level: Intermediate]

In the context of a major confectionery and non-alcoholic beverage company, identify the nature and potential extent of **six** risks that the company might face. (These risks should be specific to the industry in question.)

See **Answer** at the end of this chapter.

1.7 Sources of risk

1.7.1 Sources of risk and uncertainty

Risk	Comment
Physical	Earthquakes, fire, flooding, equipment breakdown. In the long term, climatic changes: global warming, drought (relevant to water firms).
Economic	Assumptions about the economic environment may be incorrect. Not even the government forecasts are always correct.
Business	Lowering of entry barriers (eg new technology); changes in customer/supplier industries, leading to changed relative power; new competitors and factors internal to the firm (eg culture); management misunderstanding of core competences; volatile cash flows; uncertain returns; changed investor perceptions, increasing the required rate of return.
Product life cycle	Different risks exist at different stages of the life cycle.
Political	Nationalisation, sanctions, civil war, political instability – all of these can have an impact on the business.

Risk	Comment
Financial	Can be affected by changes in interest rates, economic climate, gearing, bad debt risk, liquidity, insolvency.
Reputation	Loss of reputation caused by the adverse consequences of another risk. The loss of reputation will be usually perceived by external stakeholders, and may have serious consequences, depending on the strength of the organisation's relationship with them.

Case example: GlaxoSmithKline – disclosure of key risks

In its 2012 annual report, GlaxoSmithKline (GSK) – one of the world's largest pharmaceutical companies – identified a number of key risks that may have a significant impact on business performance and ultimately, the value of shareholders' investment in the company.

'There are risks and uncertainties relevant to the Group's business, financial condition and results of operations that may affect the Group's performance and ability to achieve its objectives. The factors below are among those that the Group believes could cause its actual results to differ materially from expected and historical results:

- Risk that R & D will not deliver commercially successful new products
- Risks of failing to secure and protect intellectual property rights, including failure to obtain effective intellectual property protection and expiry of intellectual property rights protection
- Risk to patient or consumer as a result of the failure by GSK, its contractors or suppliers, to comply with good manufacturing practice regulations in commercial manufacturing or through inadequate governance of quality through product development
- Risk of interruption of product supply
- Risk that the Group may fail to secure adequate pricing/reimbursement for its products or existing regimes of pricing laws and regulations become more unfavourable
- Risks arising from non-compliance with laws and regulations affecting the Group
- Risk of exposure to various external political and economic conditions, as well as natural disasters, that may impact the Group's performance and ability to achieve its objectives
- Risks from alliances and acquisitions, including risk of assuming significant debt, becoming subject to unknown or contingent liabilities, failing to realise expected benefits and problems with integration
- Risk associated with financial reporting and disclosure and changes to financial reporting standards, including having to account for changes in market valuation of certain financial instruments before gains/losses are realised and volatility from deferred tax on inter-company inventory
- Risk that as the Group's business models change over time, the Group's existing tax policies and operating models will no longer be appropriate, or that significant losses arise from treasury investments
- Risk of failing to create a corporate environment opposed to corruption or failing to instil business practices that prevent corruption and comply with anti-corruption legislation
- Risk of substantial adverse outcomes of litigation and government investigations. Key areas of concern include product liability, anti-trust and sales and marketing litigation
- Risk of ineffectively managing environment, health, safety and sustainability objectives and requirements
- Risk from Group's sales of products to a small number of wholesalers (large exposure to credit risks)
- Risk of exposing business critical or sensitive data due to inadequate data governance or information systems security'

Later in this chapter, we shall examine the ways in which GlaxoSmithKline manages these risks.

1.7.2 Strategic risks

Definition

Strategic risk: Potential volatility of profits caused by the nature and type of the business's activities.

The most significant risks are focused on the **strategy** the organisation adopts, including concentration of resources, mergers and acquisitions and exit strategies. The market segments that the business chooses will be a significant influence. These will have major impacts on **costs, prices, products and sales,** and also the **sources of finance** used. Risks are likely to be greatest for those in start-up businesses or cyclical industries. However, perhaps the most notable victim of the credit crunch over the last few years, Lehman Brothers, was not immune to business risks, even after 158 years of operating.

Organisations also need to guard against the risks that **business processes and operations** are **not aligned** to **strategic goals**, or are disrupted by events that are not generated by business activities.

Strategic risks can usefully be divided into:

- Threats to profits, the magnitude of which depends on the decisions the organisation makes about the products and services it supplies
- Threats to profits that are not influenced by the products or services the organisation supplies.

Risks to products and services include long-term **product** obsolescence. **Changes in technology** also have long-term impacts if they change the production process. The significance of these changes depends on how important technology is in the production processes. Long-term **macroeconomic changes**, for example a worsening of a country's exchange rate, are also a threat.

Non-product threats include risks arising from the long-term **sources of finance** chosen and risks from a collapse in trade because of an **adverse event**, an accident or natural disaster.

1.7.3 Operational risks

Definition

Operational risk: The risk of loss through a failure of business and internal control processes.

Operational risks include:

- Losses from internal control systems or audit inadequacies
- Non-compliance with regulations or internal procedures
- Information technology failures
- Human error
- Loss of key-person risk
- Fraud
- Business interruptions

The main difference between strategic and operational risks is that strategic risks relate to the organisation's **longer-term** place in, and relations with, the **outside environment**. Although some of them relate to internal functions, they are internal functions or aspects of internal functions that have a **key bearing** on the organisation's situation in relation to its environment. Operational risks are what could go wrong on a **day-to-day basis**, and are not generally very relevant to the key strategic decisions that affect a business, although some (for example, a major disaster) can have a major impact on the business's future.

You may also think that as strategic risks relate primarily to the outside environment that is not under the organisation's control, it is more difficult to mitigate these risks than it is to deal with the risks that relate to the internal environment, which is under the organisation's control.

Many risk categories include strategic and operational risks.

(a) For example, the **legal risk of breaching laws in day-to-day activities** (for example, an organisation's drivers exceeding the speed limit) would be classed as an **operational risk**. However, the legal risk of stricter health and safety legislation forcing an organisation to make changes to its production processes would be classed as a **strategic risk,** as it is a long-term risk impacting seriously on the way the business produces its goods.

(b) The same is true of information technology risks. The risks of a **system failure, resulting in a loss of a day's data** would clearly be an **operational risk**. However, the risks from using **obsolete technology** would be a **strategic risk**, as it would affect the organisation's ability to compete with its rivals.

1.8 Business risk and financial risk

1.8.1 Business risk

Business risk, as the name suggests, is the risk associated with the day-to-day operations of a particular company. It relates to the variability of operating cash flows, the company's exposure to markets, competitors, exchange rates and so on. It is part of the company's overall systematic (or undiversifiable) risk.

Case example: Clinton Cards

Strategic risks are risks that relate to the fundamental decisions that the directors take about the future of the organisation. These can include adopting the wrong strategy at the wrong time or failing to adopt the right strategy quickly enough.

In May 2012, Clinton Cards, the high street chain specialising in greeting cards, was forced to go into administration. Although aggressive tactics by its principal supplier, American Greetings, precipitated its failure, it was also a consequence of the increasing pressure that Clinton had come under from supermarkets and online retailers, such as Funky Pigeon and Moonpig, that sell personalised on-line greetings cards.

At one stage, Clinton owned 1,145 shops and controlled 25% of the greetings card market. However, it rapidly declined from a pre-tax profit of £24.1m in 2009 to a loss of £10.6m in 2011. Clinton failed to adapt quickly enough to the demand for e-cards, relying for too long on the belief that most people preferred sending and receiving real cards in the post. By the time it launched its own e-card business, it was up against firmly established rivals such as Moonpig. Clinton also relied on a large high street presence, reinforcing it by buying up high street rival, Birthdays. Its logic was that cards were a secondary purchase and it therefore had to be where shoppers went. Again however, it failed to realise the implications of increased online shopping early enough and kept expanding for too long. The result was a £80m a year rental bill.

Nevertheless, there still appeared to be some life in the model Clinton followed. Ironically, a subsidiary of American Greetings acquired the brand, assets and about half the stores that were still open in June 2012.

1.8.2 Financial risk

Financial risk can be seen from different points of view:

- **The company as a whole**. If a company borrows excessively, it may have insufficient funds to meet interest and capital repayments, which may eventually force it into liquidation.
- **Lenders**. If a company to whom money has been lent goes into liquidation, lenders may not be paid in full. Companies considered to be a risky investment will be charged higher rates of interest to compensate lenders for the possibility of default.
- **Ordinary shareholders**. This group is at the bottom of the list for payment in the event of a company winding up. The lower the profits, and the higher the level of gearing, the greater the risk that is faced by ordinary shareholders.

1.8.3 Relationship between business and financial risk

Business risk is borne by both the firm's equity holders and providers of debt, as it is the risk associated with investing in the firm in whatever capacity. The only way that either party can get rid of the business risk is to withdraw its investment in the firm.

Financial risk, on the other hand, is borne entirely by equity holders, payment to debt holders (ie interest) taking precedence over dividends to shareholders. The more debt there is in the firm's capital structure, the greater the financial risk to equity holders as the increased interest burden coming out of earnings reduces the likelihood that there will be sufficient funds remaining from which to pay a dividend. Debt holders know there is a legal obligation on the firm to meet their interest commitments.

Case example: Thomas Cook

A key risk highlighted in Thomas Cook's 2011 annual report was a reduction in demand for products and services due to the downturn in the global economy. Thomas Cook combated this risk by using a flexible and asset-light business model. Its features included aircraft operating leases with staggered maturity profiles, minimisation of committed hotel capacity, being able to make changes in capacity late in the booking season and tight cost discipline.

1.9 Continuous v event risk

Continuous risk as the name suggests, is risk that companies face all the time, simply by virtue of being in business. Multinationals, for example, face the continuous risk of foreign currencies moving in the wrong direction and the political risks of operating in different countries. These risks must be continuously monitored as part of the company's general risk management policy.

Event risk is the risk of suffering excessive financial losses due to severe and sudden shocks arising from, for example, human error, natural disasters or stock market crashes. Event risks are difficult to predict but once these events have happened, there will be inevitable consequences, such as liquidity problems. Event risk is often characterised by contagion – that is, one event can precipitate other events whose effects spread across markets and end up affecting everyone. Companies can prepare for event risk by carrying out regular stress testing, which involves generating credible worst-case scenarios that show how particular events could affect all relevant markets. It is essential for companies to have crisis management processes in place, covering such crucial areas as communication and leadership.

Case example: Texas fertiliser plant disaster

An explosion and fire at a Texas fertiliser plant in April 2013 killed 15 people and injured at least 160 in what appeared to be the worst US industrial disaster since the 2010 Upper Big Branch mine accident in West Virginia.

A fire tore through the facility, sparking an explosion that destroyed dozens of homes in the 2,700-person town of West, 80 miles south of Dallas and 20 miles north of Waco.

West Fertilizer is an anhydrous ammonia facility, a spokesman for the Texas Department of Public Safety said .The gas is used to make nitrogen fertiliser, which is applied by farmers directly to the soil to boost crop yields.

The plant, owned by Adair Grain which is also based in the town of West, was fined $2,300 by the Environmental Protection Agency (EPA) in 2006 for **failing to have a risk management plan that met federal standards**, records show.

According to the EPA website a risk management plan 'includes an executive summary, registration information, off-site consequence analysis, five-year accident history, prevention program and emergency response program.'

In a statement about the incident, President Barack Obama said: 'A tight-knit community has been shaken, and good, hard-working people have lost their lives.'

Source: FT.com, April 18, 2013

Case example: The global credit crunch

A credit crunch is a crisis caused by banks being too nervous to lend money to customers or to each other. When they do lend, they will charge higher rates of interest to cover their risk.

One of the first obvious high-profile casualties of the recent global credit crisis was New Century Financial – the second largest sub-prime lender in the United States – which filed for Chapter 11 bankruptcy in early 2007. By August 2007, credit turmoil had hit financial markets across the world.

In September 2007 in the UK, Northern Rock applied to the Bank of England for emergency funding after struggling to raise cash. This led to Northern Rock savers rushing to empty their accounts as shares in the bank plummeted. In February 2008, the UK Chancellor of the Exchequer, Alistair Darling, announced that Northern Rock was to be nationalised.

Years of lax lending on the part of the financial institutions inflated a huge debt bubble as people borrowed cheap money and ploughed it into property. Lenders were quite free with their funds – particularly in the US, where billions of dollars of 'Ninja' mortgages (no income, no job or assets) were sold to people with weak credit ratings (sub-prime borrowers). The idea was that if these sub-prime borrowers had trouble with repayments, rising house prices would allow them to remortgage their property. This was a good idea when US Central Bank interest rates were low – but such a situation could not last. In June 2004, following an interest rate low of 1%, rates in the US started to climb and house prices fell in response. Borrowers began to default on mortgage payments and the seeds of a global financial crisis were sown.

The global crisis stemmed from the way in which **debt was sold on to investors**. The US banking sector packaged sub-prime home loans into mortgage-backed securities known as **collateralised debt obligations** (CDOs). These were sold on to hedge funds and investment banks that saw them as a good way of generating high returns. However, when borrowers started to default on their loans, the value of these investments plummeted, leading to huge losses by banks on a global scale.

In the UK, many banks had invested large sums of money in sub-prime backed investments and have had to write off billions of pounds in losses. On 22 April 2008, the day after the Bank of England unveiled a £50 billion bailout scheme to aid banks and ease the mortgage market, Royal Bank of Scotland (RBS) admitted that loan losses had hit £1.25 billion in just six weeks. In August 2008, RBS reported a pre-tax loss of £691 million (after writing down £5.9 billion on investments hit by the credit crunch) – one of the biggest losses in UK corporate history. At the beginning of 2009, RBS announced that it expected to suffer a loss of up to £28 billion as a result of the credit crunch. On 3 March 2008, it was reported that HSBC was writing off sub-prime loans at the rate of $51 million per day.

A number of critics went back to basics and highlighted lending by banks to customers who could not supply sufficient assurance that they could repay debt. To quote Paul Moore, former Head of Group Regulatory Risk at HBOS:

> *There must have been a very high risk if you lend money to people who have no jobs, no provable income and no assets. If you lend that money to buy an asset which is worth the same or even less than the amount of the loan and secure that loan on the value of that asset purchased, and then assume that asset will always continue to rise in value, you must be pretty much close to delusional.*

Some critics have focused on the doubtful quality of the CDOs and other investments. These products appear to have been imperfectly understood by many in the financial sector. However, they created positions in the trading books of banks that were hugely vulnerable to shifts in confidence and liquidity.

Others have focused on the increasing complexity in the financial sector caused by the variety of the securities sold. The 2009 Turner report highlighted a complex chain of relationships between multiple institutions. However, the results were that, 'most of the risks (were still left) somewhere on the balance sheets of banks but in a much more complex and less transparent fashion.' Turner also highlighted the growth of the relative size of the financial sector, accompanied by very high growth in the debt and leverage of financial institutions, which increased the impact of financial sector instability on the real economy.

Other experts highlighted the role of governance. The 2009 Walker report commented that, 'why different banks operating in the same geography, in the same financial and market environment and under the same regulatory arrangements generated such massively different outcomes can only be fully explained in terms of differences in the way they were run.'

In June 2010, the Independent Commission on Banking in the UK (the Vickers Commission, chaired by economist Sir John Vickers) was set up by the incoming Coalition government. It produced its final report in September 2011. The report recommended that UK banks' domestic retail operations (operations concerned with customer deposits, business lending and the transmission of money) should be ring-fenced from their wholesale and investment operations. Retail banking activities should be carried out by separate subsidiaries within banking groups, with the ring-fenced part of the bank having its own board and being legally and operationally separate from the parent bank. Ring-fenced banks should have a capital cushion of up to 20%.

Non-retail parts of banking groups should be allowed to fail. The report anticipated that this would mean that their cost of capital went up. However, the lack of guaranteed government support for investment activities should mean that banks were less likely to take excessive risks in this area.

Banks were given until 2019 to implement these requirements fully, a period felt by some commentators to be very lengthy. The time period was set to coincide with the international capital requirements changes being introduced by the Basel regulators.

In May 2012, the UK government set out details of a banking reform bill, giving the UK Treasury the power to ring-fence the retail operations of large banks from their investment divisions, and to ensure that depositors recover their money before unsecured creditors if a bank becomes insolvent.

1.10 Managing risk in business strategy and financial strategy

Traditionally, management teams tend to be risk-averse – that is, they prefer less risk and are prepared to take steps to reduce any potential risks arising from either being in business in general or from specific projects that the company undertakes. The objective of risk management is ultimately to have procedures in place that will reduce these risks to a level that is acceptable to the company and its shareholders. However, setting up and maintaining these procedures takes time, money and human resources, all of which are limited within any organisation.

Case example: Tesco

Tesco has the following approach to interest rate and foreign currency risk management.

> *'Interest rate risk management – Our objective is to limit our profit and loss downside from rising interest rates. Forward rate agreements, interest rate swaps, caps and floors are used to achieve the desired mix of fixed and floating rate debt.'*
>
> *'Our policy is to fix interest rates for the year on a minimum of 40% of actual and projected debt interest costs of the Group excluding Tesco Bank. At the year end £6.2 billion of debt was at fixed rates of interest. This equates to 91% of total debt... Potential exposures to interest rate movements in the medium to long term are measured and controlled through position and sensitivity limits. Short-term exposures are measured and controlled in terms of net interest income sensitivity over 12 months to a 1% parallel movement in interest rates.'*
>
> *'Foreign currency risk management – Our principal objective is to reduce the effect of exchange rate volatility on operating margins. Transactional currency exposures……are managed, typically using forward purchases or sales of foreign currencies and currency options......we do not actively hedge our investment in our international subsidiaries other than by ensuring that each subsidiary is appropriately leveraged…'*

Tesco's treasury function manages its financial risks. It has clear policies and parameters. It does not operate as a profit centre and is not allowed to undertake speculative transactions.

Source: Tesco Annual Report and Financial Statements, 2011

1.11 Corporate reporting consequences

The risks businesses face and the judgements made about those risks, may have a number of consequences for financial reporting.

- Under IAS 10, *Events after the reporting period*, a business's view of risks will help determine which events are disclosed. Thus, for example, if there are significant exchange rate movements that could result in a risk of material foreign exchange losses, these movements would need to be disclosed.
- Part of risk assessment is an analysis of the external business environment, including economic, technological and legal aspects. Adverse changes that are identified may not only require risk management action to be taken, they may also provide evidence of loss of value of assets that needs to be accounted for under the provisions of IAS 36, *Impairment of assets*.
- Risk assessment is significant in a number of ways when applying the requirements of IAS 37, *Provisions, Contingent Liabilities and Contingent Assets*. IAS 37 requires that a transfer of resources embodying economic benefits, needs to be assessed as probable, if a provision is to be made. In addition, if the amount of the transfer may be affected by future events, then these should influence how much provision is made, if they are reasonably expected to occur. Allowance is to be made for uncertainty when the amount of a provision is calculated, so that if there are a large number of possible outcomes, the provision is estimated based on its **expected value**, by weighting outcomes with associated probabilities. If risk assessments are revised subsequently, then the amount of the provision may need to be revised as well.

2 Enterprise risk management

Section overview

- Enterprise risk management provides a coherent framework for organisations to deal with risk, based on such components as internal environment, objective setting and event identification.
- The framework is designed to identify potential events that may affect the entity and manage risks to be within its risk appetite.

2.1 Nature of enterprise risk management

Definition

Enterprise risk management (ERM) is a process, effected by an entity's board of directors, management and other personnel, applied in strategy setting and across the enterprise, designed to identify potential events that may affect the entity and manage risks to be within its risk appetite, in order to provide reasonable assurance regarding the achievement of entity objectives.

(Committee of Sponsoring Organisations of the Treadway Commission (*COSO*))

The Committee of Sponsoring Organisations of the Treadway Commission (COSO) goes on to expand its definition. It states that enterprise risk management has the following characteristics.

(a) It is a **process**, a means to an end, which should ideally be intertwined with existing operations and exist for fundamental business reasons.

(b) It is operated by **people at every level** of the organisation and is not just paperwork. It provides a mechanism for helping people to understand risk, their responsibilities and levels of authority.

(c) It is applied in **strategy setting**, with management considering the risks in alternative strategies.

(d) It is applied **across the enterprise**. This means it takes into account activities at all levels of the organisation, from enterprise-level activities such as strategic planning and resource allocation, to business unit activities and business processes. It includes taking an entity level portfolio view of risk. Each unit manager assesses the risk for his unit. Senior management ultimately consider these unit risks and also **interrelated risks**. Ultimately, they will assess whether the overall risk portfolio is consistent with the organisation's risk appetite.

(e) It is designed to **identify events** potentially affecting the entity and manage risk within its **risk appetite**, as well as the amount of risk it is prepared to accept in pursuit of value. The risk appetite should be aligned with the desired return from a strategy.

(f) It provides **reasonable assurance** to an entity's management and board. Assurance can, at best, be reasonable, since risk relates to the uncertain future.

(g) It is geared to the **achievement of objectives** in a number of categories, including supporting the organisation's mission, making effective and efficient use of the organisation's resources, ensuring reporting is reliable, and complying with applicable laws and regulations.

As these characteristics are broadly defined, they can be applied across different types of organisations, industries and sectors. Whatever the organisation, the framework focuses on **achievement of objectives**.

An approach based on **objectives** contrasts with a **procedural approach** based on rules, codes or procedures. A procedural approach aims to eliminate or control risk by requiring conformity with the rules. However, a procedural approach cannot eliminate the possibility of risks arising because of poor management decisions, human error, fraud or unforeseen circumstances arising.

2.2 Framework of enterprise risk management

The COSO Framework consists of eight interrelated components.

- Objective setting
- Event identification
- Risk assessment
- Risk response
- Internal environment or control environment
- Control activities or procedures
- Information and communication
- Monitoring

Case example: Enterprise risk management

Different commentators have developed guidance on enterprise risk management in different ways.

Ernst and Young identified six components of risk management:

- Risk strategy
- Risk management processes
- Appropriate culture and capability
- Risk management functions
- Enabling technologies
- Governance

Ernst and Young suggests that risk management should focus on what shareholders consider to be vital for the business. Companies should establish what shareholders think affects company value, link risks to value drivers, determine shareholders' preferred treatment of risks and communicate what the company is doing.

2.3 Benefits of enterprise risk management

COSO highlights a number of advantages of adopting the process of enterprise risk management.

Alignment of risk appetite and strategy	The framework demonstrates to managers the need to consider risk toleration. They then set objectives aligned with business strategy and develop mechanisms to manage the accompanying risks. This will help to ensure that risk management becomes part of the culture of the organisation, embedded into all its processes and activities.
Link growth, risk and return	Risk is part of value creation, and organisations will seek a given level of return for the level of risk tolerated.
Choose best risk response	Enterprise risk management helps the organisation select whether to reduce, eliminate or transfer risk.
Minimise surprises and losses	By identifying potential loss-inducing events, the organisation can reduce the occurrence of unexpected problems.
Identify and manage risks across the organisation	The Framework means that managers can understand and aggregate connected risks. It also means that risk management is seen as everyone's responsibility. Experience and practice is shared across the business and a common set of tools and techniques is used.
Provide responses to multiple risks	For example, risks associated with purchasing, over- and under-supply, prices and dubious supply sources might be reduced by an inventory control system that is integrated with suppliers.
Seize opportunities	By considering events as well as risks, managers can identify opportunities as well as losses.
Rationalise capital	Enterprise risk management allows management to allocate capital better and make a sounder assessment of capital needs.

2.4 Criticisms of enterprise risk management

There have been some criticisms made of COSO's framework:

(a) **Internal focus**

One criticism of the ERM model has been that it starts at the wrong place. It begins with the internal and **not the external environment**. Critics claim that it does not reflect sufficiently the impact of the competitive environment, regulation and external stakeholders on risk appetite and management and culture.

(b) **Risk identification**

The ERM model has been criticised for discussing risks primarily in terms of **events,** particularly sudden events with major consequences. Critics claim that the guidance insufficiently emphasises slow changes that can give rise to important risks, for example, changes in internal culture or market sentiment.

(c) **Risk assessment**

The ERM model has also been criticised for encouraging an **over-simplified approach to risk assessment**. It has been claimed that the ERM encourages an approach which thinks in terms of a single outcome of a risk materialising. This outcome could be an expected outcome or it could be a worst-case result. Many risks will have a range of possible outcomes if they materialise, for example, extreme weather, and risk assessment needs to consider this range.

(d) **Stakeholders**

The guidance fails to discuss the **influence of stakeholders**, although many risks that organisations face are due to a conflict between the organisation's objectives and those of its stakeholders.

2.5 Risk architecture

In its 1999 report, *Enhancing Shareholder Wealth by Better Managing Business Risk*, the International Federation of Accountants argued for the development of a **risk architecture** within which risk management processes could be developed. The architecture involves designing and implementing **organisational structures**, **systems** and **processes to manage risk**. This is a slightly different framework to that of enterprise risk management.

IFAC argued that developing a risk architecture is not just a response to risk but marks an organisational shift, changing the way the organisation:

- Organises itself
- Assigns accountability
- Builds risk management as a core competency
- Implements continuous, real-time risk management

Best practice, IFAC argued, is to develop a highly integrated approach to risk management, using a common language, shared tools and techniques and periodic assessments of the risk profile for the entire organisation. Integration is particularly important when most units have **many risks in common**, and when there is **significant interdependency** between units. It is vital when managers are trying to achieve a **shared corporate vision**.

The risk architecture developed by IFAC has eight components:

- Acceptance of a risk management framework
- Commitment from executives
- Establishment of a risk response strategy
- Assignment of responsibility for risk management process
- Resourcing
- Communication and training
- Reinforcing risk cultures through human resources mechanisms
- Monitoring of the risk management process

IFAC identified four components of risk management:

- **Structure** – To facilitate the identification and communication of risk

- **Resources** – Sufficient to support implementation
- **Culture** – Reinforcing decision-making processes
- **Tools and techniques** – Developed to enable organisation-wide management of risk

2.6 The Turnbull report

The UK Turnbull report (published 1999, revised 2005) aims to provide guidance on risk management and control systems to supplement the broad outlines set out in the Combined Code (now the UK Corporate Governance Code). Turnbull emphasises the importance of the **evolution** of a system of internal control to take account of new and emerging risks, control failures, market expectations or changes in the company's circumstances or business objectives. Evolution requires regular and systematic assessment of the risks facing the business.

2.7 Risk resourcing

Whatever the division of responsibilities for risk management, the organisation needs to think carefully about how risk management is resourced; sufficient resources will be required to implement *and* monitor risk management (including the resources required to obtain the necessary information). Consideration will be given not only to the **expenditure** required, but also the human resources in terms of **skills and experience**.

Case example: Intercontinental Hotel Group (IHG)

IHG's risk report in its annual report describes the elements of its approach to enterprise risk management:

- **Policies and standards** – Formal documentation of the approach, controls and actions for IHG employees when dealing with specific risks. These set out accountability for risks, relevant roles and responsibilities and actions that are measurable or auditable
- **Ways of working** – Practical aspects of risk management such as tools, templates, systems, forums and behaviours, which help management bring the policies and standards to life
- **Training and communication** – Face-to-face and online learning programmes to provide appropriate skills and knowledge, and regular communication to raise awareness
- **Operate and control** – Ongoing operational activities and control measures to comply with policies and standards, and to manage risk
- **Risk financing** – Consideration of the financial impact of risks and ensuring that arrangements are in place – usually insurance coverage or budgetary funds
- **Monitor and report** – The collection and analysis of management information to evaluate the effectiveness of the risk profile, policies and standards, ways of working, training and communications and risk financing activities

3 Risk management responsibilities

Section overview

- This section discusses the underlying features of risk and control systems.
- Consideration of risk issues should be an integral part of board agendas.
- The board's risk committee and the risk management function are also key players in managing risk.
- There are various methods that can be used to promote awareness of risk and control issues within a company.
- The Turnbull report stresses the importance of embedding risk management and control systems within business processes.

3.1 Board responsibilities

As we saw in Chapter 6, if effective risk management is to be embedded within a company, the board must oversee its establishment.

The Walker report in 2009 highlighted that the monitoring role of the board in financial sector institutions was particularly important because of the speed and scale of change in this sector:

'The whole board needs to be attentive to developments in the risk space to a degree far exceeding that in non-financial business.'

Ownership of the risk management and internal control system is a vital part of the chief executive's overall responsibility for the company. The chief executive must consider, in particular, the **risk and control environment,** focusing amongst other things, on how his or her example promotes a **good culture.** The chief executive should also monitor other directors and senior staff, particularly those whose actions can put the company at significant risk.

As well as explicit responsibilities, the board's role in '**setting the tone'** and demonstrating clearly that the directors respect the need for effective control systems is a very important part of risk management. This includes respecting the need for separation of duties between managers carrying out executive duties, and non-executive directors and staff responsible for monitoring them.

3.1.1 Review of board's role

Following on from the revisions to UK corporate guidance in 2010, the Financial Reporting Council undertook a review of how boards were approaching their responsibilities, with a view perhaps to revising the Turnbull guidance originally published in 1999. The consultation found that boards' focus on risk had changed significantly over the last decade and the approaches and techniques that they used were developing rapidly.

The main points arising from the consultation included the following:

- Boards should aim for **better risk taking**, but this does not necessarily mean less risk taking, as risk taking is essential to entrepreneurship.
- **Different board committees** are appropriate for different industries. The decision on appropriate committee structure should be left to individual boards, rather than making a risk committee compulsory for everyone. A risk committee is appropriate for companies in the financial sector. Separate committees are commonly used by companies in the pharmaceutical and extractive industries, which are exposed to significant safety, environmental or regulatory risks. Examples in these industries include compliance committees and corporate responsibility committees.
- Responsibility for monitoring internal controls and risk management could be delegated to board committees, but the whole board should retain strategic responsibility for risk decision-taking. Boards need to understand how risk exposure might change as a result of changes in strategy and the operating environment.
- Boards need to focus on individual risks capable of undermining the strategy or long-term viability of the company or damaging its reputation. Reputation risk requires greater attention, partly because failures can be publicised widely and quickly in the global information environment. Boards need to have robust crisis management plans.
- Boards should not just focus on net or residual risk, but also need to understand exposure to the combination of risks faced, before risk management policies are implemented.
- It could be difficult to decide how much information about risks boards need, and in particular, when a particular risk should be brought to the board's attention.
- Organisations need transparency and clear lines of reporting and accountability.
- Investors are increasingly seeking more meaningful reporting on risk, for example, an integrated discussion of business model, strategy, key risks and mitigation. Investors also want to know how companies' exposure to risk is changing.

Case example: HBOS

The issue of separation of duties was highlighted in February 2009 by the testimony of Paul Moore, former head of group regulatory risk at HBOS, to the UK House of Commons' Treasury Select Committee. Moore commented:

'There has been a completely inadequate "separation" and "balance of powers" between the executive and all those accountable for overseeing their actions and "reigning them in" ie internal control functions such as finance, risk, compliance and internal audit, non-executive chairmen and directors, external auditors, the FSA, shareholders and politicians.

There is no doubt that you can have the best governance processes in the world but if they are carried out in a culture of greed, unethical behaviour and indisposition to challenge, they will fail.'

3.2 Risk committee

Boards need to consider whether there should be a separate board committee, with responsibility for monitoring and supervising risk identification and management. If the board doesn't have a separate committee, under the UK Corporate Governance Code, the audit committee will be responsible for risk management.

Consideration of risk certainly falls within the remit of the audit committee. However, there are a number of arguments in favour of having a separate risk committee.

(a) A risk management committee can be **staffed by executive directors**, whereas an audit committee under corporate governance best practice should be staffed by non-executive directors. However, if there are doubts about the competence and good faith of executive management, it will be more appropriate for the risk committee to be staffed by non-executive directors.

(b) As a key role of the audit committee will be to liaise with the external auditors, much of their time could be **focused on financial risks.**

(c) A risk committee can take the lead in **driving changes in practice**, whereas an audit committee will have a largely monitoring role, checking that a satisfactory risk management policy exists.

Morris in *An Accountant's Guide to Risk Management*, suggests that written terms of reference might include the following:

- Approving the organisation's risk management strategy and risk management policy
- Reviewing reports on key risks prepared by business operating units, management and the board
- Monitoring overall exposure to risk and ensuring it remains within limits set by the board
- Assessing the effectiveness of the organisation's risk management systems
- Providing early warning to the board on emerging risk issues and significant changes in the company's exposure to risks
- In conjunction with the audit committee, reviewing the company's statement on internal control with reference to risk management, prior to endorsement by the board

Note that the focus is on supervision and monitoring rather than the committee having responsibility for implementation of policies.

Having a separate risk committee can aid the board in its responsibility for ensuring that adequate risk management systems are in place. The application of risk management policies will then be the responsibility of operational managers, and perhaps specialist risk management personnel.

Case example: Intercontinental Hotel Group (IHG)

IHG's annual report sets out responsibilities for risk management:

'The board of IHG has of course, ultimate responsibility for the group's strategy, risk management and internal control and reviewing their effectiveness. The audit committee carries out an annual review of the risk management system. In addition, the company's Risk Working Group, which is chaired by the Company

Secretary and comprises the Global Heads of Strategy, Risk Management and Internal Audit, takes an active role in overseeing the most significant risks to IHG. Risks identified in the regions and corporate functions are consolidated, refined and calibrated against a strategic view of risks by the Risk Working Group. Major risks are discussed to gain agreement on the risk descriptions, ownership and actions, before final presentation to the audit committee and Board. The Risk Working Group monitors changes to the major risks and the progress of actions on a quarterly basis, to ensure these risks are appropriately managed and emerging risks are identified.'

3.2.1 Risk committees in the financial sector

The UK Walker report recommended that FTSE 100 bank or life insurance companies should establish a risk committee. Reasons for this recommendation included the need to avoid over-burdening the audit committee, to draw a distinction between the largely backward-looking focus of the audit committee and the forward-looking focus of determining risk appetite; and from this, monitoring appropriate limits on exposures and concentrations. The committee should have a majority of non-executive directors.

Walker recommended that the committee should concentrate on the fundamental prudential risks for the institution: leverage, liquidity risk, interest rate and currency risk, credit/counterparty risks and other market risks. It should advise the board on current risk exposures and future risk strategy, and the establishment of a supportive risk culture.

The committee should regularly review and approve the measures and methodology used to assess risk. A variety of measures should be used. The risk committee should also advise the remuneration committee on risk weightings to be applied to performance objectives incorporated within the incentive structure for executive directors.

3.3 Risk management personnel

3.3.1 Risk specialists

Most individuals have little time for looking after their personal safety and security, still less for searching the market for the most suitable insurances. They frequently employ agents to help manage some of their risks.

A specialist advising on management of personal risks can work only as well as the client allows. A good specialist will ask for information and for co-operation with the expert surveys that enable him to provide a proper service. He will ensure that the client understands what safety measures are required and he will see that they are put into practice.

3.3.2 Risk manager

The risk manager will need technical skills in **credit, market, and operational risk**. Leadership and persuasive skills are likely to be necessary to overcome resistance from those who believe that risk management is an attempt to stifle initiative.

Lam (Enterprise Risk Management) includes a detailed description of this role, and the COSO framework also has a list of responsibilities. Combining these sources, we can say that the risk manager is typically responsible for:

(a) **Providing the overall leadership, vision and direction** for enterprise risk management.

(b) **Establishing an integrated risk management framework** for all aspects of risk across the organisation, integrating enterprise risk management with other business planning and management activities, and framing authority and accountability for enterprise risk management in business units.

(c) **Promoting an enterprise risk management competence** throughout the entity, including facilitating the development of technical enterprise risk management expertise, helping managers align risk responses with the entity's risk tolerances and developing appropriate controls.

(d) **Developing risk management policies**, including the quantification of management's risk appetite through specific risk limits, defining roles and responsibilities, ensuring compliance with codes, regulations and statutes, and participating in setting goals for implementation.

(e) **Establishing a common risk management language** that includes common measures around likelihood and impact, and common risk categories. Developing the analytical systems and data management capabilities to support the risk management programme.

(f) **Implementing a set of risk indicators and reports** including losses and incidents, key risk exposures, and early warning indicators. Facilitating managers' development of reporting protocols, including quantitative and qualitative thresholds, and monitoring the reporting process.

(g) **Dealing with insurance companies:** An important task because of increased premium costs, restrictions in the cover available (will the risks be excluded from cover?) and the need for negotiations with insurance companies if claims arise. If insurers require it, demonstrating that the organisation is taking steps to actively manage its risks. Arranging financing schemes such as self-insurance or captive insurance.

(h) **Allocating economic capital to business activities** based on risk, and optimising the company's risk portfolio through business activities and risk transfer strategies.

(i) **Reporting to the chief executive on progress** and recommending action as needed. Communicating the company's risk profile to key stakeholders such as the board of directors, regulators, stock analysts, rating agencies and business partners.

The risk manager's contribution will be judged by how much the value of the organisation is increased. The specialist knowledge a risk manager has should allow the risk manager to assess long-term risk and hazard outcomes and therefore decide what resources should be allocated to combating risk.

Clearly, certain strategic risks are likely to have the biggest impact on corporate value. Therefore, a risk manager's role may include management of these strategic risks. These may include those having a fundamental effect on future operations, such as mergers and acquisitions, or risks that have the potential to cause large adverse impacts, such as currency hedging and major investments. In financial institutions, the Walker report highlighted the assessment of whether product launches or the pricing of risk in a particular transaction was consistent with the risk tolerance determined by the risk committee.

The Walker report stressed the need for provisions enhancing the **independence** of the chief risk manager, for example, rights of access to the chairman of the risk committee and removal from office to require the agreement of the whole board.

Walker also highlighted the need for effective reporting. The risk committee's report should be a separate report in the annual accounts and include details of risk exposures and risk appetite for banking and trading exposures, and the effectiveness of the risk management process. Some detail should be given with regards of the stress-testing of risk.

Case example: HBOS

The role of the risk manager in banks was highlighted in February 2009 by the evidence given to the UK House of Commons' Treasury Select Committee enquiry into the banking system by Paul Moore, the ex head of Group Regulatory Risk at HBOS. Moore had allegedly been sacked by Sir James Crosby, Chief Executive Officer at HBOS. As a result of Moore making his allegations, Sir James resigned as deputy chairman of London city watchdog, the Financial Services Authority.

Moore stated that in his role, he 'felt a bit like being a man in a rowing boat trying to slow down an oil tanker'. He said that he had told the board that its sales culture was out of balance with its systems and controls. The bank was growing too fast, did not accept challenges to policy, and was a serious risk to financial stability and consumer protection. The reason why Moore was ignored and others were afraid to speak up was, he alleged, that the balance of powers was weighted towards executive directors, not just in HBOS, but in other banks as well.

> *I believe that, had there been highly competent risk and compliance managers in all the banks, carrying rigorous oversight, properly protected and supported by a truly independent non-executive, the external auditor and the FSA, they would have felt comfortable and protected to challenge the practices of the executive without fear for their own positions. If this had been the case, I am also confident that we would not have got into the current crisis.*

Moore was replaced by a group risk director who had never previously been a risk manager. The new head had been a sales manager and was allegedly appointed by the chief executive officer without other board members having much, if any, say in the appointment.

During the time that Paul Moore was head of Group Regulatory Risk, the Financial Services Authority had raised its own concerns about practices at HBOS and had kept a watching brief over the bank. In December 2004, the authority noted that although the group, 'had made good progress in addressing the risks highlighted in February 2004, the group risk functions still needed to enhance their ability to influence the business'. In June 2006, the authority stated that whilst the group had improved its framework, it still had concerns: 'The growth strategy of the group posed risks to the whole group and these risks must be managed and mitigated.'

At the end of the week in which Paul Moore's evidence was published, Lloyds, which had taken HBOS over, issued a profit warning in relation to HBOS for 2008 for losses of over £10 billion.

3.3.3 Risk management function

Larger companies may have a bigger risk management function whose responsibilities are wider than a single risk manager or risk specialist. The Institute of Risk Management's *Risk Management standard* lists the main responsibilities of the risk management function:

- Setting policy and strategy for risk management
- Primary champion of risk management at a strategic and operational level
- Building a risk aware culture within the organisation, including appropriate education
- Establishing internal risk policy and structures for business units
- Designing and reviewing processes for risk management
- Co-ordinating the various functional activities which advise on risk management issues within an organisation
- Developing risk response processes, including contingency and business continuity programmes
- Preparing reports on risks for the board and stakeholders

3.3.4 Internal audit

The assurance work carried out by internal audit will play a significant part in the organisation's risk management processes, internal audit being required to assess and advise on how risks are countered. Internal auditors will be concerned to see that managers have made adequate responses to risks, have designed robust risk management processes and that these mitigate the risks. This approach can be refined to focus on particular areas, for example start-ups and other future-oriented activities, where core controls have not developed and which thus carry higher risks.

The starting point for a risk audit is to **identify business objectives** and the **risks** that may prevent the organisation from achieving those objectives. Internal audit's work will be influenced by the organisation's **appetite** for bearing risks. Internal audit will assess:

- The **adequacy of the risk management and response processes** for identifying, assessing, managing and reporting on risk
- The risk management and control **culture**
- The **appropriateness of internal controls** in operation to **limit risks**
- The **operation and effectiveness** of the **risk assessment and management processes**, including the internal controls, with a focus on processes aimed at risks that are classified as key risks
- The **reliability of reporting on risks and controls**

The areas that auditors will concentrate on will depend on the **scope** and **priority** of the assignment and the **risks identified**. Where the risk management framework is insufficient, auditors will have to rely on their own **risk assessment** and will focus on **recommending an appropriate framework**. Where a framework for risk management and control is embedded in operations, auditors will aim to use **management's assessment of risks** and concentrate on **auditing the risk management processes**.

A key part of internal audit's role in control systems is to provide feedback that influences the **design and operation** of **internal control systems.** Internal audit recommendations need to be seen in the context of the organisation's **strategic objectives** and **risk appetite.**

Case example: Changing role of internal audit

Reports such as the PriceWaterhouseCoopers *Internal Audit 2013* report emphasise the importance of internal audit in providing risk management assurance, along with its traditional responsibility of assurance over controls. The 2013 report suggested that although companies were increasing expectations of their own performance in contending with the changing risk landscape, increased regulation and greater stakeholder pressures, the expectations of internal audit were not increasing at the same pace.

Stakeholders were least satisfied with internal audit's contribution in emerging risk areas such as new product introductions, capital project management and mergers and acquisitions. Internal audit can also help by carrying out their work earlier. The Chief Audit Executive of Microsoft commented: 'The quicker we can get in and identify risks and concerns, the quicker the business can respond. We spend a lot of time looking at future P&Ls, not just current ones.'

The report stressed that internal audit's role as an assurance provider, delivering objective assurance on the effectiveness of organisations' internal controls, remained the cornerstone of its work. However, it also had to use its expertise and analysis to identify root causes of risk, provide greater insights and give proactive advice and forward-looking recommendations.

Audit committees have a key responsibility, to ensure that significant business risks a being addressed in current internal audit plans and strategies over the longer-term.

3.4 Procedures for embedding risk

Employees cannot be expected to avoid risks if they are not aware that they exist in the first place. Embedding a risk management frame of mind into an organisation's culture requires top-down communications on what the risk philosophy is and what is expected of the organisation's employees.

Case example: Internal communications programme

Here is an example of an internal communications programme slightly adapted from an example in the COSO *Framework.*

Internal communications programme

- Management discusses risks and associated risk responses in regular briefings with employees.
- Management regularly communicates entity-wide risks in employee communications such as newsletters, or via the intranet.
- Enterprise risk management policies, standards, and procedures are made readily available to employees, along with clear statements requiring compliance.
- Management requires employees to consult with others across the organisation as appropriate when new events are identified.
- Induction sessions for new employees include information and literature on the company's risk management philosophy and enterprise risk management programme.
- Existing employees are required to take workshops and/or refresher courses on the organisation's enterprise risk management initiatives.
- The risk management philosophy is reinforced in regular and ongoing internal communication programmes and through specific communication programmes to reinforce tenets of the company's culture.

3.4.1 Human resource procedures

The COSO framework also recommends certain organisational measures for spreading ownership of risk management.

(a) Enterprise risk management should be an explicit or implicit part of everyone's **job description.**

(b) Personnel should understand the need to **resist pressure from superiors** to participate in improper activities, and channels outside normal reporting lines should be available to permit reporting such circumstances.

(c) Managers should **provide appropriate incentives.** This may entail setting performance targets and tying results to performance pay.

3.4.2 Training

Aside from practical matters like showing employees which buttons to press or how to find out the information they need, training should include **explanations** of why things should be done in the way that the trainer recommends. If employees are asked to carry out a new type of check but are not told why, there is every chance that they won't bother to do it, because they don't understand its relevance. Instead, it will just seems to mean more work for them and to slow up the process for everyone.

3.4.3 Risk policy statement

Organisations ought to have a statement of risk policy and strategy that is distributed to all managers and staff.

3.5 Control systems

The Turnbull report emphasises the importance of control systems in effectively managing risks. The report provides a helpful summary of the main purposes of an internal control system.

Turnbull comments that internal control consists of 'the policies, processes, tasks, behaviours and other aspects of a company that taken together:

(a) **Facilitate its effective and efficient operation** by enabling it to respond appropriately to significant business, operational, financial, compliance and other risks to achieving the company's objectives. This includes the **safeguarding of assets** from inappropriate use or from loss and fraud and ensuring that **liabilities are identified and managed.**

(b) **Help ensure the quality of internal and external reporting**. This requires the maintenance of proper records and processes that generate a flow of timely, relevant and reliable information from within and without the organisation.

(c) **Help ensure compliance with applicable laws and regulations**, and also with internal policies with respect to the conduct of business.

The Turnbull report also summarises the key characteristics of the internal control systems. They should:

- Be embedded in the operations of the company and form part of its culture
- Be capable of responding quickly to evolving risks within the business
- Include procedures for reporting immediately to management, significant control failings and weaknesses, together with control action being taken

The system should include control activities, information and communication processes and methods for monitoring the continued effectiveness of the system of internal control. The Turnbull report goes on to say that a sound system of internal control reduces, but does not eliminate, the possibilities of losses arising from poorly-judged decisions, human error, deliberate circumvention of controls, management override of controls and unforeseeable circumstances. Systems will provide reasonable (not absolute) assurance that the company will not be hindered in achieving its business objectives and in the orderly and legitimate conduct of its business, but won't provide certain protection against all possible problems.

Case example: Three lines of defence model

The three lines of defence model is one approach to safeguarding the internal control framework. It was the UK regulatory authority Financial Services Authority's (FSA) preferred approach.

1st line of defence

This describes the **controls** an organisation has in place to deal with its day-to-day business. Controls are designed into systems and processes, and assuming that the design is sound enough to appropriately mitigate risk, compliance with process should ensure an adequate control environment. There should be adequate managerial and supervisory controls in place to ensure compliance and to highlight control breakdown, inadequacy of process and unexpected events.

2nd line of defence

This describes the **committees and functions** that are in place to provide an oversight of the effective operation of the internal control framework. These committees review the management of risk in relation to the particular risk appetite of the business, as determined by the board. The effectiveness of the second line is determined by the oversight committee structure, their terms of reference, the competence of the members and the quality of the management information and reports that are considered by these oversight committees.

The second line is reinforced by the advisory and monitoring functions of risk management and compliance. Risk management defines and prescribes the financial and operational risk assessment processes for the business; maintains the risk registers and undertakes regular reviews of these risks in conjunction with line management. Compliance advises on all areas of regulatory principles, rules and guidance, including leading on any changes, and undertakes monitoring activity on key areas of regulatory risk.

These functions report upon their work undertaken and significant findings to the appropriate executive risk oversight committees in the second line.

3rd line of defence

This describes the **independent assurance** provided by the **board audit committee**, a committee of non-executive directors chaired by the senior independent director, and the **internal audit function** that reports to that committee.

Internal audit undertakes a programme of risk based audits covering all aspects of both the first and second lines of defence. Internal audit may well take some assurance from the work of the second line functions and reduce or tailor its checking of the first line.

Clearly, the level of assurance taken will depend on the effectiveness of the second line, including the oversight committees, and internal audit will need to co-ordinate its work with compliance and risk management as well as assessing the work of these functions. The findings from these audits are reported to all three lines, ie accountable line management, the executive and oversight committees and the board audit committee.

This third line role likens internal audit to that of a goalkeeper in a football match. When the ball is lost in midfield (the first line) and the defence (the second line) fails to pick up the opposition's attack, it is left to the goalkeeper (as the third line) to save the day. There is a reasonable expectation that internal audit will identify the weaknesses in both the first and the second lines, because failure to do so may lead to significant loss to the organisation.

4 Stakeholders and risk

Section overview

- Organisations' attitudes to risks will be influenced by the priorities of their stakeholders and how much influence stakeholders have. Stakeholders that have significant influence may try to prevent an organisation bearing certain risks.

We discussed generally in Chapter 1 how stakeholders can influence objectives and strategies. This section focuses on the impacts that stakeholders can have on the strategies that businesses develop for managing their risks.

Businesses have to be aware of stakeholder responses to risk. They may take actions, or events could occur, that may generate a response from stakeholders. This response could have an adverse effect on the business.

To assess the importance of stakeholder responses to risk, the organisation needs to determine how much leverage its stakeholders have over it.

4.1 Shareholders

Shareholders can affect the market price of shares by selling them. They also have the power to remove management. It would appear that the key issue for management to determine is whether shareholders:

(a) **Prefer a steady income from dividends**, in which case, they will be alert to threats to the profits that generate the dividend income such as investment in projects that are unlikely to yield profits in the short term.

(b) **Are more concerned with long-term capital gains,** in which case they may be less concerned about a short period of poor performance, and more worried about threats to long-term survival that could diminish or wipe out their investment

However, the position is complicated by the different risk tolerances of shareholders themselves. Some shareholders will, for the chances of a higher level of income, be prepared to bear greater risks that their investments will not achieve a that level of income. Therefore, some argue that because the shares of listed companies can be freely bought and sold on stock exchanges, if a company's risk profile changes, its existing shareholders will sell their shares, but the shares will be bought by new investors who prefer the company's new risk profile. The theory runs that it should not matter to the company who its investors are.

However, this makes the assumption that the investments of all shareholders are actively managed and that shareholders seek to reduce their own risks by diversification. These are not necessarily true in practice. It is also unlikely that the directors will be indifferent to who the company's shareholders are.

Shareholders' risk tolerance may depend on their views of the organisation's risk management systems, how effective they are and how effective they should be. Shareholder sensitivity to this will increase the pressures on management to ensure that a risk culture is **embedded** within the organisation.

4.2 Debt providers and creditors

Debt providers are most concerned about threats to the amount the organisation owes. They can take various actions, with potentially serious consequences such as denial of credit, higher interest charges or ultimately, putting the company into liquidation.

When an organisation is seeking credit or loan finance, it will obviously consider what action creditors will take if it does default. However, it also needs to consider the ways in which debt finance providers can limit the risks of default by, for example, requiring companies to meet certain financial criteria, provide security in the form of assets that can't be sold without the creditors' agreement, or personal guarantees from directors.

These mechanisms may have a significant impact on the development of an organisation's risk strategy. There may be a conflict between strategies that are suitable from the viewpoint of the business's long-term strategic objectives, but are unacceptable to existing providers of finance because of threats to cash flows, or are not feasible because finance suppliers will not make finance available for them, or will do so only on terms that are unduly restrictive.

4.3 Employees

Employees will be concerned about threats to their job prospects (money, promotion, benefits and satisfaction) and ultimately, threats to the jobs themselves. If the business fails, the impact on employees will be great. However, if the business performs poorly, the impact on employees may not be so great if their jobs are not threatened. Employees will also be concerned about threats to their personal well-being, particularly health and safety issues.

The variety of actions employees can take include pursuit of their own goals rather than shareholder interests, industrial action, refusal to relocate or resignation.

Risks of adverse reactions from employees will have to be managed in a variety of ways:

- Legislation requires that some risks, principally threats to the person, should be avoided
- Businesses can limit employee discontent by good pay, conditions etc
- Businesses can take out insurance against key employees leaving. However, they may decide to accept that some employees will be unhappy but believe the company will not suffer a significant loss if they leave

4.4 Customers and suppliers

Suppliers can provide (possibly unwillingly) short-term finance. As well as being concerned with the possibility of not being paid, suppliers will be concerned about the **risk of making unprofitable sales.** Customers will be concerned with **threats to their getting the goods or services** that they have been promised, or not getting the value from the goods or services that they expect.

Suppliers can respond to risk of non-payment by refusing credit. Customers can shop elsewhere. The impact of customer-supplier attitudes will also depend on how much the organisation wants to **build long-term relationships with them.** A desire to build relationships implies involvement of the staff that are responsible for building those relationships in the risk management process. It also may imply a greater degree of disclosure about risks that may arise to these long-term partners in order to maintain the relationship of trust.

4.5 The wider community

Governments, regulatory and other bodies will be particularly concerned with risks where the organisation does not act as a **good corporate citizen,** implementing, for example, poor employment or environmental policies. A number of the resulting actions that might be taken could have serious consequences. Government can impose tax increases or regulation or take legal action. Pressure group tactics can include publicity, direct action, political sabotage or campaigning.

Although the consequences can be serious, the risks that the wider community are concerned about are rather less easy to predict than for other stakeholders, being governed by varying political pressures. This emphasises the need for careful monitoring of changing attitudes and likely external responses to the organisation's actions as part of the risk management process.

5 Risk assessment

Section overview

- This section covers a commonly used framework for assessing and managing risk.
- The initial stage will include establishing both the internal and external contexts, the risk criteria and the structure for risk analysis.
- Identifying the risks that the organisation faces should be a continuous process. As the business environment changes, so do the risks faced by organisations operating in that environment.
- The fundamental difficulty in assessing risk is determining how often this particular risk may occur. Information may not be available on all past events.
- The other main element of risk assessment is assessing the impact upon the organisation if a risk materialises.
- For physical assets, quantification is often fairly straightforward. However, exposure of financial and intangible assets is more difficult to put a monetary figure on.
- Grouping of risks according to their likelihood and potential impact supports the establishment of priorities for risk mitigation.
- The individual risks that have been identified in different parts of the business must be consolidated (ie aggregated) to establish the risk at the corporate level.

5.1 The risk management process

A commonly used framework for assessing and managing risk involves the following processes.

- Establishing the context
- Risk identification
- Risk assessment
- Risk quantification
- Risk profiling

- Risk consolidation
- Risk responses

In real life, none of these processes are easy – what is considered to be a risk by some might not be seen as such by others, which can lead to disputes over which risks should be given priority. Quantification of an item that is essentially subjective is never going to be straightforward – in itself, putting a value on different risks is a subjective process.

5.2 Risk register

Organisations should have formal methods of collecting information on risk and response. A risk register **lists and prioritises the main risks** an organisation faces, and is used as the basis for decision-making on how to deal with risks. It acts as a basic component of the risk and control assessment process in order to record identified risks. The existence of a risk register illustrates that risks have been identified and to what activities they relate.

The risk register will typically include the following:

- Description of the risk
- When the risk might occur
- The impact, assuming that the risk does occur
- An assessment of the risk's likelihood or probability of occurrence
- A priority rating or score, obtained from the impact and probability assessment
- The management's strategy as to how the risk will be addressed
- The containment strategy, defining what exactly will happen if the risk occurs

This figure shows a simple example:

Function/Activity:		Compiled by:		Date:	
Date of risk review:		Reviewed by:		Date:	

Reference	The risk	What can happen? (event)	How can it happen?	What can happen? (consequences)	Identify existing controls	Effectiveness and implementation of existing controls	Analysis			Risk priority	Treat risk Y/N	Further action
							Likelihood	Consequences	Level of risk			

NOTE: Indicative example only.

In compiling the risk register, the firm must describe the risk in a clear manner so that everyone in the firm who needs to be aware of the risk, understands it and not just the person who is most directly involved in its management.

A risk register would take an individual event and state what the **loss of value** might be, should the risk occur and then will apply an impact assessment to it.

Worked example: Risk register

Consider, for example, a case of potential fraud where the risk impact might be assessed at say, CU5 million with a 15% chance of its occurrence in any one individual year. Multiplying these together (CU5 million x 15%) would give a severity of CU0.75 million in any one individual year. Of course, this would not mean that the company would expect a loss of CU5 million or even CU0.75 million. The actual cost would be based upon the distribution of losses. So the loss could be at least CU0.25 million with a 75% likelihood, or up to CU2 million with a 25% likelihood.

Any assessments are based upon actual knowledge from real loss events that have occurred, together with additional assessment made by management and risk specialists regarding the quality of the control environment, along with control and risk self assessment key performance indicators.

The severity could be calculated by assessors who might be asked to choose from a number in the range of 1 to 10 for each of the risk issues that they are addressing. These expectation (or likelihood) levels would then be multiplied to come up with a severity rating. Hence, **expectation** multiplied by **impact** would deliver the severity figure.

The risk manager, or the person administering the risk register and the assessment, would be the person who would then take the different expectations and convert them into something more meaningful in terms of real values, rather than levels of severity. An expectation of 6 could equate to say, 30% and an impact of 5 could equate to CU10 million. This then, would give the severity of CU3 million ie 30% of CU10 million.

5.3 Establishing the context

Before any risk can actually be identified, the context within which that risk will be assessed must be established. For example, management may only be interested in identifying financial risks, which means that those responsible for gathering information will concentrate on that area of risk only.

5.3.1 Establishing the internal context

Risk is essentially the chance that an event will occur which will prevent the company from meeting its objectives. Therefore, in order to understand the risks, you must first identify the objectives. By doing so you will ensure that decisions taken to reduce risk still support the overall goals of the organisation, thus encouraging long-term and strategic thinking.

Case example: Owner managed restaurant

A small restaurant employs a full-time chef, an apprentice chef and two waiters. Business is slow and cash flow is becoming a problem, so the owner decides that he will therefore have to let the apprentice chef and one of the waiters go.

Four months later, the restaurant wins a five-year contract to supply lunches to a local firm and business in general picks up, with the opening of a new office block in close proximity to the restaurant's premises. The restaurant owner was in the process of preparing for the new contract, having tendered for it several months before paying off the apprentice chef and the waiter, and was also aware of the imminent opening of the office block.

The owner then had problems of a different kind. The chef could not cope with both the contracted lunches and the general improvement in business, nor could the remaining waiter deal with a full restaurant on his own. The apprentice chef had already found alternative employment, as had the previous waiter. The owner was forced to take on a less experienced apprentice, who then had to be trained by the already overworked chef and another waiter, who was unfamiliar with the general operations of the restaurant.

In this context, the restaurant owner would have been better trying to find an alternative means of dealing with what he must have known to be a temporary cash flow problem, rather than getting rid of staff in whose training time and money had already been invested.

When trying to establish the internal context, business owners should also consider such issues as:

- Internal culture. Are staff likely to be resistant to change?
- Existing business capabilities, such as people, equipment and processes.

5.3.2 Establishing the external context

The external context is the overall environment in which the business operates, including an understanding of the perceptions that clients or customers have of the business. This could take the form of a SWOT analysis. It should also cover such issues as external regulations that the business must comply with.

5.3.3 Establishing the risk management context

In order to correctly identify risks associated with a project, you must first define the project's limits, objectives and scope.

Case example: Accountancy body

Due to expansion of staff and necessary documentation, the student support and education departments of a professional accountancy body are moving into larger office premises. Before the move takes place, the head of administration, who is taking charge of the move, undertakes a risk assessment of the relocation.

The risk management context includes:

- The main objective: to move staff, furniture, equipment and documentation to the new premises with a minimum of disruption to student services and production of examination papers
- Ensure the security and confidentiality of the examination papers held at the current premises which will be transferred in locked safes to the new location
- An overall timeframe (including planning, liaison with telephone companies, etc) of three months
- A budget of CU25,000 for the use of external relocation support

This risk management context provides sufficient information with which the head of administration can assess the risks associated with the relocation, particularly those that impact on the primary objective of minimising disruption to student services and the production of examination papers.

5.3.4 Developing risk criteria

This step allows the business to identify unacceptable levels of risk, or, looking at it another way, to define acceptable levels of risk for a specific project. These risk levels can be more closely defined as the process progresses.

In the case study above, for example, it would be completely unacceptable for the confidentiality and security of the examination papers to be compromised, so this documentation must therefore be kept in locked safes and transported using professional safe movers.

5.3.5 Defining the structure for risk analysis

The final stage in the establishment of context is to define the structure for risk analysis. This involves isolating the risk categories that need to be managed, which can then be assessed individually. This will allow for greater depth and accuracy when identifying important risks.

5.4 Risk identification

No-one can manage a risk without first being aware that it exists. Some knowledge of perils, what items they can affect and how, is helpful to improve awareness of whether **familiar risks** (potential sources and causes of loss) are present, and the extent to which they could harm a particular person or organisation. The risk manager should also keep an eye open for **unfamiliar risks** which may be present.

Actively identifying the risks before they crystallise makes it easier to think of methods that can be used to manage them.

Risk identification is a **continuous process**, so that new risks and changes affecting existing risks may be identified quickly and dealt with appropriately, before they can cause unacceptable losses.

5.4.1 Risk conditions

Means of identifying conditions leading to risks (potential sources of loss) include:

(a) **Physical inspection**, which will show up risks such as poor housekeeping (for example, rubbish left on floors, for people to slip on and to sustain fires)

(b) **Enquiries**, from which the frequency and extent of product quality controls and checks on new employees' references, for example, can be ascertained

(c) **Checking** a copy of every letter and memo issued in the organisation for early indications of major changes and new projects

(d) **Brainstorming** with representatives of different departments

(e) **Checklists** ensuring risk areas are not missed

(f) **Benchmarking** against other sections within the organisation or external experiences

5.4.2 Event identification

A key aspect of risk identification, emphasised by the Committee of Sponsoring Organisations of the Treadway Commission's report, *Enterprise Risk Management Framework,* is identification of events that could impact upon implementation of strategy or achievement of objectives.

Events analysis includes identification of:

(a) **External events** such as economic changes, political developments or technological advances

(b) **Internal events** such as equipment problems, human error or difficulties with products

(c) **Leading event indicators**. By monitoring data correlated to events, organisations identify the existence of conditions that could give rise to an event, for example, customers who have balances outstanding beyond a certain length of time being very likely to default on those balances

(d) **Trends and root causes**. Once these have been identified, management may find that assessment and treatment of causes is a more effective solution than acting on individual events once they occur

(e) **Escalation triggers**, certain events happening or levels being reached that require immediate action

(f) **Event interdependencies**, identifying how one event can trigger another and how events can occur concurrently. For example, a decision to defer investment in an improved distribution system might mean that downtime increases, and operating costs go up

Once events have been identified, they can be classified horizontally across the whole organisation and vertically within operating units. By doing this, management can gain a better understanding of the interrelationships between events, gaining enhanced information as a basis for risk assessment.

5.4.3 Key risk indicators

COSO provides guidance on key risk indicators (KRIs), metrics that some organisations use to provide an early signal of increasing risk exposure. At their simplest, they can be **key ratios** that management uses as indications of evolving problems requiring actions. Sometimes they may be more elaborate, involving the aggregation of several risk indicators.

The COSO guidance comments that KRIs are derived from specific events or root causes that can prevent performance goals from being achieved. Examples include the introduction of a new product by a competitor, a strike at a supplier's plant, proposed changes in the regulatory environment or input-price changes.

The guidance points out that effective KRIs should be developed by risk managers and business unit managers working together. They should be developed in concert with strategic plans. Determining the frequency of reporting of KRIs will be important – operational management may need to see them in real-time; senior management on a less frequent, aggregated basis.

The guidance highlights the following elements of well-designed KRIs:

- Based on established practices or benchmarks
- Developed consistently across the organisation
- Provide an unambiguous and intuitive view of the highlighted risk
- Allow for measurable comparisons across time and business units
- Provide opportunities to assess the performance of risk owners on a timely basis
- Consume resources effectively

5.5 Risk assessment

It is not always simple to forecast the financial effect of a possible disaster, as it is not until *after* a loss that extra expenses, inconveniences and loss of time can be recognised. Even then, it can be difficult to identify all of them.

Organisations will probably keep more detailed records of their activities and the unit costs involved, but it is unlikely that any organisation can predict the full cost of every loss that might befall it with certainty.

5.6 Risk quantification

Risks that require more analysis can be quantified, where possible results or losses and probabilities are calculated and distributions or confidence limits added on. From this exercise is derived the following key data to which the organisation could be exposed by a particular risk:

- Average or expected result or loss
- Frequency of losses
- Chances of losses
- Largest predictable loss

The risk manager must also be able to estimate the effects of each possible cause of loss, as some of the effects that he needs to consider may not be insured against.

The likely frequency of losses from any particular cause can be predicted with some degree of confidence, from studying available records. This confidence margin can be improved by including the likely effects of changed circumstances in the calculation, once they are identified and quantified. Risk managers must therefore be aware of the possibility of the increase of an existing risk, or the introduction of a new risk, affecting the probability and/or possible frequency of losses from another cause.

Often, quantification of losses will not involve statistical techniques, but a simple single estimate of what would be lost if adverse events or circumstances occur. For example, if an accountancy firm had a client that generated a fixed fee each year, the loss would be their contribution (fees lost less labour and other variable costs saved).

Ultimately, the risk manager will need to know the frequency and magnitude of losses that could place the organisation in serious difficulty.

5.6.1 Exposure of physical assets

Exposures with physical assets may include:

- **Total value of the assets**, for example, the value of items stolen from a safe
- **Costs of repair**, if for example, an accident occurs
- **Change of value of an asset**, for example, property depreciating in value because of a new airport development nearby
- **Decrease in revenues**, for example, loss of rent through a rental property being unlettable for a period
- **Costs of unused capacity**, costs incurred by spare capacity that is taken as a precaution but does not end up being used

5.6.2 Exposure of financial assets

Whilst the risk of trading shares and most forms of debt might be that their values fall to zero, this is not necessarily true of futures (where losses could be unlimited) and options (whose losses are limited to the option premium). In addition, anyone who is exposed to loss as a **result of price rises** is, in theory, exposed to the risk of **infinite loss**, since prices could rise indefinitely.

Case example: Banking crisis

The 2009 Turner report highlighted faulty measurement techniques as a reason why many financial institutions underestimated their risk position during the 2007-8 global financial crisis. The required capital for their trading activities was excessively light. Turner also highlighted the rapid growth of 'off balance sheet' vehicles that were highly leveraged but were not included in standard risk measures. However, the crisis demonstrated the economic risks of these vehicles, with liquidity commitments and reputational concerns requiring banks to take the assets back onto their balance sheets, increasing measured leverage significantly.

Turner also saw the complexity of the techniques as itself being a problem.

> *The very complexity of the mathematics used to measure and manage risk made it increasingly difficult for top management and boards to assess and exercise judgements over risks being taken. Mathematical sophistication ended up not containing risk, but providing false assurance that other prima facie indicators of increasing risk (eg rapid credit extension and balance sheet growth) could be safely ignored.*

5.6.3 Exposure of human assets

The most severe risk to employees is the risk of death or serious injury. The loss to the employee's family, for which the organisation may be liable, could be the **future value** of their **expected income stream**, mitigated by any benefits available but enhanced by other losses that arise as a result of death, for example, loss of any available tax allowance. Alternatively, it could be measured by the expenditure required to fulfil the **needs** of the deceased's dependent family. For less serious injuries, the costs of medical care may be the relevant figure.

Certain individuals may make a significant contribution to the office because of their knowledge, skills or business contacts. One measure of this loss will be the present value of the individual's contribution (attributable earnings less remuneration). Indirect costs may include the effect on other staff of the loss of the key person (decreased productivity or indeed, the costs of their own departure).

If a director, partner or senior employee dies or departs, there may be costs of having to cope with the disruption, perhaps even including the costs of dissolution, if local law requires termination of a partnership on the departure of a single partner.

5.7 Risk profiling

This stage involves using the results of a risk assessment to group risks into risk families. One way of doing this is a likelihood/consequences matrix.

		Consequences	
		Low	*High*
Likelihood	*Low*	Loss of suppliers	Loss of senior or specialist staff Loss of sales to competitor Loss of sales due to macroeconomic factors
	High	Loss of lower-level staff	Loss of key customers Failure of computer systems

This profile can then be used to set priorities for risk mitigation.

5.8 Risk consolidation

Risk that has been analysed or quantified at the division or subsidiary level, needs to be aggregated at the corporate level and grouped into categories. This aggregation will be required as part of the overall review of risk that the board needs to undertake. The process of risk categorisation also enables the risks categorised together to be managed by the use of common control systems.

6 Risk response

Section overview

- Although organisations operating in the same industry may face similar risks, the ways in which they respond to these risks can differ significantly.
- Risk responses depend on such factors as the potential impact of the risk on the organisation and management's attitude towards risk.
- The four main responses to risk are: avoidance, reduction, transfer and acceptance.
- Implementation of the risk management process should be treated as a separate project with clear objectives and success criteria.
- Just because risk management procedures are in place, does not mean that companies are immune from the effects of risk. Such procedures may reduce the impacts of risk but will not eliminate them completely.
- Risks must be continually monitored to determine any change in profile that may lead to procedures that control those risks being changed. This stage is effectively an audit of the overall risk management process, where expected and actual results are compared; and recommendations made for remedial actions.

Once risks have been identified, assessed and quantified, decisions must be taken as to how to respond to these risks. Methods of dealing with risk include avoidance, reduction, acceptance (retention) and transfer.

Risk response can be linked into the likelihood/consequences matrix and also the organisation's appetite for risk-taking.

	Consequences	
Likelihood	*Low*	*High*
Low	**Accept or absorb** Risks are not significant. Keep under review, but costs of dealing with risks unlikely to be worth the benefits.	**Transfer** Insure risk or implement contingency plans. Reduction of severity of risk will minimise insurance premiums.
High	**Reduce or manage** Take some action, eg self-insurance to deal with frequency of losses.	**Avoid or control** Take immediate action to reduce severity and frequency of losses, eg insurance, charging higher prices to customers or ultimately abandoning activities.

6.1 Avoidance of risk

Organisations will often consider whether risk can be avoided and if so, whether avoidance is desirable – that is, will the possible savings from losses avoided be greater than the advantages that can be gained by not taking any measures and running the risk?

An extreme form of avoiding business risk is terminating operations altogether – for example, operations in politically volatile countries where the risks of loss (including loss of life) are considered to be too great; or the costs of security, too high.

Case example: Toyota

We mentioned in Chapter 5 the problems Toyota has faced in recent years regarding concerns regarding the safety of its cars. Toyota responded to these concerns by employing a risk avoidance strategy. Sales of a number of models were suspended in the USA. Although Toyota's actions aimed to resolve the risks to health and safety, it may have been less effective in mitigating the risks to its reputation. Commentators highlighted an initial reluctance to admit the problem, along with poor communication of what it intended to do to regain control of the situation. The impact threatened car sales and share price, with investors reluctant to hold Toyota shares because of the level of uncertainties involved.

6.2 Reduction of risk

Often, risks can be avoided in part, or reduced, but not avoided altogether. This is true of many business risks, where the risks of launching a new product can be reduced by market research, advertising and so on.

Other risk reduction measures include contingency planning and loss control.

Case example: Pearson

Pearson highlights the risks to its intellectual property and proprietary rights as potential major constraints on its ability to grow. Pearson seeks to mitigate these risks through general vigilance, co-operation with other publishers and trade associations, advances in technology and taking legal action. The group has developed data rights management standards and monitoring programs, and has established a piracy task force to identify weaknesses and remediate breaches. Pearson also monitors developments in copyright and intellectual property law in each of its markets.

6.2.1 Contingency planning

Contingency planning involves identifying the **post-loss needs** of the business, **drawing up plans** in advance and **reviewing them regularly** to take account of changes in the business. The process has three basic constituents.

Information	How, for example, are the sprinklers turned off once the fire is extinguished? All the information that will need to be available during and after the event should be gathered in advance.
Responsibilities	The plan should lay down what is to be done by whom.
Practice	Unless the plan has been tested, there is no guarantee that it will work. A full-scale test may not always be possible; simulations, however, should be as realistic as possible and should be taken seriously by all involved.

Case example: London emergency services

Before and since the London bombings in 2005, the London emergency services have held regular simulation exercises of how they would react in an emergency situation. Usually held at weekends, these simulation exercises often take place in tube stations, using hundreds of 'extras' to play the parts of injured members of the public. Such exercises are vital to test the way in which, and how quickly, the emergency services will deal with any future terrorist attacks.

6.2.2 Loss control

Control of losses also requires careful advance planning. There are two main aspects to good loss control: the physical and the psychological.

- There are many physical devices that can be installed to minimise losses when harmful events actually occur. Sprinklers, fire extinguishers, escape stairways, burglar alarms and machine guards are obvious examples. It is not enough, however, to install such devices. They will need to be inspected and maintained regularly.
- The key psychological factors are awareness and commitment. Every person in the business should be made aware that losses are possible and that they can be controlled.

6.3 Accepting risks

Risk acceptance or retention is where the organisation bears the risk itself, and if an unfavourable outcome occurs, it will suffer the full loss. Risk retention is inevitable to some extent. However good the organisation's risk identification and assessment processes are, there will always be some unexpected risk. Other reasons for risk retention are that the risk is considered to be insignificant, or the cost of avoiding the risk is considered to be too great compared with the potential loss that could be incurred.

The decision of whether to retain or transfer risks depends firstly on whether there is anyone to transfer a risk to. The answer is more likely to be 'no' for an individual than for an organisation, because:

- Individuals have more small risks than do organisations, and the administrative costs of transferring and carrying them can make the exercise impractical for the insurer; and
- The individual has smaller resources to find a carrier.

In the last resort, organisations usually have customers to pass their risks or losses onto, up to a point; whilst individuals do not.

6.4 Transfer of risk

Alternatively, risks can be transferred – to other internal departments or externally to suppliers, customers or insurers. Risk transfer can even be to the state.

Decisions to transfer risk should not be made without careful checking to ensure that as many influencing factors as possible have been included in the assessment. A decision not to rectify the design of a product, because rectification could be as expensive as paying any claims from disgruntled customers, is, in fact, a decision to transfer the risk to the customers without their knowledge: it may not take into account the possibility of courts awarding exemplary damages to someone injured by the product, to discourage people from taking similar decisions in the future.

Internal risk transfer can also cause problems if it is away from departments with more 'clout' (for example, sales) and towards departments, such as finance, that may be presumed to downplay risks excessively.

6.4.1 Legal and other restrictions on transferring risks

The first restriction is that a supplier or customer may **refuse** to enter a contract unless the organisation agrees to take a particular risk. This depends on the trading relationship between the firms concerned, and not a little on economics: how many suppliers could supply the item or service in question, for example, and how great is the need for the item?

6.4.2 Risk sharing

Risks can be partly held and partly transferred to someone else. An example is an insurance policy, where the insurer pays any losses incurred by the policyholder above a certain amount.

Risk sharing arrangements can be very significant in business strategy. For example, in a **joint venture** arrangement, each participant's risk can be limited to what it is prepared to bear.

Interactive question 2: VSYS

[Difficulty level: Intermediate]

VSYS Inc manufactures a range of computer products from its single factory located in a medium-sized town in central USA. About 20% of the working population are employed at VSYS, and the company has a reputation for being a good employer with specific focus on maintaining and enhancing benefits for its employees.

Although the company is profitable, the recent management accounts show falling margins with the possibility of a loss being made next year – the first in the 25 year history of the company. The main reasons for the falling profits have been identified as increasing competition from manufacturers in the Far East, and ongoing quality control issues with several key manufacturers. A recent feasibility study shows that moving production to a Far Eastern country would enable VSYS to take advantage of lower labour costs and proximity to suppliers of high quality components. The administration and marketing functions would remain at their current location.

Movement of production systems to the Far East is seen as a particular problem for VSYS. Specific areas of concern include:

(a) Obtaining and maintaining supplies from new suppliers

(b) Setting up production lines with new workforce and new machinery

(c) Maintaining sufficient inventory of materials to meet demand when the delivery times are uncertain

(d) Implementing any necessary revisions to the management accounting systems

However, the board is confident that the move will be successful and looks forward to a positive response from workers and shareholders.

Requirement

Assess the risks associated with the decision to outsource to the Far East, briefly recommend ways in which these risks can be controlled and briefly describe the assurance work that VSYS should carry out on potential suppliers.

See **Answer** at the end of this chapter.

6.5 Risk pooling and diversification

Risk pooling and diversification involves using portfolio theory to manage risks. You may remember that portfolio theory is an important part of an organisation's financial strategy, but its principles can be applied to non-financial risks as well.

Risk pooling or diversification involves creating a portfolio of different risks based on a number of events, some of which may turn out well while others will turn out badly, the average outcome of which will be neutral. What an organisation has to do is to avoid having all its risks positively correlated, meaning that everything will either turn out extremely well or extremely badly.

One means of diversification may be geographical – spreading risk across countries at different stages of the trade cycle.

In addition, although diversification may sound good in theory, the company may have insufficient expertise in the product or geographical markets into which it diversifies leaving it vulnerable to competition from other companies that focus on a specific market or product type.

Interactive question 3: Budget airline [Difficulty level: Intermediate]

A budget airline that offers low cost short-haul flights is considering the provision of flights to a country with a volatile political environment, where public spending on such facilities as airports is often withdrawn without warning. There is also a history of foreign planes being grounded for no apparent reason and being forbidden to leave the country for several days. Market research has shown that despite these problems, there is considerable demand for low cost flights to this country.

Requirement

Identify any potential risk strategies that could be adopted by the airline's management.

See **Answer** at the end of this chapter.

6.6 Implementation of risk management plans

Implementation of the risk management process help to clarify what ongoing actions should be taken beyond the planning stage to ensure that the system is implemented in a manner that is beneficial to the management team. The implementation process helps to ensure that you get the best risk protection for the amount invested in the risk and other management processes.

The implementation process focuses on the process itself rather than the risks of a particular project. This step should be ongoing, focusing on the performance of the risk management process and the way in which it is integrated with other processes relevant to the project in question.

Organisations need to treat the implementation stage as a separate project with clear objectives and success criteria, clear planning, proper resourcing and effective monitoring and control.

6.7 Monitoring of risk management plans

All risk management plans must be monitored to ensure that they are achieving the desired results and that changes to the project's risk profile are reflected.

To assess the effectiveness of risk management plans, standards and benchmarks must be established against which results should be measured. Standards can come from such sources as industry regulations or the industry leader.

Once the standards and benchmarks have been established, the risk management plan can be measured continually against them over time to allow actual performance to be compared with expected performance, which in turn can be used to adjust below-standard results.

In order to determine when adjustments to performance should take place, a business needs to establish a threshold (or 'trigger point') which represents a sufficient change in risk exposure to warrant another risk analysis being carried out. Risk management is a continuous process and those responsible for handling risk should be prepared to treat it as such.

As with any process, evaluation of risk management plans is essential to ensure they are performing to expectations. Managers and stakeholders in the risk management process should consider such areas as:

- How successful was the plan and were the benefits and costs at the predicted level?
- In the light of the above, are any changes needed to improve the plan?
- Would the plan have benefited from the availability of additional information?

Risk monitoring is similar to an audit of the risk management process. Various tests will be carried out to determine whether individual controls are working properly and recommendations made in the light of results. However, unlike auditing, risk management monitoring does not take place only on an annual basis. Risk monitoring is a continuous process.

Case example: GlaxoSmithKline – risk management

We have already discussed the key risks facing GlaxoSmithKline (GSK) according to its 2012 annual report. The report goes into detail about how risks are being managed.

Risk	Mitigation
Research and Development (R&D) not delivering new commercially viable products	Reorganisation of R & D department into smaller units, to encourage entrepreneurialism and accountability. Collaboration with partners in academia, biotechnology companies and other pharmaceutical companies and consultation with payers and patients. (You may remember that we discussed in detail how GSK has regenerated its R & D capabilities over the years in Chapter 1.)
Failure to protect intellectual property rights	Use of a global patents group to oversee processes and monitor new developments in patent law, in particular litigation processes to ensure successful enforcement and defence of patents.
Product quality failures causing risk to the patient or consumer	Adoption of Quality Management System throughout supply chain and lifecycle of products. Oversight by a Chief Product Quality Officer and Quality Council that examines emerging risks, shares experience and cascades what has been learnt over the group. Assignment of quality staff to each business unit.
Interruption of product supply	Assessment of standing of suppliers, safety stocks and backup supply arrangements and, if possible, avoidance of dependence on a single supplier.
Inability to obtain adequate prices	Demonstration, particularly to governments of value of medicines. Exploration of different pricing models for innovative products. Restructuring of business to take advantage of growth opportunities.
Non-compliance with laws and	Continuously changing internal control framework to take into account changes in commercial model, marketplace, guidance and regulations.

Risk	Mitigation
regulations	Oversight by a chief regulatory officer and regulatory governance board. Involvement of Medical Governance Ethical Committee to ensure application of principles of good medical science, integrity and ethics. Global code of practice for marketing and promotional activities. Policies ensuring adherence to economic sanctions and export control laws.
Exposure to political and economic risks and natural disasters	Diversification mitigates exposure to local risks. Assignment of a cross-business team to manage European economic risks, which has developed response plans to different European economic events. Reduction of exposure in key countries, including exercising caution in counterparty exposures and proactively managing liquidity positions.
Alliances and acquisitions difficulties	Due diligence procedures, review of major transactions by management boards and management of integration by Corporate Strategy group, with integration team being appointed for each acquisition.
Financial reporting risks	Testing of design and operating effectiveness of key management controls, working with advisers to ensure group up-to-date with latest developments. Procedures for review and sign-off across group and by senior management.
Tax and treasury losses	Monitoring of current debates to anticipate changes in tax law, use of compliance policies and procedures and engagement of advisers to review application. Use of simplified intellectual property ownership model to give greater certainty in application of transfer pricing. GSK's treasury department does not act as a profit centre, to reduce risks. Treasury risk is managed by a detailed set of management policies that is reviewed and approved annually by board.
Failure to comply with anti-corruption legislation	Global anti-bribery programme that includes global policy, ongoing training and requirements relating to due diligence, contracting and oversight. Stronger controls over interactions with government officials and business development transactions. Dedicated team drives implementation of programme, supported by extended team of functional experts.
Adverse outcome of litigation and government investigations	Focus on patient safety in drug development. Medical governance system involving Global Safety Board and Chief Medical Officer responsible, amongst other things, for safeguarding human subjects in tests. Dispute management procedures aiming to resolve disputes early.
Non-compliance with health, safety and environment requirements	Emphasis on culture where employees feel valued, along with procedures to minimise hazards. Reduction of water and energy consumption and hazardous waste, and reporting in corporate responsibility report.
Credit risk from large customers	Monitoring of financial information and credit ratings, and review of credit limits.
IT security breaches	Assessment of changes in risk environment, review of policies and controls and routine training of employees.

However, as we shall see in Chapter 19, the systems and controls that GSK had in place failed to prevent a police investigation into corrupt activities by some of its Chinese executives.

6.8 Board monitoring of control systems

As well as monitoring specific plans, the board needs to review the effectiveness of systems taken as a whole. The UK Turnbull report suggests that boards should regularly receive and review reports and information on internal control, concentrating on:

- What the risks are and strategies for identifying, evaluating and managing them
- The effectiveness of the management and internal control systems in the management of risk, in particular how risks are monitored and how any weaknesses have been dealt with
- Whether actions are being taken to reduce the risks found
- Whether the results indicate that internal control should be monitored more extensively

In addition, when directors are considering annually the disclosures they are required to make about internal controls, Turnbull states they should conduct an annual review of internal control. This should be wider-ranging than the regular review; in particular it should cover:

- The changes since the last assessment in risks faced, and the company's ability to respond to changes in its business environment
- The scope and quality of management's monitoring of risk and internal control, and of the work of internal audit, or consideration of the need for an internal audit function if the company does not have one
- The extent and frequency of reports to the board
- Significant controls, failings and weaknesses which have, or might have, material impacts upon the accounts
- The effectiveness of the public reporting processes

Case example: Basel Committee

Since 1974, the Basel Committee on Banking Supervision has made important recommendations affecting risk management and internal controls operated by banks.

The Basel II accords were particularly important in establishing risk management and capital adequacy requirements.

The Committee highlighted the need for boards to treat the analysis of a bank's current and future capital requirements in relation to its strategic objectives as a vital element of the strategic planning process. Control systems should relate risk to the bank's required capital levels. The board or senior management should understand and approve control systems such as credit rating systems. Banks should use methods such as value at risk models that capture general market risks and specific risk exposures of portfolios.

The Committee stressed the importance of banks having an operational risk management function that develops strategies, codifies policies and procedures for the whole organisation and designs and implements assessment methodology and risk reporting systems. It is particularly important for banks to establish and maintain adequate systems and controls sufficient to give management and supervisors the confidence that their valuation estimates are prudent and reliable.

Banks' risk assessment systems (including the internal validation processes) must be subject to regular review by external auditors and/or supervisors. The regular review of the overall risk management process should cover:

- The adequacy of the documentation of the risk management system and process
- The organisation of the risk control unit
- The integration of counterparty credit risk measures into daily risk management
- The approval process for counterparty credit risk models
- The validation of any significant change in the risk measurement process
- The scope of counterparty credit risks captured by the risk measurement model
- The integrity of the management information system
- The accuracy and completeness of position data

- The verification of the consistency, timeliness and reliability of data sources used to run internal models, including the independence of such data sources
- The accuracy and appropriateness of volatility and correlation assumptions
- The accuracy of valuation and risk transformation calculations
- The verification of the model's accuracy through frequent testing and review of results

The most recent guidance, Basel III, published in December 2010 and updated in June 2011, focused on capital and liquidity standards. Basel III established higher minimum capital levels and tightened the rules on the definition of capital. In particular, it focused on raising capital requirements for trading and complex securitisation processes, which have been a major source of losses. It also introduced measures to strengthen the capital requirements for counterparty credit exposures arising from banks' derivatives, repo and securities' financing activities. The capital requirements were supplemented by a leverage ratio requirement, aiming to limit the risk of destabilising deleveraging processes and introducing additional safeguards against model risk and measurement error.

The Committee also introduced for the first time global liquidity standards, noting that the difficulties experienced by banks were sometimes due to lapses in the basic principles of liquidity risk management. The liquidity standards have two objectives, firstly to ensure that banks have enough liquidity to survive an 'acute stress scenario' lasting one month. The second objective is concerned with the longer-time horizon, creating incentives for banks to use more stable sources of funding.

Other requirements aim to limit the shocks caused to financial systems by the impact of cycles. These include promoting disclosure of expected losses, conserving capital above the minimum requirements and adjustment of the capital buffer range when there are signs that credit has grown to excessive levels.

Basel III has been seen as building on the risk management requirements of Basel II, in particular promoting an enterprise risk management approach.

The US Federal Reserve announced in December 2011 that it would implement virtually all of the Basel III rules.

[Further details about the reports of the Basel Committee are available on the website of the Bank for International Settlements: www.bis.org/list/bcbs/index.htm]

6.9 Reporting on risk management

The UK Turnbull Report laid down the minimum expected guidelines for disclosure on risk management and corporate governance. The report was intended to encourage best practices, and stated that publicly traded companies should report on the risks they faced and outline these risks in more detail.

The Turnbull Report requires the following disclosures.

- The governing body of the company (generally the board of directors) should acknowledge responsibility for internal control systems
- An ongoing system should be in place for identifying, evaluating and managing significant risks
- An annual process should be in place for reviewing the effectiveness of the internal control systems
- There should be a process to deal with the internal control aspects of any significant problems disclosed in the annual report and accounts

Case example: Risk disclosures

A survey of risk disclosures in the annual reports of publicly listed companies in Australia, published in 2012, found that there was moderate or high disclosure (ie disclosure in over 40% of annual reports) of management of only a very limited number of risks:

- Insurance risks
- Changes in regulatory regime
- Reputation risk
- Occupational health and safety risk

There were more examples of occupational health and safety risk management than of any other risk. Intoll Group gave a good example:

As a minimum, each Business Unit is required to complete an OH&S plan that addresses their identified OH&S issues together with any audit corrective actions and agreed prevention strategies. OH&S audits are conducted by both internal OH&S professionals, including dangerous goods specialists, and external OH&S auditors...each State Government Authority conducts OH&S audits of the Toll OH&S management system to enable Toll to retain their licence. Failure in any such audit may result in a reduced self insurance licence period or in some instances, loss of licence.

6.10 Limitations of risk management plans

As with all business processes, regardless of their quality, risk management plans have their limitations. They are only as good as the information that is used to construct them. If risks are not assessed properly, then a great deal of time and resources could be wasted in dealing with the risk of losses that, in fact, are highly unlikely to occur – time and resources that could have been more gainfully employed elsewhere. Some organisations over-estimate what risk management processes should be able to achieve, to the extent that work is suspended until the risk management process is considered to be complete.

At the other extreme, there are organisations who believe themselves to be immune from losses resulting from business risk, simply because they have risk management processes in place. Complacency is one of the worst enemies of successful businesses. As mentioned above, risk management processes must be continually monitored for any weaknesses – just like the business environment itself, they are not static instruments.

Such is the focus on risk and its consequences in today's business that there is a danger of management spending so long thinking about the negative aspects of projects that they forget about the positive aspects.

Interactive question 4: LP **[Difficulty level: Intermediate]**

LP manufactures and supplies a wide range of different clothing to retail customers from 150 stores located in three different countries in the Eurozone.

In order to increase sales, a new internet site is being developed which will sell LP's entire range of clothes using 3D revolving dummies to display the clothes on screen. The site will use some new compression software to download the large media files to purchasers' PCs so that the clothes can be viewed. This move is partly in response to environmental scanning which indicated a new competitor, PVO, will be opening an unknown number of stores in the next six months.

As a cost cutting move, the directors are considering delaying LP's new range of clothes by one year. Sales are currently in excess of expectations and the directors are unwilling to move away from potentially profitable lines.

A retail customer of LP's has recently brought legal proceedings against LP for loss of business through one of the chemicals used to waterproof some garments releasing toxic fumes after prolonged exposure to sunlight. The case is due to come to court in two weeks' time but LP's lawyers think that it could be a very lengthy case and believe that LP will eventually lose it. LP's board has made a number of estimates. The directors believe that the best outcome for LP will be damages of CU300,000 payable in one year's time. The worst possible outcome would be for the case to continue for three years, in which case the estimate of damages and costs is CU2,500,000, payable in three years' time. A further estimate, between these two extremes, is that damages of CU900,000 will be payable in two years' time. Management's estimates of probabilities are best outcome 30%, worst case outcome 10% and middle ground outcome 60%. No provision nor any disclosure has been made for this court case in the draft financial statements that are due to be finalised over the next few weeks. Prior to the legal claim being made, LP had already stopped using the chemical in its manufacturing process.

Requirements

(a) Explain the business risks facing LP and briefly describe how these risks can be managed.

(b) Explain how the possible losses arising from the legal claim should be dealt with in LP's financial statements.

See **Answer** at the end of this chapter.

Case example: BP

The impact of the oil spill in the Gulf of Mexico on BP was a significant news story in much of 2010. On 3 August 2010, the US government stated that the oil spill in the Gulf of Mexico was officially the biggest leak ever, with an estimated 4.9 million barrels of oil leaked before the well was capped in July 2010. The consequences of the spill included the departure of BP's chief executive, Tony Hayward. BP created a compensation fund of $20bn and had paid out a further $8bn in the clean-up campaign by the end of 2010.

The results of BP's own internal investigation were published in September 2010. It blamed a 'sequence of failures involving a number of different parties', that is BP and two other companies working on the well, although both of the other companies criticised this report. Problems highlighted by the BP report included 'a complex and interlinked series of mechanical failures, human judgements, engineering design, operational implementation and team interfaces.'

Critics have pointed to other operational problems BP has had, from the explosion at its Texas City refinery to the temporary shut-down at Prudhoe Bay. CNN news quoted an employee who had worked at both locations as saying that no one should be surprised by the 2010 disaster: 'The mantra was 'Can we cut costs by 10%.' Transocean, one of the other companies criticised in BP's September 2010 report, also blamed BP for cost-cutting. Transocean was quoted by Associated Press as commenting: 'In both its design and construction BP made a series of cost-saving decisions that increased risk – in some cases severely.'

The US Commission that reported on BP in January 2011 found that BP did not have adequate controls in place, and that its failures were systemic and likely to recur. The report apportioned blame between the various companies involved, although it emphasised BP had overall responsibility. The report highlighted failures of management of decision-making processes, lack of communication and training, and failure to integrate the cultures and procedures of the different companies involved in the drilling.

The report drew attention to the failure of BP's engineering team to conduct a formal, disciplined analysis of the risk factors on the prospects for a successful cement job and also the failure to address risks created by late changes to well design and procedures. The report highlighted the flawed design for the cement used to seal the bottom of the well, that the test of the seal was judged successful despite identifying problems, and the workers' failure to recognise the first signs of the impending blow-out. The commission found that decisions were taken to choose less costly alternative procedures. These were not subject to strict scrutiny that required rigorous analysis and proof that they were as safe as the more expensive regular procedures.

The report also blamed inadequate government oversight and regulation, with the agency responsible lacking staff who were able to provide effective supervision. Many aspects of control over drilling operations were left to the oil industry to decide. There were no industry requirements for the test that was misinterpreted, nor for testing the cement that was essential for well stability. When BP contacted the agency to ask for a permit to set the plug so deep in the well, the agency made the same mistake as BP, focusing on the engineering review of the well design and paying far less attention to the decisions regarding procedures during the drilling of the well.

On the basis of what BP has published however, its risk management approach did not appear to differ greatly from other oil companies, and from many other large organisations across the globe. For example, BP had sophisticated risk assessment processes in place. In 2007, it completed 50 major accident risk assessments. The assessments identified high-level risks that, if they occurred, would have a major effect on people and the environment. BP's monitoring procedures included the work carried out by the safety, ethics and environment assurance committee. The committee's work encompassed all non-financial risks.

BP's systems also received external backing. Accreditations BP held included ISO 14001 at major operating sites, reporting to GRI A+ standard and assurance by Ernst and Young to AA100AS principles of inclusivity, materiality and responsiveness.

It's possible that BP relied on generally accepted risk management practices which had become less effective over time.

In February 2012, BP announced a 14% rise in dividends, after profits for 2011 of $23.9bn, compared with a $4.9bn loss in 2010. In July 2012, however, BP set aside an additional $847m provision to pay for the 2010 disaster, raising the potential cost to $38bn. Second quarter figures for 2012 showed a 35% fall in underlying profits. The $38bn included $14bn in costs to restore over 4,000 miles of shoreline and $8.8bn in compensation payments, although it had been reduced by $4bn following settlements with partners in the venture. BP also still faced 'significant uncertainty' as it had not yet reached a settlement with the US Department of Justice. The company had, however, resumed drilling in the Gulf of Mexico.

In April 2012, former BP engineer, Kurt Mix, was arrested on charges of intentionally destroying text messages between himself and a supervisor, containing details about how attempts to cap the leaking well were going.

Summary and Self-test

Summary

Risk management tools and plans have become increasingly important over the last few years. More and more organisations are recognising the benefits of having formal plans for dealing with the risk.

As with all business processes, risk management plans require detailed groundwork to ensure they fulfil the objectives. A commonly used framework is:

- Establishing the context
- Risk identification
- Risk assessment
- Risk profiling
- Risk quantification
- Risk responses
- Implementation of plans

Each part of the framework must be dealt in with detail to allow management to fully understand what they want the risk management plan to do.

Management should also be aware of the limitations of risk management, including guarding against complacency at the one extreme and trying to build a perfect system at the other.

Self-test

Self-test question 1

ANG

ANG is a road haulage contractor. The company specialises in collection and delivery of large or heavy items such as railway locomotives and sections of bridges, from the manufacturer to the customer. The company owns 49 road vehicles of different sizes to enable transportation of the different goods.

ANG's risk management policy is based on taking out insurance. As well as the standard employer and third party liability classes of insurance, ANG also insures against damage to road infrastructure such as bridges and tunnels from its own vehicles, or as a result of goods being carried becoming unstable and falling off ANG's lorries.

ANG's terms and conditions of carriage note that radioactive goods will not be transported under any circumstances. Explosives are carried, but only where the owner accepts liability on their own insurance.

Contingency planning is limited; the board of ANG believes that if any risks do occur, then ANG has sufficient vehicles to continue operations.

The Board of ANG is also considering a new venture for the same day delivery of goods where the distance to travel is more than its existing fleet of road vehicles could travel in one day. This venture involves the purchase of surplus Hercules transport planes from the army. The board has recently decided to make the purchase of the planes because they are being offered at a substantial discount. Marketing activities will commence next month.

Requirements

(a) Explain the elements of a risk management framework in an organisation.

(b) Explain the risk management strategies available to an organisation.

(c) Evaluate the risk management strategy of ANG, explaining any amendments that you think are necessary.

Self-test question 2

HOOD

HOOD sells a wide range of coats, anoraks, waterproof trousers and similar outdoor clothing from its 56 stores located in one country. The company is profitable, although the gross profit in some stores has declined recently for no apparent reason.

Each store uses EPOS to maintain control of inventory and provides the facility to use EFTPOS for payments. However, about 55% of all transactions are still made in cash. Details of sales made and inventories below re-order levels are transferred to head office on a daily basis where management reports are also prepared.

Inventory is ordered centrally from head office, details of requirements being obtained from the daily management information provided by each store. Orders are sent to suppliers in the post, with stock arriving at each store approximately ten days after the re-order level is reached.

Requirements

(a) Identify the different risks facing HOOD, placing the risks into suitable categories.

(b) Discuss the potential effect of each risk on the organisation, describing how the impact of that risk may be minimised.

Self-test question 3

LinesRUs

The LinesRUs Company is responsible for maintaining the railway infrastructure for the rail network in a large European country. Main areas of responsibility for the company include:

- Ensuring that the railway tracks are safe
- Ensuring its signalling equipment is installed correctly and works properly
- Maintenance of overhead power lines for electric trains

Income is fixed each year dependent on the number of train services being operated and is paid via a central rail authority. The company is granted a sole franchise each year to provide services on the rail network.

Work is scheduled in accordance with the amount of income, and to provide LinesRUs with an acceptable operating profit. Any additional work, over and above standard maintenance (eg due to foreseen factors such as bridges being damaged by road vehicles and unforeseen factors such as car drivers falling asleep and driving their cars onto railway tracks), is negotiated separately and additional income obtained to repair the infrastructure in these situations.

A lot of maintenance work is relatively simple (eg tightening nuts and bolts holding railway tracks together) but is extremely important as an error may result in a train leaving the rails and crashing. The board of LinesRUs is aware of many of these risks and attempts to include them in a risk management policy.

However, recently a train was derailed, causing the death of 27 passengers. Initial investigations show that faulty maintenance was the cause of the derailment. One of the unforeseen consequences of the crash has been a fall in the numbers of people using trains, with a subsequent fall in income for train operators. LinesRUs are being sued by the train operators for loss of income, and the national press is suggesting LinesRUs must be incompetent and are calling for a re-evaluation of the method of providing maintenance on the rail network.

Requirements

(a) Advise the directors of LinesRUs of the main stages of a structured risk analysis approach that will be appropriate to the company's needs.

(b) Using the 'Transfer-Avoid–Reduce-Accept' framework, construct four possible strategies for managing the risk that rail crashes could occur. Your answer should describe each strategy and explain how each might be applied to this case.

Self-test question 4

Bush

Bush Council is the local government authority responsible for the running of public services in a district of approximately 300 square miles and with a population of over 400,000. The Bush district comprises a mixture of towns, villages and rural areas.

The council employs approximately 16,000 staff in a wide variety of occupations. The council is responsible for the maintenance of the entire public infrastructure in its area of responsibility, including the roads and sewerage systems. The council also manages education and care for vulnerable residents. The council has a divisional structure, with each division taking responsibility for specific matters such as education, roads and so on throughout the Bush district.

Injury statistics

Employment law requires that every employer, including Bush Council, must maintain a register of all workplace injuries sustained by employees. There is no precise definition of a reportable injury, but Council guidelines indicate that anything that requires a dressing, such as a bandage or sticking plaster, must be reported as minor injuries. Injuries are classified as 'serious' if they require the victim to be absent from work for more than three days and 'severe' if they require admission to hospital or involve a fatality.

The latest injury statistics show that there were 175 injuries during the year ended 31 December 20X0, of which 25 were serious injuries and three were severe. The council's director of operations is satisfied with these figures because the number of injuries is no worse than in previous years. He holds the view that such figures are to be expected, given the diverse range of jobs, many of which are risky, throughout the council. The chief executive of the council does not share these views: he thinks that the council should try to prevent all injuries by eliminating accidents in the workplace. The chief executive is also concerned about the accuracy of the injury statistics and wants the council's internal audit department to ascertain whether the figures are reliable.

Requirements

(a) Discuss the director of operations' view that it is impossible to prevent all workplace injuries and discuss the chief executive's view that it is unacceptable for Bush Council to tolerate any injuries.

(b) Recommend assurance procedures that internal audit could use to verify the figures for the number of injuries in Bush Council's workplaces.

Self-test question 5

Risk management and internal audit

Many companies are too small to justify the existence of separate risk management and internal audit functions.

Requirement

Briefly explain the distinctive roles performed by each of these functions and recommend ways of maintaining their separate effectiveness within a combined department.

IAS 10, *Events after the Reporting Period*

- Outlines the requirements as to when events after the end of the reporting period should be adjusted in the financial statements for that period. Adjusting events are those which provide evidence of conditions existing at the end of the reporting period, whereas non-adjusting events are those which indicate conditions arising after the reporting period. Overview

IAS 36, *Impairment of Assets*

- Seeks to ensure that an entity's assets are not carried at more than their recoverable amount (being the higher of fair value less costs of disposal, and value in use). An annual impairment test is required for goodwill and certain intangible assets, but for the majority of assets an impairment test is only required where there is an indication of impairment of an asset. Overview

IAS 37, *Provisions, Contingent Liabilities and Contingent Assets*

- Outlines the accounting for provisions (liabilities of uncertain timing or amount), as well as contingent assets (possible assets) and contingent liabilities (possible obligations and present obligations which are not probable or are not reliably measurable). Provisions are measured at the best estimate of the expenditure required to settle the present obligation, and reflect the present value of expenditures required to settle the obligation where the time vale of money is material. Overview

Answers to Interactive questions

Answer to Interactive question 1

Note: This is not an exhaustive list – you may have thought of different examples that are equally relevant.

- **Seasonality of business** – Most purchases are likely to be associated with seasons. Easter and Christmas are major seasons for the confectionery business, but there may be dips at other times of the year.
- **Impulse buying** – A large proportion of confectionery purchases are made on impulse. If economic changes reduced the amount of impulse buying – due to consumers having less money to spend – this could have a major effect on profits.
- **Supply of raw materials** – Sugar is a major raw material used in the manufacture of confectionery and non-alcoholic beverages. There may be a risk of relying too heavily on one major source of supply of sugar and other raw materials necessary for the continued production of products.
- **Competition** – The confectionery and non-alcoholic beverages markets are highly competitive. If there is a particular product that contributes a large proportion of sales revenue, there is a considerable risk that a rival company will bring out a similar product and take some of the market share. The extent of this risk will depend very much on the power of the brand.
- **Role of food in public health** – With lots of publicity about levels of obesity, children's eating habits, heart disease and diabetes, there is a significant threat to the confectionery and fizzy drinks markets. There is potential for governments to restrict advertising of certain products and to impose additional taxes on confectionery and fizzy drinks, which could make marketing more difficult. This could have a significant downward effect on sales and profits. Consumer tastes may change for health-related reasons. If the company is unable to respond, this will also result in declining sales or margins.
- **Product recalls and incorrect labelling of merchandise** – The confectionery industry is particularly susceptible to the risk of product recalls and incorrect labelling. The necessary publicity given to the potential consequences of nut allergies, for example, has led to much stricter regulation of labelling information. There have been instances of products being recalled due to failure to include warnings of nut content on labels. It is not just the product recall itself that is expensive – the potentially damaging effect on the company's reputation could have an even greater impact. Although product recalls are infrequent, their considerable impact is such that very tight internal controls are necessary to prevent their occurrence.

Answer to Interactive question 2

Risks

Possible non-compliance with laws – USA

The possible reduction in the workforce in the USA will mean that many employees will be entitled to some redundancy pay. There is the possibility of breach of employment law in the processing and payment of final salaries. Internal audit will need to review any redundancy calculations on a test basis to ensure that employment law has been complied with.

Possible non-compliance with laws – Far East

Establishing a factory in the Far East will mean that VSYS will have to comply with the laws and regulations of a foreign country. The directors must ensure that the law in the country is understood, possibly by hiring local solicitors.

Overall risks from new systems

Setting up a new factory in the Far East will also mean establishing new management and financial accounting systems in that country. Risks inherent in establishing those systems may be minimised by exporting the systems currently being used in the USA. However, it is unlikely that no modifications will be necessary, as new systems will be necessary to meet the specific situation in the new location. New systems always provide a risk of failure or incorrect reporting, due to lack of adequate testing or implementation problems. Internal audit will need to review the systems in detail to try to minimise the errors that occur.

Communication risks – Far East to USA

Establishing a new production location will mean that regular management and other reports will be sent between two geographically diverse locations. This new communication system will run risks such as communications being lost or intercepted en route. The board will need to ensure that appropriate encryption systems are introduced across the communication system to minimise these risks.

Board control

Geographical distance from the USA to the Far East may limit the board's ability to maintain appropriate control of the new production location. The risk is that the new factory may manufacture the computer components correctly, but fail to meet its own constraints regarding mix of components produced or timescales for production. To maintain adequate control, a director may have to be appointed to be in residence at the new factory to ensure both locations are attempting to meet the objectives of VSYS.

Assurance work

- Review financial statements of supplier for evidence of financial health
- Discuss with supplier's directors their future plans and forecasts, to see if there is a possibility of future financial problems or whether the supplier is at risk of overtrading
- Review ethical code, if supplier has one, and ascertain how the supplier ensures adherence to this code
- Review evidence of supplier's employment terms and, if feasible, inspect suppliers' factories for evidence of working conditions
- Search for evidence in media or on the internet of whether the supplier has been accused of poor employment practices or unethical behaviour
- Review terms of contract and assess strength of guarantees and effectiveness of remedies if supplier fails to perform in accordance with contract
- Ensure that contract includes sufficient protection for VSYS's intellectual property
- Obtain evidence of supplier's capacity and assess whether supplier may have trouble meeting orders, particularly during periods of peak demand
- Examine samples of production to see if supplier reaches required quality standards

Answer to Interactive question 3

- **Risk avoidance**
  - The airline could abandon plans to offer services to this country
- **Risk reduction**
  - Invite the host government to be a partner in the venture
  - Seek written assurances from the host government that the airport to be used will be fully maintained to international safety standards and that planes will not be prevented from taking off without good – and communicated – reasons
  - Have contingency plans in place to adequately deal with any operational problems while in the country – for example, establish contacts with a local coach company to ensure transport to hotels if passengers have to spend another night in the country before the plane can take off; negotiate deals with local hotels to provide any necessary accommodation
  - If the new service is likely to boost the country's economy due to, for example, an increase in visitors, it may be worth trying to lobby the country's government for a change in policy
- **Risk transfer**
  - Have adequate insurance in place to cover the cost of any planes being grounded
  - Consider setting up an alliance with an airline located in the country in question, with the service being offered in that airline's name but with a codeshare arrangement

- **Risk retention**
  - Accept the possibility that airports may not be properly maintained or planes may be grounded, and any accompanying costs

Answer to Interactive question 4

Part (a)

Business risks

These are risks that LP's **performance could be better or worse than expected**.

(i) **The new business venture to sell clothes on the internet using 3D models to display the clothes**.

There is the risk that demand will be far short of that anticipated or that costs of developing the internet site will significantly exceed budget.

LP should have assessed the 3D project for feasibility. Budgets should have been established and **actual expenditure** regularly **compared with budgets**. If actual expenditure is unavoidably and significantly in excess of budget, the board should consider whether the **project should continue**. Thorough **testing procedures** should have been built into the plan, and these should ensure that the website is capable of coping with anticipated demand. Once the website is operational, LP should monitor the level of sales generated by obtaining customer feedback through the site, and comparing sales generated with the costs of keeping the website updated.

(ii) **Product obsolescence**

The decision to lengthen the time of sale for each product may appear to decrease development costs. However, the board of LP must also take into account **demand** for the goods. The fashion industry tends to issue new clothes and designs every few months, and certainly in temperate climates, fashions will change according to the season. There is a risk that not amending the style of products sold will **reduce sales** far in **excess of the reduction in expenditure**. The overall going concern of the company may also be adversely affected if customers perceive the clothes to be 'out of date' and change to other suppliers.

LP should **monitor the performance of products** in detail, and look for evidence of falling sales and other signs that its products are viewed as old-fashioned, for example adverse customer or press comment. The board should also consider whether work on developing new products should continue to some extent, so that new lines can be launched quickly if demand falls.

(iii) **New competition**

The new company PVO appears to be aggressively attacking LP's market place position. While the overall effect of the new competitor is difficult to determine, having a new range of clothes available is likely to attract customers with little, if any, brand loyalty to LP.

LP should make sure that **competitor activity** is **carefully monitored** and responses are made to known or predicted competitor activity, for example, an advertising campaign to counter new products being launched by the competitor. LP's board should also **review very regularly the performance of products** which are most vulnerable to competitor activity and decide whether to invest more in these or concentrate on other less vulnerable products.

Part (b)

Provision

According to IAS 37, *Provisions, Contingent Liabilities and Contingent Assets*, a provision shall be recognised when:

- An entity has a present obligation as a result of a past event
- It is probable that an outflow of resources embodying economic benefits will be required to settle the obligation
- A reliable estimate can be made of the amount of the obligation

If these conditions are met, then a provision must be recognised.

The assessment of a provision for a legal claim is always a difficult area as it will be based upon the evidence available but it could also be argued that any provision or disclosure could be prejudicial to the court case itself.

In this case, it would appear that the lawyers and management are fairly certain that damages and costs will be payable. The problem is the amount of any provision to be made. As there is a timescale involved here, the first stage will be to calculate the present value of each of the outcomes. Management have also assigned probabilities to each of the three possible outcomes, so a further decision must be made as to whether to calculate an expected value or take the value of the most likely outcome. IAS 37 states that where a single obligation is being measured, the individual most likely outcome may be the best estimate of the liability, although in some circumstances, the range of outcomes may mean that a higher figure is required.

Outcome		*Discount factor @ 10%*	*Present value*	*Probability*	*Expected Value*
	CU'000		CU'000		CU'000
Best	300	1/1.10	273	30%	82
Most likely	900	$1/1.10^2$	744	60%	446
Worst	2,500	$1/1.10^3$	1,878	10%	188
					716

IAS 37 requires the estimated value of the provision to be the amount that the entity would rationally pay to settle the obligation. Arguably, in this case that could either be CU744,000 as the most likely outcome or CU716,000 as the expected value. As the directors are likely to want as low a provision as possible, they are likely to choose the expected value.

Answers to Self-test

Answer to Self-test question 1

ANG

Part (a)

Risk management structure

The organisation needs a structure **to facilitate and communicate information about risks**. A system such as an intranet or groupware product would be suitable as it connects all the individuals in an organisation, allowing access to shared databases where information about risks can be stored.

Resources

Sufficient resources are required to support **effective risk management**. This means that the board of an organisation must allocate **an appropriate budget for risk management**, and then the budget should be spent on appropriate areas. The appointment of a risk management officer will help to ensure budgeted amounts are spent appropriately.

Risk culture

The **culture** of the organisation should be developed as far as possible to ensure employees are **aware of risk and to act to avoid risks where possible**. Having a risk avoidance culture will help to ensure that management decisions taken focus on, and avoid, important risks.

Tools and techniques

Appropriate tools and techniques should be available in the organisation to enable the **efficient and consistent management of risks across an organisation**. Tools and techniques available may include obtaining **appropriate insurance** against risks and having a **clear risk management policy in place**.

Part (b)

Avoidance

In this situation, the organisation attempts to determine whether the possible **losses avoided from not undertaking a risky activity are greater than the advantages that can be gained from carrying out the activity**. If the losses avoided appear to outweigh the benefits of carrying out the activity, then the activity may not take place. In an extreme situation, entire sections of the business may be closed down if the risk or loss is considered to be too great.

Reduction

Risks are avoided in part but not reduced to zero. For example, the risk of launching a new product can be reduced by obtaining market research on possible demand for the product prior to manufacture and launch.

Risk reduction will also involve **contingency planning** to ensure that **if a risk does crystallise, that the damage from that risk is minimised**. For example, most companies will have a contingency plan against their computer systems failing. Files will be backed-up regularly, and alternative processing locations will be available if one centre becomes unavailable, eg due to fire or flood.

Acceptance

Risk retention is where the **organisation bears the risk itself**. This means that if the unfavourable outcome occurs, then the organisation will suffer the full loss of that event.

Risk retention normally occurs in two situations. First, where some **risk occurs** which the organisation's **risk management policy did not detect**. Second, where risk was **classified as insignificant** or **the cost of eliminating the risk** was deemed to be **too great compared to the likelihood of that risk occurring**.

Risk retention may also involve **self-insurance**. This means that funds are placed into some fund against risks actually occurring.

Transfer

The last risk management strategy is to **transfer the risk to a third party**. The most commonly used risk transfer policy is to take out **insurance** against a risk occurring. However, **risks may also be transferred to other third parties, often without the knowledge of that party**. For example, there may be a minimal risk of errors occurring in some software. The cost of carrying out additional testing may be more than any compensation that may be payable if the error occurs and the customer makes a successful complaint. In this situation, risk has been transferred to the customer without the customer's knowledge.

Part (c)

Transfer

The **overall risk management strategy** of ANG appears to be one of **risk transfer**. This is the policy adopted by most businesses and is wholly **appropriate**, given that the **likelihood of many risks occurring is low; but if they do occur, then significant expenditure would be involved**. For example, if a load did fall off one of ANG's lorries, then the damage caused could be considerable, not only to the load itself, but also to other vehicles, people and even the roads being used. **ANG would not be able to operate legally without this insurance**, and so it is essential to obtain it.

Insurance

Whether ANG needs to insure against **damage to roads, bridges** and so on, is unclear. The government of the country is normally responsible for maintaining the transport infrastructure. ANG could probably withdraw this insurance and effectively **transfer the risk to the government**. Some cost savings would accrue from this move.

Self-insurance

It appears that ANG effectively **self-insures against loss of vehicles** in respect of being able to provide a replacement vehicle at short notice. This may be acceptable in the case of individual losses. However, it may be **inappropriate** in situations where, for example, a **significant number of ANG's vehicles are destroyed** in a fire or flood. Where haulage contracts are signed for time critical delivery of goods, then some **reciprocal agreement with another haulage company may be appropriate**.

Avoidance

The decision by ANG to **avoid risk** completely in the **transfer of hazardous materials** seems sensible. There has been some bad publicity about the transfer of radioactive goods by road, and the potential for claims, particularly if an accident occurred in an area of high population density, could be excessive and the damage to ANG's reputation would be considerable. In the case of **explosives**, ANG would need to **ensure** that the contract for carriage clearly stated that the **owner of the goods was responsible for insurance**. ANG may also want to obtain a copy of the insurance contract to confirm this.

Risk acceptance

There appears to **be some risk in purchasing the transport planes** prior to any market appraisal of the new venture. Normally the **risk** of a new venture would be **reduced by carrying out market research prior to significant expenditure being incurred**. The board would usually be advised to check whether there was a demand for this service prior to expenditure being committed.

Published accounts, internal accounts and budgets are a useful source of information. The more carefully costs are allocated to each department, the easier it should be to calculate additional costs that would be incurred in a given emergency, which budgets will be affected and how quickly necessary funds can be made available.

Detailed plans of site and buildings will show potential bottlenecks in fire escape routes, obstructions which might create difficulties for fire engines; and problems of access, which could occur for both the site and its neighbours from fire, explosion, or escaping gas.

Physical inspection of buildings and machines (and perhaps of personnel, in the medical sense, and of their working practices) should take place on a regular basis.

Answer to Self-test question 2

HOOD

Risk can be defined as the possibility that events or results will turn out differently from what is expected.

Part (a)

The risks facing the HOOD Company are outlined below.

Operational risks

These are risks relating to the business's day-to-day operations.

(i) **Accounting irregularities**

The unexplained fall in gross profit in some stores may be indicative of **fraud** or **other accounting irregularities**. Low gross profit in itself may be caused by **incorrect inventory values** or loss of **sale income**. Incorrect stock levels, in turn, can be caused by **incorrect inventory counting** or **theft of inventory** by employees. Similarly, **loss of sales income** could result from **accounting errors** or employees **fraudulently removing cash** from the business rather than recording it as a sale.

(ii) **Systems**

Technical risks relate to the **technology** being **used by the company** to run its business.

(1) **Backup**

Transferring data to head office at the end of each day will be **inadequate for backup purposes**. Failure of computer systems during the day will still result in loss of that day's **transaction data**.

(2) **Delays in inventory ordering**

Although stock information is collected using the EPOS system, **re-ordering of inventory takes** a **significant amount of time**. Transferring data to head office for central purchasing may result in some discounts on purchase. However, the average 10 days before inventory is received at the store could result in **the company running out of inventory**.

Non-business risks

These are risks that arise for reasons beyond the normal operations of the company or the business environment within which it operates.

(i) **Event**

HOOD may be vulnerable to losses in a warehouse fire.

Business risks

External risks relate to the business; they are essentially uncontrollable by the company.

(i) **Macro-economic risk**

The company is dependent on one market sector and vulnerable to competition in that sector.

(ii) **Product demand**

The most important social change is probably a change in fashion. HOOD has not changed its product designs for four years, indicating some lack of investment in this area. Given that fashions tend to change more frequently than every four years, HOOD may experience falling sales as customers seek new designs for their outdoor clothing. HOOD may also be vulnerable to seasonal variations in demand.

(iii) **Corporate reputation**

Risks in this category relate to the overall perception of HOOD in the marketplace as a supplier of (hopefully) good quality clothing. However, this reputation could be damaged by problems with the manufacturing process and a consequent high level of returns.

Profiling

By identifying and profiling the effects of the risks, HOOD can assess what the consequences might be, and hence what steps (if any) are desirable to mitigate or avoid the consequences.

Part (b)

The potential effects of the risks on HOOD and methods of overcoming those risks are explained below.

Operational risks

(i) **Accounting irregularities**

The potential effect on HOOD is **loss of income**, either from inventory not being available for sale or cash not being recorded. The overall amount is unlikely to be significant as employees would be concerned about being caught stealing.

The risk can be minimised by introducing additional controls, including the necessity of producing a **receipt for each sale** and the **agreement of cash received** to the **till roll** by the shop manager. Loss of inventory may be identified by more frequent inventory checks in the stores or closed-circuit television.

(ii) **Systems**

(1) **Backup**

The potential effect on HOOD is relatively minor; **details of one shop's sales** could be lost for part of one day. However, the cash from sales would still be available, limiting the actual loss.

Additional procedures could be implemented to **back up transactions** as **they occur**, using online links to head office. The **relative cost of providing these links**, compared to the likelihood of error occurring, will help HOOD decide whether to implement this solution.

(2) **Delays in inventory ordering**

The potential effect on HOOD is **immediate loss of sales** as customers cannot purchase the garments that they require. In the longer term, if stock outs become more frequent, **customers may not visit** the store because they believe goods will not be available.

The risk can be minimised by letting the stores **order goods directly** from the manufacturer, using an extension of the EPOS system. Costs incurred relate to the provision of internet access for the shops and a possible increase in cost of goods supplied. However, this may be acceptable compared to overall loss of reputation.

Non-business risks

(i) **Event**

The main effects of a warehouse fire will be a **loss of inventory and** the incurring of costs to replace it. There will also be a **loss of sales** as the inventory is not there to fulfil customer demand, and perhaps also a loss of subsequent sales as customers continue to shop elsewhere.

Potential losses of sales could be avoided by **holding contingency inventory** elsewhere, and losses from the fire could be reduced by **insurance**.

External risks

(i) **Macro-economic risk**

The potential effect on HOOD largely depends on HOOD's **ability to provide an appropriate selection of clothes**. It is unlikely that demand for coats etc will fall to zero, so some sales will be expected. However, an increase in competition may result in **falling sales**, and without some diversification, this will automatically affect the overall sales of HOOD.

HOOD can minimise the risk by **diversifying into other areas**. Given that the company sells outdoor clothes, commencing sales of other outdoor goods, such as camping equipment, may be one way of diversifying risk. It can also look to reduce **operational gearing**, fixed cost as a proportion of turnover.

(ii) **Product demand**

Again the **risk of loss of demand and business to competitors** may undermine HOOD's ability to continue in business.

This risk can be minimised by having a **broad strategy** to **maintain** and **develop** the **brand** of HOOD. Not updating the product range would appear to be a mistake as the brand may be devalued if products do not satisfy changing tastes of customers. The board must therefore allocate appropriate investment funds to updating the products and **introduce new products** to maintain the company's image.

(iii) **Corporate reputation**

As well as **immediate losses of contribution from products** that have been returned, HOOD faces the consequence of loss of future sales from customers who believe its products no longer offer quality. Other clothing retailers have found this to be very serious; a **reputation for quality**, once lost, undoubtedly **cannot easily be regained**. The potential effect of a drop in overall corporate reputation will be falling sales for HOOD, resulting eventually in a **going concern problem**.

HOOD can guard against this loss of reputation by **enhanced quality control procedures**, and introducing processes such as **total quality management**.

Answer to Self-test question 3

LinesRUs

Part (a)

Risk identification

Risks cannot be managed without first realising that they exist. Managers need to maintain a **list of known or familiar risks** and the extent to which they can harm the organisation or people within it. Managers also need to be aware that unfamiliar risks may exist and maintain vigilance in case these risks occur. **Risk identification** is an **ongoing process** so that new risks and changes affecting existing risks may be identified quickly and dealt with appropriately, before they result in unacceptable losses.

LinesRUs appear to have **identified some risks** in their risk management policy. However, other risks do occur and managers within LinesRUs must be able to identify and respond to those risks quickly.

Risk assessment

It may be difficult to forecast the financial effects of a risk until after a disaster has occurred. Areas such as **extra expenses, inconvenience and loss of time** can then be recognised, even if they were not thought of in initial risk analysis. In a severe situation, damage to the company's reputation could result in LinesRUs becoming bankrupt.

In this situation, there has been a loss of confidence in the company, the extent of which may not have been foreseen. This has resulted in **additional expense in terms of lost passengers** – legal advice will be needed to determine whether LinesRUs is liable and whether the company's insurance meets this liability. It is also uncertain what the **additional time and cost of repairing the track** will be and whether LinesRUs can claim additional income for this work.

Sources of information to ensure that the risk can be minimised may include **obtaining regular reports** from train operators on the state of the rail infrastructure, and **monitoring news feeds** such as Reuters for early indication of potential disasters. LinesRUs should **file appropriate reports** of physical inspection of track as evidence of maintenance work carried out.

Risk profiling

This stage involves using the results of risk assessment in order to group risks into families. A consequence matrix is one method of doing this.

Likelihood	Consequences	
	Low	High
High	Loss of lower level staff	Loss of senior staff
Low	Loss of suppliers	Major rail disaster affecting reputation of company Loss of computer data on maintenance work Loss of franchise

The analysis will be incomplete for LinesRUs because not all risks can be identified.

Risk quantification

Risks that require more detailed analysis can be quantified, and, where possible, results and probabilities calculated. The result of calculations will show average or expected result or loss, frequency of losses, chances of losses and largest predictable loss to which LinesRUs could be exposed by a particular risk.

Unfortunately, **many of the risks facing LinesRUs** are **significant**. So while quantification can be enhanced by past events such as drivers falling asleep, they appear to be one-off situations, meaning that the actual event may not occur again. However, the adverse effects of the risk in terms of costs necessary to repair the rail infrastructure will be helpful, enabling LinesRUs to ensure that appropriate insurance is available – effectively guarding against loss by transferring the risk.

Risk consolidation

Risks analysed at the divisional or subsidiary level need to be **aggregated at the corporate level**. This aggregation will be required as part of the overall review of risk that the board needs to undertake. **Systems** should **identify changes in risks as soon as they occur**, enabling management to monitor risks regularly and undertake annual reviews of the way that organisation deals with risk.

There is no information on the **organisational structure** of LinesRUs. Given the risky nature of the company's business, LinesRUs is likely to be an independent legal entity to ensure that no other companies are adversely affected should LinesRUs go out of business.

Part (b)

Risk responses

Transfer

The risk is transferred to a third party. As noted above, this may not be possible if insurers are **not willing to accept the risk**. Alternative methods of risk transfer may have to be considered, including asking the state for some form of insurance.

Avoidance

LinesRUs may consider whether the risk can be **avoided**. However, given that maintenance work must continue and that errors are always possible, then the risk may **crystallise**. Avoidance is not possible.

The only method of avoidance would appear to be **termination of operations**. This again may not be appropriate, given that this would close LinesRUs's business.

Reduction

The risk can be **reduced by taking appropriate measures**. In the case of LinesRUs, these will include **regular training** for maintenance staff. Management should use other methods such as newsletters to **raise awareness** of the importance of work being carried out and the potential consequences of error. There should be **maintenance and enforcement of appropriate disciplinary procedures** where breaches of work practices have been identified.

LinesRUs may also consider loss control options. These may include **hiring of lawyers** to defend LinesRUs and **release of publicity material** on the work of LinesRUs, showing the extent of maintenance work normally carried out.

Acceptance

This is where the organisation retains the risk, and if an unfavourable outcome occurs, it will suffer the full loss. In the case of the rail crash, LinesRUs may have to **retain the risk** if **suitable insurance cannot be found**. Given the uncertainties regarding the costs resulting from the unfavourable outcome, insurers may be unwilling to insure for this type of event.

Answer to Self-test question 4

Bush

Part (a)

Points in favour of Director of Operations' view

Human error

Even if Bush has strong risk management systems in place, they may still be **undermined by human error**. An isolated lapse in concentration could result in an accident.

Credible policies

In order to minimise or eliminate risks, more onerous health and safety procedures may be introduced, including investigation of the factors that have led to injuries. However, staff **may not take these procedures seriously** if they feel they are impractical. Staff failing to operate onerous procedures properly may result in greater risk than staff operating less strict procedures effectively.

Points against Director of Operations' view

Complacency

The director's view appears to be **complacent.** The current injury statistics seem to be high. There is scope for reducing injuries towards zero, even if Bush can never prevent all injuries.

Reduction measures

Practical measures can be taken to reduce injuries. **Health and safety training** can be improved. Bush can introduce **requirements for staff** performing certain tasks, for example, lifting heavy objects.

Negligence claims

The director's toleration of an 'acceptable' level of injuries may leave the council **vulnerable to legal claims**. Staff who have been injured could use the director's statements as evidence of a negligent attitude by senior management towards employee safety.

Points in favour of zero tolerance

Consequences of breaches

A strong argument in favour of zero tolerance is the **consequences of accidents,** possibly serious injury or death. Although a lapse may only have resulted in a minor injury on one occasion, the same lapse another time could have much more severe consequences.

Duty of council

However health and safety law is drafted, the council has a **clear moral duty** to ensure its employees' safety.

Safety culture

Aiming towards eliminating injuries can **help promote a strong culture of safety**. If staff understand that there is no such thing as an acceptable level of injuries, they are unlikely to become complacent and will take steps to reduce the level of accidents further.

Points against zero tolerance

Employee involvement in hazardous activities

The extent of the council's responsibilities make it inevitable that some staff will become **involved in hazardous activities.** This will mean that there will always be a risk of injuries occurring, even if it can be reduced to very small levels.

Costs

Some risk prevention procedures, for example, requiring staff to wear cumbersome clothing, may be **impractical**. The costs and time taken to investigate minor problems may be excessive.

Part (b)

Assurance work

- Review HR records of the number and type of accidents and injuries in the workplace
- Review accident and injury records from a sample of locations and establish whether the categorisation of reportable and serious injuries is being applied correctly
- Enquire whether the Council has received any health and safety visits. Review documentation from any of these for evidence of serious accidents and injuries

- Talk to employees to identify any accidents not recorded in accident book

Answer to Self-test question 5

Risk management and internal audit

Risk management

Objectives

The risk management function has responsibility for **implementing the objectives** of risk management that the board, and audit and risk committees have decided.

Role

Risk management will be responsible for **building a risk aware culture** throughout the organisation by **information provision and training.** Risk management will provide **guidelines on overall risk policy** and **co-ordinate the various functional activities that deal with risks.**

Risk management will also be responsible for **designing and reviewing risk analysis procedures and risk response processes**. They should ensure that not only their **recommendations** for improvements, but the recommendations of the board, board committees and internal audit functions, are **implemented.**

Internal audit

Objectives

Internal audit will be responsible for **confirming** that appropriate risk management systems are being implemented, and that **risks associated with major business objectives** are being **managed effectively.**

Role

Internal auditors will be looking for evidence that risk management and internal control systems will be **able to take effective steps to counter major risks**. They will also review whether the systems are **working as they are supposed to work**. This includes **reviewing the activities of the risk management function itself.** Internal audit will be responsible for making **recommendations for improvements,** but will not be responsible for implementing these improvements. They should be acting in accordance with **internal auditing standards** as well as the requirements of the organisation.

Maintaining separate effectiveness of both functions

Different staff for risk management and internal audit

Although staff work for a combined department, managers can try to organise the department so that as far as possible, **different staff** work on risk management and internal audit activities.

Different training and staff development programmes

Staff could follow **different training programmes** and **train for different qualifications**.

Supervision and management

Different line managers should manage risk management staff and internal audit staff. Risk management staff and managers should report to the **risk committee**; internal audit, to the **audit committee**.

Restrictions on what staff can audit

Where staff have both internal audit and risk management responsibilities, they should **not be allowed to review systems in specific functional areas** that they themselves have **designed or implemented**.

CHAPTER 8

Data analysis

Introduction

Topic List

1. Data and analysis
2. Strategic, financial and operational data
3. Strategic data analysis
4. Financial data analysis
5. Operational data analysis
6. Obtaining more information
7. Data analysis in the Strategic Business Management exam

Summary and Self-test

Answers to Interactive questions

Answers to Self-test

Introduction

Learning objectives

Tick off

- Undertake appropriate data analysis, business analysis and financial statement analysis ☐
- Explain financial and operational data and other management information, drawing inferences relating to its completeness, accuracy and credibility, as a basis for a meaningful analysis of the position, future prospects and risks for a business ☐
- Demonstrate how suitable financial, strategic and operational analysis can be used to analyse financial and operational data and to evaluate business position, prospects and risks ☐
- Communicate an explanation (stating any reservations regarding transparency and objectivity of data and information) of the position, prospects and risks of a business, based on analysis of financial and operational data and information, and assess the extent to which the limited assurance and reasonable assurance engagements can identify and mitigate information risks in this context ☐

Examination context and syllabus links

This chapter reviews data analysis skills that you have covered already in the *Business Strategy* exam at Professional Level. Data analysis is even more important at the Advanced Level, because of the requirement to analyse more complex scenarios. In the exam, you may need to analyse financial and/or non-financial data, as well as financial statements.

It is important to note these different sources of data or financial information:

A company's **financial statements** are a vital source of information about the company's performance, and so, in your exam, you should be prepared to analyse and interpret published financial statements. You should also be prepared to consider how well this information from a company's financial statements correlates with any other information you have been given about the company (including, possibly, management's own statements about the company in their 'Management Commentary' in an Annual Report).

However, as well as published financial information you might also need to **analyse internal data** or **management information** in your exam. Remember, this data could be non-financial as well as financial. For example, if a company is using a balanced scorecard approach to performance measurement, it might be necessary to analyse its performance in relation to customer service, process efficiency, and learning and development, as well as its financial performance.

The reference to the balanced scorecard (which we discussed in more detail in Chapter 4) highlights that you may need to undertake data analysis in the context of **performance measurement**. For example, you might need to analyse performance information in order to assess how well an entity is performing, for example, against its objectives, or against its key performance indicators (KPIs). In turn, performance measurement might involve **benchmarking performance** between different divisions or different companies, or it might involve analysing whether managers have achieved their performance targets and therefore, qualify for a bonus.

Alternatively, you may find a situation where the management of an entity think that the entity is performing well, but analysis of the management accounting information does not support this. For example, the KPIs which management are monitoring may not cover the entity's **key processes**, and performance in those areas may be poor (while performance in the areas actually being measured has remained quite good).

However, the scenarios where data analysis could take place will not be limited to performance measurement only, and you should be prepared to face a wide range of scenarios in your exam. For example, other possible scenarios might include:

- **Valuation of a business**, for example, either by a company considering acquiring the business, or by a group considering the disposal of one of its companies. We will look at valuation methods in detail in Chapter 12 of this Study Manual.

- **Evaluation of capital projects**, for example, using NPV calculations.

- **Evaluation of proposals** to outsource a business division or a process.

- **Evaluating performance of divisions or SBUs**, for example, using Return on capital employed (ROCE) or Economic value added (EVA) techniques.
- **Cost analysis**, for example, the mix between fixed and variable costs (operational gearing), or issues around overhead apportionment across different products, and the link between costs and prices. Alternatively, cost analysis could be used in relation to strategic choices. For example, if an organisation wants to pursue a cost leadership strategy, how well do its costs – in relation to competitors' costs – fit with that strategy?

Please note, however, that this is only a small selection of the possible types of scenario you *might* face in your exam. The type of scenarios where data analysis could take place will not be limited to these though. Remember that, in Chapter 2, we discussed how potential strategic choices should be evaluated in relation to the suitability, acceptability and feasibility for an organisation. Financial analysis, and an evaluation of an organisation's financial resources and financial constraints, is likely to be a key part of evaluating the feasibility of a proposed strategy.

Also, note that data analysis could be required more generally in the context of strategic management accounting issues: for example, in order to identify an entity's market share, or to calculate the rate of market growth.

Feedback from past exams shows that the lack of meaningful analysis remains a common weakness in candidates' scripts at Advanced Level.

A key point to remember is that the data analysis you perform should be linked to the wider strategy, position or issue in the scenario. Numbers will form part of the analysis, but the numbers should act as a 'peg' on which to hang discussion: you must demonstrate an understanding of the story behind the numbers. Explanation and evaluation of any numerical analysis is therefore an important element of data analysis.

1 Data and analysis

Section overview

- This section considers the problems with using information in reports or statements, because of the characteristics or quality of the data in them. Professional accountants have to use their common sense and judgement when they analyse data. They are often required to draw conclusions or make recommendations on the basis of information in business reports and financial statements. The analysis of such data is normally both quantitative and qualitative. It is important that accountants should be aware of the limitations of any data they are using when they make such conclusions or recommendations.

The word 'data' has several meanings. It is commonly associated with input to a computer, or 'raw data' which is processed to obtain meaningful information. For the purpose of this chapter, a useful definition of data is: 'Facts from which other information may be inferred'.

Professional accountants are often presented with reports and statements, from which they are expected to identify issues and draw conclusions. In other words, they have to analyse the data and consider its implications.

Reports and statements vary in nature. They may be **internally-produced** business reports or financial reports, as well as published financial statements:

(a) Internally-produced business reports may cover internal operational issues, such as:

  – Performance reports, or
  – External issues relating to markets and competition, or the business environment generally

  Internal reports may be produced by any department section or unit of the business and may contain historical data or forward-looking forecasts and plans.

(b) Internally-produced financial reports may be management accounting reports, particularly performance reports on costs and profitability. The nature of management accounting reports varies with the type of business and the type of cost and management accounting system in use.

Data may also be provided in **externally produced reports**, such as reports by consultancy firms, government departments or international bodies.

1.1 Requirements for data analysis

The Strategic Business Management examination expects you to be able to do the following:

(a) Study data on any business-related or finance-related topic, from internal or external sources.

(b) Consider the implications of what the data appears to show, make inferences and draw tentative conclusions.

(c) Consider the reliability of the data, and therefore your confidence in the conclusions you have drawn.

(d) Where appropriate, recommend how additional data may be obtained to test the validity of your conclusions: where information may not be conclusive, the challenge is to identify what more you need to know and how to set about finding it.

This chapter does not set out to provide more technical content and knowledge. Instead, it suggests methods of approaching data analysis and using the technical knowledge that you already have.

The skills required for data analysis may be summarised as follows:

- Choosing analytical tools that are appropriate in the context of the question, eg financial ratios, KPIs, break-even calculations

- Carrying out the relevant calculations

- Interpreting the resulting information to demonstrate an understanding of the story behind the numbers and communicating that analysis succinctly

- Analysing the wider consequences and implications of the numerical data, for example, a fall in production costs, perhaps harming product quality
- Exercising judgement to draw conclusions and/or produce sensible recommendations
- Looking beyond the information provided at what additional information may be useful to generate a better analysis/understanding and at any reservations regarding the data/techniques/assumptions applied
- Linking different pieces of data to explain trends or outcomes
- Highlighting weaknesses or omissions in the data provided
- Discussing cause and effect relationships – eg identifying underlying causes of changes in the data

1.2 Characteristics of data

A useful starting point is an appreciation of the characteristics or qualities of data. Information should be reliable; but data often **lacks reliability**, for any of the following reasons.

(a) **Incomplete**. Data is often incomplete, in the sense that it does not tell the user everything that he or she needs to know. Incomplete information is a source of evidence, but not enough for the evidence to be conclusive. The user should want to learn more before reaching a conclusion.

Incompleteness of data can be a particular problem with external reports, whose purpose may be only indirectly related to the interests and concerns of the report user.

(b) **Lacks neutrality**. Information may lack neutrality. A report may contain opinions and recommendations that reflect the opinions and bias of the report writer. Professional scepticism may need to be applied in interpreting such data or placing reliance upon it.

(c) **Inaccurate**. The data in a report or statement may be inaccurate, or the user of the report or statement may suspect that it is inaccurate. Alternatively, data may be insufficiently accurate for the requirements of the user. Without confidence in the accuracy of data, the user cannot make reliable conclusions.

(d) **Unclear**. Information may lack clarity, especially when it comes from an external source. Lack of clarity may be due to:

- **Poor expression of ideas** in an external report by the report author, or lack of clarity about the assumptions on which information in the report is based
- **Deliberate lack of transparency** by the information provider. An example of this might be press releases by a competitor organisation, whose statements about a particular item of news may be deliberately obscure without being untruthful

(e) **Historical**. Historical data may be used to make forecasts or conclusions about the future. However, any historical-based prediction is inevitably based on the assumption that what has happened in the past is a valid guide to what will happen in the future. This may not be the case.

(f) **Not up to date**. When events in the business environment are changing rapidly, information may get out of date very quickly. There is a risk that any data in a report or statement is no longer accurate because it is no longer up to date.

(g) **Not verifiable**. Some data or information may not be verifiable. Management may want corroboration of a fact or allegation, but there may not be an alternative source for checking its accuracy. This is often the case in employment disputes at work: two individuals may contest claims made by the other, and there may be no way of checking whose allegations are correct.

(h) **Source**. Information may come from a source that is not entirely reliable. This may be a particular problem with secondary data from external sources.

Accountants must use the data that is available to them, even though it is not 100% reliable. They may have to qualify their opinions or judgements according to their view about how much reliance they can place on it. A major problem is often incompleteness.

Data may **lack relevance** as well as reliability.

(a) There may be a risk of drawing unjustified conclusions from available data, and interpreting data in ways that the facts do not properly justify. The data user may imagine that that there is evidence to justify a conclusion, when the evidence from the data is not at all conclusive.

(b) With financial data, there may be a risk of using financial statements prepared under the accruals concept to make conclusions when cash flows and incremental costs should be used.

An accountant may want to use data to make comparisons, such as comparing the performance of different companies or different segments of a business. Unfortunately, data may not be properly comparable. For example, comparing sets of data about the performance of two rival companies may not be entirely reliable because the available data for the two companies:

- Has been collected in different ways, or
- Is based on different assumptions, or
- Is presented differently, under different headings

1.3 Making judgements about the quality of data

If the information is not entirely reliable, you may have to make a judgement on the degree to which it may be trusted. It is not sufficient to decide that information is either 'reliable' or 'unreliable': there are *degrees of reliability* between the two ends of the scale.

Having made a judgement about the reliability of data, the accountant must:

- Reach a conclusion, but possibly with some reservations, or
- Consider what additional information can be obtained before making a firm conclusion

Case example: Like-for-like retail sales

In their report *Audit insights: Retail* the ICAEW's Audit & Assurance Faculty note that, although like-for-like sales figures are the most prominent key performance indicator (KPI) for the retail sector, they are not comparable on a consistent basis.

Instead, retailers use their judgement to calculate movements in like-for-like sales by identifying and removing any distorting elements from the calculation. There is no standard basis for calculating like-for-like sales, nor is there any standard agreement as to what factors should be classified as 'distortions' and therefore, excluded from like-for-like sales.

Figures may not be calculated in the same way between different retailers. Perhaps even more importantly, the basis of the calculation may change from year to year within the same business.

As the report points out, 'Without an understanding of the adjustments and judgements in each case, the public may place greater significance on comparisons between like-for-like sales than is warranted.'

Factors that may lead to stores being excluded from like-for-like sales include:

- Stores undergoing a refurbishment or a refit
- Stores undergoing a resize (eg where adjustment to floor space is greater than 5% of the original floor space)
- Stores due to be closed in the near future
- Stores opened during the period under review
- Stores suffering from a major disruption to trading (eg flood; fire; roadworks in the immediate vicinity leading to a significant decline in footfall; redevelopment; or opening of a direct competitor's store nearby)
- Impact of one-off events (eg impact of London Olympics)

The judgement involved in determining which stores classify as 'like-for-like,' and the lack of standardisation, means the performance measure is less valuable to the public than it might otherwise be.

The ICAEW report suggests that the fundamental judgements required to develop an approach to like-for-like sales in each period depend on a fully developed understanding of sale activity across the business.

Unfortunately, however, one reason for the variations in like-for-like calculations may simply be the range of data available to different retailers.

Finally, the report suggests that the usefulness of like-for-like sales as a performance measure is further reduced because the core relationship between like-for-like sales and profitability has changed, due to increasingly widespread deep discounting. As a result, sales numbers can be pushed upwards at the expense of profitability. But retailers rarely link data on profitability (such as movements in profit margins) to like-for-like sales.

In summary, the report suggests that, 'Greater transparency around the method used to calculate like-for-like sales, for example disclosure of calculation methods alongside the results, would benefit retailers, investors and customers alike.' The key question, however, is whether retailers could collectively develop, and implement, an agreed calculation standard.

Implications for assurance

In the scenarios described by the ICAEW report, the like-for-like sales figures appear not to be an audited section of the retailers' annual reports. Nonetheless, trends in sales highlighted by the like-for-like figures could be useful for readers of the accounts in understanding the performance of the retailers.

In this respect, given that the like-for-like sales figures are a prominent KPI, it could be beneficial for them to be subject to an external assurance report, which, for example, could evaluate the methodology used to calculate the figures, ensure that the figures have been presented in accordance with the methodology, and that the methodology remains consistent from one period to the next within the same entity.

1.4 Other aspects of data analysis

It has already been suggested that an important aspect of data analysis is an understanding of the limitations of the data or information available for analysis. Other issues may also be relevant for consideration.

(a) **Materiality and priorities**

When analysing data, it may be necessary to keep a sense of perspective. Some issues may be relatively insignificant and so immaterial for the purpose of analysis.

When a report or statement raises several different issues, you may need to identify which is the most important, and prioritise them.

(b) **Uncertainty**

When available data consists of numerical estimates, you should question the accuracy and reliability of the estimates. It may be possible to undertake some sensitivity analysis, such as considering a 'worst possible' scenario or a 'best possible' scenario, and commenting on these, as well as the 'most likely' scenario (based on the estimates provided).

2 Strategic, financial and operational data

Section overview

- Data or information in reports may be strategic, financial or operational in character. This section provides a brief overview of the types of report you may be expected to analyse or comment on.

You may be required to analyse information in a report or statement, and state opinions or reach judgements on the basis of what the report or statement contains. A suitable approach depends on the nature of the report or statement. These may conveniently be classified into three types:

(a) Strategic level reports
(b) Financial reports
(c) Operational reports

These classifications are useful for considering an approach to analysis, but it is possible to have strategic level financial reports and financial reports on operational aspects of a business.

2.1 Strategic level reports

Strategic level reports contain information that is used to make strategic judgements or to guide strategic thinking by senior management. Some strategic reports are produced internally, but many are reports produced externally, which may have some relevance for an organisation's strategic thinking and choice of strategies.

Examples of strategic reports are:

(a) A report produced by an independent research organisation or consultancy firm on the state of a particular industry and the future challenges facing that industry

(b) A government report on the national economy and on monetary and fiscal policies for management of the economy

(c) A report from an international organisation such as the World Trade Organisation on the current state of international trade

(d) A general report on the business and financial markets infrastructure in a particular country or region

(e) A market research report from an independent research agency into conditions in a particular product-market area

These are examples, but there are other types of report that may contain information of strategic relevance and interest. What they have in common is that the information within the report can be used to formulate strategic thinking within an organisation.

2.2 Financial reports

Financial reports can have either strategic or operational value.

(a) Published reports and accounts of rival quoted companies can provide useful insights into competitor organisations – their strategies, revenues, profitability. Comparisons of a business with a rival company may suggest areas of difference where one company or the other appears to have a competitive advantage or enjoys superior performance.

(b) A company should not have to rely on its own published financial statements for relevant information. More detailed financial reports should be produced internally for management. These may be strategic reports, linked to aspects of strategy but financial in nature. Most organisations have regular reports relating to annual budgets and monthly or quarterly budgetary control reports. Other financial reports may be operational in nature, such as reports on product costs and profitability, segmental profitability reports or customer profitability analysis.

2.3 Operational reports

Accountants may produce or may be required to analyse a range of operational reports. Accountants may produce non-financial reports as well as financial reports, or reports that mix financial and non-financial data. In your examination, you may be required to analyse the information in an internally-produced performance report, which may have implications for the efficiency or effectiveness of operations.

2.4 An approach to analysing data in reports

A basic approach to analysis should be the same for each type of report:

(a) Assess the information in the report or statement.

(b) Identify the issues that it raises.

(c) Consider the implications.

(d) Consider the reliability of the data and whether it is sufficient to make conclusions with confidence.

(e) Consider the additional information that should be obtained before reaching a conclusion or making a recommendation.

(f) When reaching conclusions or making recommendations, qualify your views by recognising the limitations of the data on which your views are based.

The approach to analysing data should differ to some extent according to the nature of the report or statement: strategic, financial or operational. This is because the issues that it raises may be strategic, financial or operational in nature.

3 Strategic data analysis

Section overview

- This section suggests an approach to analysing strategic data. The challenge in an exam scenario may be to identify the strategic implications of information in a report or statement, and this section highlights how you could use strategic models as a way of identifying key issues.

Strategic decision-making is concerned with the formulation and review of strategies for achieving the objectives of the organisation. In a rational approach to planning, strategies are developed after analysing the external business environment and the internal resources and competences of the organisation.

If you are required to analyse a strategic level report, you may be expected to identify any of the issues relating to environmental change, the state of the industry, competitiveness, resources and competences.

3.1 Change in the business environment: PESTEL analysis

A report may contain strategic information about change in the wider business environment. In such a context, PESTEL analysis can provide a useful framework when reading a report and considering its strategic implications. Changes in the environment may prompt a change in strategic thinking.

(a) **Political change**. Political change may have implications for business and business strategy:

- A change of government could have implications for the government's fiscal policy and spending plans. This may be significant for companies that earn substantial revenues from government contracts. In many countries, government policy towards privatisation of public services has implications for private sector service providers.
- Political change in another country may affect strategic plans for investing in the country. Liberalisation of politics may attract more foreign investment: greater autocracy in government or the threat of nationalisation of foreign businesses is likely to deter foreign investment.
- International political co-operation may have implications for business: examples may be changes in international attitudes to free trade and free trade agreements, and international efforts to restrict opportunities for tax avoidance by international companies.

(b) **Economic change**. Changes in economic conditions have obvious implications for business strategy. As one example, the slow economic recovery after the global financial crisis in 2008 may have persuaded some companies to defer new investment decisions, whereas others may have had difficulty in obtaining new finance to invest.

(c) **Social change**. Social change may have implications for business strategy. For example, as a result of an ageing population, companies may be affected by changes in demand for certain types of product such as healthcare, and there may be implications for retirement age in the working population. Very high and sustained levels of youth unemployment could have implications for social unrest and security.

(d) **Technological change**. Some technological changes, with associated social change, continue to have a major impact on businesses, especially those producing technology-related products such as smartphones, tablets, broadband services and software products. With some technological changes, an important strategic concern is the speed of adoption by consumers, and so the need of companies to respond very quickly to changes as they happen.

(e) **Environmental change**. Environmental change affects most companies in some ways and to some extent, and many large companies have environmental policies aimed at reducing levels of pollution and waste. Changes in government attitudes to environmental protection, such as changes in carbon pollution regulation, 'green' energy sources, the use of fracking to extract shale gas and the use of genetically-modified food products, can have long-term strategic implications for many companies in many different industries.

(f) **Legal change**. Legal and regulatory change can also have important strategic implications. In Bangladesh for example, it seems probable that the companies will be vastly affected by the upcoming enactment of new companies act.

The examples given here are indicative of issues that may be raised in a strategic level report. When change is identified, organisations should consider the implications of the change for strategy. When the report relates to the wider business environment, PESTEL is a useful checklist of areas to consider. It is a framework for analysis, however, and does not provide automatic answers.

Worked example: Energy costs

An accountant working for a leading German car manufacturer has read a report from a consultancy group about the future of energy and energy sources. The report includes analysis of two developments:

- Reports that the UK authorities are willing to permit energy exploration companies to tap shale reserves. This is seen as a key driver of falling energy costs in the UK over the next few years.
- A policy of the German government to replace nuclear energy by 2020 and replace it with renewable energy sources.

What are the strategic implications of this information?

Solution

Some points you could suggest are:

Exploiting shale reserves in the UK will reduce energy costs in the UK, and the UK could presumably become an exporter of energy in the future.

The replacement of nuclear energy with 'green' energy is likely to increase energy costs in Germany.

Manufacturing companies such as car producers are likely to have high energy costs as a proportion of their total production costs. These changes could make German car producers less competitive than UK car producers, but there is insufficient information to assess the scale of the threat.

It may, however, force German producers to consider the location of their production facilities and re-locating out of Germany, to a lower cost country.

3.2 Industry analysis

A strategic report may focus on conditions in a particular industry, rather than changes in the broader business environment. A report may indicate threats to the industry as a whole, or opportunities for the industry to develop and expand as a whole.

You may be asked to analyse a report on decline in a particular industry, where decline may be due to:

(a) Limited natural resources on which the industry depends, and the challenge of securing supplies of essential resources

(b) Over-consumption of resources and threats to sustainability of the industry

(c) Decline in total market demand for the product

(d) The emergence of new products or services that threaten to make an entire industry obsolete: here the strategic challenge may be to re-define the industry in which a company operates

Interactive question 1: Treadway **[Difficulty level: Intermediate]**

Treadway Stores is a UK-based international supermarket group. The following information has been extracted from an internal report to management on the position of the group within its industry.

Currently over two-thirds of its annual revenue comes from the UK, about 15% from the rest of Europe, 15% from Asia and about 1% from the USA, where its business remains unprofitable in spite of large investment.

Until last year, the company invested heavily in new store space in all regions. Opening new stores had the advantage of helping the group to increase annual turnover. However, this was at the expense of smaller operating margins. More recently, new investment has slowed down: consumer spending in UK supermarkets is expected to continue to grow over the next few years, but only at the rate of general price inflation.

Growth rates in Asia and the rest of Europe are better. In recent years, every £1 spent by the group in Asia has produced annual sales of £0.85, and every £1 spent in Europe outside the UK has produced additional revenue of £0.40.

There is strong evidence that consumers have become much more price-conscious. Revenues of discount stores have increased sharply, and Treadway customers are now buying more low-price or discounted products. Treadway has responded to growing competition in the industry by hiring more staff to improve customer service, cut prices and change the products that it sells. Last year, profit margins fell to their lowest level in over 20 years.

The UK operation continues to invest in smaller local convenience stores, where average prices are 5% higher than in larger supermarkets, and the group is expanding its online shopping services. Although online sales in food and drinks products have been good, the group is unable to compete successfully with Amazon in online sales of non-food products.

With the reduction in capital investment on new superstores, the group is now trying to make its existing stores more effective. A result of the decision to reduce capex is expected to be a significant increase in free cash flow.

Treadway also intends to improve return on capital employed. Both ROCE and the company's P/E ratio are below those of major global competitors such as Walmart.

Requirements

(a) What do you consider to be the strategic implications of this information?

(b) What additional information do you think the group should try to obtain in order to carry out a review of current strategy?

See **Answer** at the end of the chapter

3.3 Competition analysis

Reports on competition within a particular industry or market may focus on profitability, revenues and market share. You may be required to comment on aspects of competition and profitability, and the implications for the future of the business.

Several models that you may remember from your previous studies could provide a useful checklist of issues that may be relevant for analysis and comment.

(a) **Porter's five forces model** identifies five factors within an industry or market that affect the strength of competition within the market and so the potential for profitability. Profitability will be limited in markets where the following forces are strong.

- **Competition between firms** that are already in the market: both price and non-price competition affects profit margins.
- **Low barriers to entry**. When new entrants are able to enter a market easily, it will be impossible for existing firms to sustain high levels of profitability for long. High profits will attract new entrants, and the added competition will reduce prices and profit margins.
- **Supplier strength**. When a market has a small number of dominant suppliers, or a single monopoly supplier, costs of supply are likely to be high and opportunities for supply flexibility are low.
- **Buyer strength**. When a market is dominated by a small number of buyers, the buyers are able to put pressure on companies in the industry to sell to them at low prices. An example is the ability of large supermarket companies to demand low prices from their suppliers and squeeze profit margins in industries such as food manufacturing and farming.
- **Availability of substitute products**. Profit margins in a market may be low when consumers have a choice of available alternatives, and can switch between the different products or services. For example, prices of tickets to live entertainment events may be restricted by the alternative that consumers have to watch the event on subscription television.

(b) A strategic report may discuss a company's product portfolio.

The Boston Consulting Group (BCG) matrix provides a method of analysing the product portfolio of a company into cash cows, stars, question marks and dogs. A company needs a sufficient number of cash cows to generate profits and funding for new investments. It also needs 'stars' that currently require substantial investment, but are expected to be successful and the cash cows of tomorrow. For 'question marks', the strategic problem may be to decide whether to stop investing in the product and use resources elsewhere.

(c) A strategic report may discuss the position of an individual product in terms of sales growth, profitability and investment requirements. **Product life cycle analysis** can be used to assess the position within its life cycle where a product has reached:

– Early introduction and early growth phases, where revenues are small, investment requirements are high, the product is making a loss and cash flows are negative

– A rapid growth phase where new investment is still required, but revenues grow strongly and the product eventually becomes profitable and generates positive cash flows

– A maturity phase, where the product becomes a cash cow

– A decline phase, where sales revenues fall, and a decision for the company is whether to withdraw from the product market, or whether to remain in the market, but operating at lower levels of output

The checklist of issues in the above list provides a basis for analysing strategic reports on competition within an industry and product-market area. As stated earlier, checklists do not provide answers, but they provide a framework for analysis.

Worked example: Auction houses

The market for auctioneering of fine art has been dominated globally by Sotheby's and Christie's. These two auction houses have competed fiercely, and succeeded in increasing sales during the global financial crisis. However in 2012, Christie's reported a 10% increase in sales compared with 2011, contrasted by a fall of 7% at Sotheby's. In May 2013, Sotheby's announced that losses for the first quarter of the year had doubled. The problem was attributed to rising costs and a shortage of single owner collections being put up for sale. This problem was expected to disappear as the year progressed, with a number of sales of large collections planned.

The biggest rivals to the two auction giants in 2011 were Chinese auction houses. There is growing demand in China for live auctions, and a strong appetite for fine art from high-net worth individuals, who are increasing rapidly in numbers in mainland China.

Christie's announced plans to open an international fine art auction house in Shanghai in September 2013. This will be owned by Christie's and will operate under the Christie's name.

Christie's has also begun to hold online-only auctions. It held seven in 2012 and had plans to hold 50 in 2013.

Requirement

Given this data, how would you analyse the implications of competition for Sotheby's?

Solution/Discussion

There is insufficient data to assess future prospects for the global auction house market. The fall in sales in the first quarter of 2013 may be temporary, or it may be the start of a longer-term trend.

The implications of competition for Sotheby's are as follows:

The main implication is that actions by Christie's and Chinese competitors create challenges for the market share held by Sotheby's. A fall in market share will have implications for profitability.

(a) Christie's has established business in the Chinese Mainland. This may or may not be successful, but given the growing demand for fine art in China (and the probability that demand there for fine art will also grow as numbers of high net worth individuals increase) Sotheby's will need to respond with an initiative of its own.

(b) Similarly, Sotheby's may need to respond to the initiative of Christie's in holding online-only auctions.

Note: Sotheby's has announced plans for a joint venture agreement in China with the state-owned Beijing GeHua Art Company. Both the large auction houses have recognised that economic developments in mainland China and potential demand for fine art from Chinese customers means that it is probably essential to set up a business in China in order to continue competing effectively for a share of the global market.

3.4 Risk analysis

Strategic data analysis typically involves analysis of strategic risk. Risk may be described as the risk to an organisation from developments in the broad business environment, the industry in which the organisation operates or the competitive environment, such as the risk from strategic initiatives by major competitors.

Where a report indicates the existence of a risk, you may be required to consider the:

- Scale or significance of the risk
- Need for urgent action to address the risk, or
- Potential implications of doing nothing about it

Worked example: Ferry routes

In July 20X0, Ferry purchased exclusive rights to operate a car and passenger ferry route until December 20X9. This offers an alternative to driving an additional 150 kilometres via the nearest bridge crossing. There have been several ambitious plans to build another crossing but they have failed through lack of public support and government funds.

Ferry refurbished two 20-year old roll on, roll off ('Ro-Ro') boats to service the route. The boats do not yet meet the emission standards of Environmental Protection Regulations which come into force in two years' time, in 20X6. Each boat makes three return crossings every day of the year, subject to weather conditions, and has the capacity to carry approximately 250 passengers and 40 vehicles. The ferry service carried 70,000 vehicles in the year to 31 December 20X3 (20X2: 58,000; 20X1: 47,000). The service operates 360 days each year.

Hot and cold refreshments and travel booking facilities are offered on the one hour crossing. These services are provided by independent businesses on a franchise basis.

Ferry currently receives a subsidy from the local transport authority as an incentive to increase market awareness of the ferry service and its efficient and timely operation. The subsidy increases as the number of vehicles carried increases and is based on quarterly returns submitted to the authority. Ferry employs 20 full-time crew members who are trained in daily operations and customer-service, as well as passenger safety in the event of personal accident, collision or breakdown.

The management of Ferry is planning to apply for a recognised Safety Management Certificate (SMC) in 20X5. This will require a ship audit including the review of safety documents and evidence that activities are performed in accordance with documented procedures. A SMC valid for five years will be issued if no major nonconformities have been found.

Requirement

Identify and explain the business risks facing Ferry which should be assessed.

Solution/Discussion

The following table summarises business risks that may be identified in the data:

Risk	Comments
Political and regulatory	Risk that the government may decide to build a new bridge, in spite of previous failures Risk that local transport authority may remove subsidy
Environmental	Environmental regulations come into force in two years' time: risk that the boats will not meet minimum regulatory standards

Legal	The business is protected by exclusive rights that run out in about six years' time. Risks that rights will not be extended beyond December 20X9
Industry analysis	Is there sufficient demand for the service? Risk of insufficient demand Evidence: Lack of public support for bridge
	Annual capacity = 2 boats × 6 crossings per day × 40 vehicles × 360 days = 172,800 car journeys. Actual sales demand in 20X3 = 70,000 = 40.5% of capacity. Is this sufficient to sustain a profitable business, even allowing for future growth (20.7% in 20X3)
	Risks of high cost of health and safety. Risk of accidents and injury. Risk of failure to obtain Safety Management Certificate
Inadequacy of data	More information is needed about revenues, costs and demand forecasts in order to assess the business risk more confidently

3.5 Internal analysis: strengths and weaknesses

Although strategic data analysis may focus mainly on external analysis of the environment, industry and competition, internal analysis of resource strengths and weaknesses may also be relevant.

Data may indicate strengths or weaknesses in the resources and competences of an organisation, which can give them a competitive advantage over rival organisations, or expose them to serious competitive disadvantage.

Strengths and weaknesses could exist in any key resource, such as:

- Intellectual property
- Management
- Location or distribution channels
- Employee skills
- Business experience

In some industries, **intellectual property** is a major strategic asset. Patents help to protect sales and profits against inroads by competitors, provided that the patent can be enforced effectively or until an improved technology is developed by a competitor – and patented.

When companies depend on the **knowledge and talents of individual employees**, they are exposed to the risk of defection by employees to rival organisations. During the early 2000s for example, it was fairly common for 'star traders' in the financial markets to defect from one bank to another, to obtain higher remuneration, often taking a whole team with them.

Depending on the nature of a strategic report, you may find it useful to think about the implications of the information in the report using **SWOT analysis** – identifying internal strengths and weaknesses and external threats and opportunities that could have strategic implications for the organisation.

4 Financial data analysis

Section overview

- Financial analysis of information in reports or statements covers issues such as profitability, revenue and costs; investment; cash flow; and funding and capital structure. You should be familiar with financial analysis from your previous studies, but you should expect an examination question to test your ability to identify potential strategic issues which are highlighted by financial data, as well as recognising any weaknesses in the available data itself.

At this stage of your studies, you should already be familiar with the basic tools of financial analysis, including key ratio analysis. If you are asked to comment on the implications of information in a financial statement or report, you will be expected to identify which ratios may be relevant and interpret the significance of any ratio that you measure. Even so, these would be basic tasks at this level of your studies.

You could be expected to analyse financial data about any of the following areas:

(a) The financial markets. You may be asked to comment on data about conditions in the financial markets, such as interest rates or exchange rates, and implications of changes in market conditions for the organisation

(b) Revenue, profitability and costs – and pricing

(c) Cash flow or liquidity

(d) Capital structure

If you are given financial data for analysis, you should consider the adequacy or limitations of the information and be aware of what the information does not tell you. What is missing could be more important than what the report or statement contains.

(a) Data about profitability may present product profitability, when you should be more concerned with customer profitability, distribution channel profitability or market segment profitability.

(b) Data about profitability may be provided, when you should be more concerned about cash flow and funding.

(c) Cost and management accounting information may be presented in a traditional format, such as an absorption costing or marginal costing statement, when you may consider that another approach to presenting information is needed – for example, an activity-based costing statement, or information about particular aspects of cost that traditional statements do not analyse, such as quality costs.

The challenge with analysing financial information may be not so much to demonstrate your knowledge of financial analysis as to demonstrate your understanding of the limits of financial analysis when insufficient or inappropriate data is available.

Worked example: Wizard Ltd

Wizard Ltd is a specialist component manufacturer for the aerospace industry employing 54 people. It has two main customers located in North America. The relative success of Wizard over the last few years has attracted interest from a number of potential industry buyers. One of Wizard's main customers, Draco Ltd, is now considering making a bid for the entire share capital of Wizard, effectively bringing Wizard's services in-house. Draco is concerned that the specialist products that Wizard supplies them with allow it to charge, in the words of the Draco purchasing manager, 'outrageous prices'.

The financial adviser to Draco has obtained the following information relating to Wizard.

Extracts from the financial statements of Wizard

	$'000
Revenue	14,730
Cost of sales	8,388
Other costs	5,202
Profit before tax	1,140
Profit after tax	798
Dividend paid	390
Non-current assets	5,364
Inventories	1,392
Receivables	876
Cash	192
Payables	1,464
Equity share capital	600
Retained earnings	5,760

Information obtained from the Aeronautical Trade Association

Average P/E ratio (for quoted companies)	9.0
Average annual growth in reported post-tax profits (2002 – 2012)	3.0%
Average pre-tax profit margin	5.1%
Average pre-tax return on capital employed	13%
Average receivables days	78
Average payables days	34
Average revenue per employee	$154,200

The finance director of Draco has provided the following summary of Draco's recent performance:

$million	*2012*	*2011*	*2010*	*2009*
Revenue	58.75	55.60	50.30	50.50
Pre-tax profit	4.40	7.15	7.75	10.05
Dividend paid	0.40	2.50	2.50	2.50

Requirement

Analyse the financial position and performance of Wizard as at the end of 2012.

Solution/Evaluation

Measure	**Industry**	**Wizard**	**Workings**
Gross ROCE		99.7%	(14,730-8,388) / (600+5,760)
Pre-tax ROCE	13%	17.9%	1,140 / (600 + 5,760)
Gross profit rate		43.1%	(14,730–8,388) / 14,730
Pre-tax profit rate	5.1%	7.7%	1,140 / 14,730
Non-current assets turnover		2.75	14,740 / 5,364
Receivables days	78	22	(876 / 14,730) × 365
Payable days	34	64	(1,464 / 8,388) × 365
Inventory days		61	(1,392 / 8,388) × 365
Revenue per employee $	154,200	272,778	(14,730 / 54) × 1000
Pre-tax profit per employee $	7,864	21,111	(1,140 / 54) × 1000
Dividend cover		2.05	798 / 390
Current ratio		1.68	(1,392+876+192) / 1,464
Quick ratio		0.73	(876+192) / 1,464

Analysis

Pre-tax ROCE and Pre-tax profit rate – These are 37% and 51% higher than industry average, which supports the view that Wizard is able to charge high prices. This would appear to be a result of the specialism of the services that Wizard provides. Additionally, there may be strict cost control within Wizard, further allowing it to generate higher margins. Should Wizard be acquired by Draco, then the products will be available at 'cost', thereby saving Draco money, while allowing it to potentially benefit from the premium prices it can charge to Wizard's other main customer.

Receivables days – At 22, these are exceptionally low compared to the industry average. This is probably due to the fact that Wizard only has two main customers, making it possible to form close working relationships. Given the specialism that Wizard provides, it is likely that its customers do not want to sour this relationship by delaying payment. There is no reason to believe that this will change if Draco acquires the company.

Payable days – At 64, this is almost twice the industry average and reflects either a strict cash management policy within Wizard, or potentially a cash flow problem. Given the high profitability within Wizard, and its healthy balance sheet, it would appear that Wizard have squeezed their suppliers quite hard. Once acquired by Draco, this strategy may need to change to bring it in line with company policy.

Inventory days – At 61, this indicates the time that inventory is held by Wizard. This demonstrates that the production process within Wizard is about two months and may be a reflection of the complexity of the manufacturing process that they undertake. It may be a result of the safety checks, which are a key feature of supply in the aerospace industry, and the time taken to do this may contribute to the 61-day figure.

Revenue and profit per employee – These are 76% and 168%, higher than industry average, which is a further reflection of the profitability and revenue generation abilities of Wizard. This is further evidence of its ability to charge high prices and possibly control costs. Interestingly, we are told nothing about the salaries within Wizard and it may be that as a smaller firm, their salaries may be different to those within Draco. Should Wizard's salaries be higher than Draco's, this could lead to demands for higher wages amongst Draco's workforce. In terms of costs, it may well be that once Wizard is acquired, that the greater purchasing power which a larger company would have may lead to further economies of scale and even cheaper supplies.

Dividend cover – As Wizard is not a listed company, its dividend ratio is not strictly comparable with Draco's. What is relevant is that it evidences Wizard's ability to pay dividends and hence, generate cash. This is potentially good news for Draco as it has recently cut its own dividends, which will have disappointed shareholders.

Liquidity ratios – Without industry statistics, these are in themselves fairly meaningless. However, the current ratio is greater than one, indicating good liquidity, and the quick ratio is close to one. Allied with its low receivables and high payables days, this indicates that Wizard does not appear to have cash flow problems.

Overall – It would appear from the above analysis that Wizard is a profitable company that does not appear to have any liquidity or working capital concerns.

Interactive question 2: Cook Manor Nursing Homes [Difficulty level: Intermediate]

Cook Manor Nursing Homes (CMNH) is a company operating residential care homes for the elderly in a developed European country.

The residents of CMNH are those elderly people who can no longer care for themselves at home and whose families are unable to look after them. The company runs 785 homes with about 30,000 residents under its care.

The company employs approximately 42,500 staff, ranging from head office staff through the home managers to the care staff and cleaners and caterers. CMNH is a private company which aims to make a suitable return to its shareholders. It had revenues of CU938m in the last year and is one of the largest providers of residential care places in its country.

The company is split into two divisions: General Care (GC), which handles ordinary elderly residents and Special Care (SC), which is a newer operation that handles residents who need intensive care and attention due to physical or mental ailments.

The company does not own its homes but rents these from a number of large commercial landlords. It has taken on a large number of new homes recently in order to cope with the expansion of SC, which has proved successful, with 24% pa revenue growth over the last two years. GC is a mature business with little growth in a sector that is now fully supplied. GC has seen volumes and margins falling as it faces increasing price pressure from its main customers (public sector health organisations who contract out this part of their care provision).

The newly-appointed chief financial officer (CFO) has asked you to analyse the current position of the company. In particular, she has asked you to investigate a problem that CMNH is having with its landlords. The company struggled to meet its most recent quarterly rental payments and the bank eventually agreed to cover them through an increase in overdraft, as CMNH has no cash readily available.

The CFO is concerned that the company's chosen strategic measures of performance (growth in earnings per share and operating profit margin) did not identify the difficulties it is currently facing, and she said she felt that gearing needs to be addressed as a key issue.

You have been given the outline financial statements to help with this task (see Appendix below).

Requirement:

Discuss why indicators of liquidity and gearing need to be considered in conjunction with profitability at CMNH. Illustrate your answer with suitable calculations.

Appendix:

Outline financial statements for CMNH for the year just ended

Summary Income Statements

	General Care	*Special Care*	*Total*
	CUm	CUm	CUm
Revenue	685	253	938
Operating costs			
Homes payroll	397	139	536
running	86	24	110
Rents	193	64	257
Central costs	27	3	30
Operating profit	(18)	23	5
Interest			5
Profit before tax			0
Tax			0
Profit for the period			0

Statement of Financial Position

	General Care	*Special Care*	*Total*
	CUm	CUm	CUm
Assets			
Non-current assets	244	87	331
Current assets	17	47	64
Total assets	261	134	395
Equity and Liabilities			
Share capital			165
Retained earnings reserve			24
Long-term borrowing			102
Current liabilities	76	28	104
Total equity and liabilities			395

Note: A breakdown of the long-term financing into the two divisions has not been possible.

See **Answer** at the end of the chapter

4.1 Users of financial analysis

Different stakeholders have different expectations of a company, and therefore will require different information about its performance:

(a) **Shareholders** – Shareholders will be interested in the quality of their investment and the returns they can expect through dividends and capital growth. Ratios which could be particularly important to them are: Earnings per share (EPS), Price/Earnings (P/E), and Dividend yield.

(b) **Bankers and debt holders** – Bankers and debt holders will be primarily interested in the risk attached to their investment in a company. Ratios which therefore could be important to them are: capital gearing, and interest cover.

(c) **Suppliers and employees** – Suppliers and employees both depend on the company continuing in business in order that it continues to be a customer or an employer in the future. These stakeholders will be interested in a company's ability to meet its short term liabilities. Ratios such as the current ratio, and acid test ratio could be important in this respect.

(d) **Management** – They may need to consider all the ratios noted above, because they are important to (and are therefore likely to be monitored by) other stakeholders. Additionally, the company's management need to consider the company's performance in relation to profitability, cost control and working capital management. Ratios such as gross and net profit margins, inventory turnover, and receivable and payable days could therefore be important performance measures.

Managers may also want to measure the performance of different divisions within an organisation. Return on Capital Employed (ROCE) and Residual Income (RI) are two methods of measuring divisional performance.

However, there are potential problems with using ROCE and RI for evaluating and controlling business divisions:

- They are based on annual profit figures, and so disregard the future earnings of the division. Using BCG terminology from Chapter 1, a cash cow might present a high ROCE; and a star, a low one, which would be a misleading guide to their true financial value, if assessed as the NPV of future earnings.
- To boost ROCE or RI, assets with low book values will be used in preference to new assets. This could lead to short-termism, with divisions preferring not to invest in new assets, even though such an investment would be better for their longer-term future performance.

However, it is important that managers in an organisation do not focus solely on financial performance measures. As we have noted in Chapter 4, it is desirable to have performance metrics which look at key aspects of non-financial performance as well as financial performance. In the same way, it is advisable to use performance metrics which act as leading indicators, rather than focusing solely on lagging indicators.

4.2 Approach to analysing financial data

If you are given financial data for analysis, you should expect to carry out some numerical analysis. You will have to decide yourself how to do the analysis.

(a) If you are given data for more than one year, you should measure changes over time. If you are given financial data about a competitor, you should try to make a comparative analysis.

(b) There may be value in carrying out cost-volume-profit analysis (breakeven analysis) on data that you are given, but you will need to state your assumptions about fixed and variable costs.

(c) If you are given information about historical performance and targets, you should try to carry out numerical analysis of the extent to which the organisation is on track for meeting its targets.

Show all your numerical workings and state clearly the assumptions you have made.

5 Operational data analysis

Section overview

- Analysis of operational data is likely to use internally-produced management reports, which are produced primarily for control purposes rather than planning purposes. Much operational data is non-financial rather than financial.

Although operational data may be financial, non-financial or a combination of both, much of it is likely to be non-financial.

Data about operations should normally come from internal sources within the organisation.

When analysing operational performance, it may be useful to have a checklist of areas of performance. Any problems or issues arising out of an operational report are likely to raise questions about one or more of the following areas.

5.1 Efficiency and effectiveness

Efficiency is concerned with getting the maximum output from a given quantity of resources or achieving a given quantity of output with the minimum of resources. Efficiency is also known as productivity, and typical productivity measures are:

- Output per worker/hour
- Output per machine per hour
- Sales per square metre of floor space
- Average time to produce a unit or complete a task
- Average number of tasks completed per day
- Quantity of materials per unit of output
- Waste per unit of output
- Production cycle time

Effectiveness is concerned with achieving objectives with the resources that are used. Measures of effectiveness depend on what the organisation is trying to achieve, and they compare planned targets with actual achievements. Important aspects of effectiveness may be:

- **Quality:** Product quality, including product design and performance reliability, may be a key factor in providing customer satisfaction.
- **Delivery:** Effectiveness in delivery of a product or service may relate to factors such as speed of delivery and reliability of delivery.

Resources may be used efficiently but ineffectively. Similarly, resources may be used effectively, but in an inefficient way.

5.2 Balanced scorecard

A balanced scorecard approach to operational performance analysis links performance targets and performance measures through all levels of an organisation, from operational level to strategic level. The four perspectives of performance in the balanced scorecard are:

- **Financial perspective**: Achieving financial objectives in both the short and long term
- **Customer satisfaction perspective**, and aspects of performance that have the biggest effect on providing customer satisfaction
- **Internal perspective**, and critical aspects of the internal operations of an organisation
- **Innovation and learning perspective**: Issues such as product innovation or innovation in service delivery, and the acquisition of learning and knowledge by employees

Note, however, that none of the perspectives of Kaplan & Norton's balanced scorecard link directly to aspects of social responsibility or sustainability, which are becoming increasingly important elements of an organisation's overall performance. In this respect, in an article for ICAEW's Finance & Management faculty (The new thinking on key performance indicators, May 2006), David Parmenter suggested that in order to achieve a properly balanced view of performance, the number of perspectives of the balanced scorecard should be increased to six: financial; customer; internal process; **employee satisfaction**; learning and growth; **environment and community**.

5.3 Cost

Cost is a financial aspect of performance. It is difficult to assess operational performance without also considering the cost incurred by a business.

Kaplan & Norton (who devised the Balanced Scorecard) recommend that activity-based costing should be used to produce cost measures for important internal business processes. These costs, in conjunction with measurements about speed/time and quality, should be monitored over time, and **benchmarked** with a view to continuous improvement or process re-engineering.

Benchmarking would allow managers to see not only how an organisation's costs vary over time (historical benchmarking), but also how costs vary in different parts of an organisation, or how an organisation's costs compare to competitors' costs. Monitoring costs and process efficiency against competitors could be particularly important for an organisation pursuing a low-cost (or cost leadership) strategy.

Information about costs could also play an important part in any decisions about whether to outsource certain functions or processes, or whether to retain them in-house.

Interactive question 3: The Eatwell Restaurant [Difficulty level: Intermediate]

The owners of The Eatwell Restaurant have diversified business interests and operate in a wide range of commercial areas. Since buying the restaurant in 20X0, they have carefully recorded the data below.

	20X1	20X2	20X3	20X4
Total meals served	3,750	5,100	6,200	6,700
Regular customers attending weekly	5	11	15	26
Number of items on offer per day	4	4	7	9
Reported cases of food poisoning	4	5	7	7
Special theme evenings introduced	0	3	9	13
Annual operating hours with no customers	380	307	187	126

Proposals submitted to cater for special events	10	17	29	38
Contracts won to cater for special events	2	5	15	25
Complimentary letters from satisfied customers	0	4	3	6
Average number of customers at peak times	18	23	37	39
Average service delay at peak times (*mins*)	32	47	15	35
Maximum seating capacity	25	25	40	40
Weekly opening hours	36	36	40	36
Written complaints received	8	12	14	14
Idle time	570	540	465	187
New meals introduced during the year	16	8	27	11

Financial data

	CU	CU	CU	CU
Average customer spend on wine	3	4	4	7
Total revenue	83,000	124,500	137,000	185,000
Revenue from special events	2,000	13,000	25,000	55,000
Profit	11,600	21,400	43,700	57,200
Value of food wasted in preparation	1,700	1,900	3,600	1,450
Total revenue of all restaurants in locality	895,000	1,234,000	980,000	1,056,000

Requirements

(a) Assess the overall performance of the business and submit your comments to the owners. They wish to compare the performance of the restaurant with their other business interests and require your comments to be grouped into the key areas of performance such as: competitive performance, financial performance, quality of service, flexibility, and resource utilisation.

(b) Identify any additional information that you would consider of assistance in assessing the performance of The Eatwell Restaurant in comparison with another restaurant. Give reasons for your selection and explain how they would relate to the key performance area categories used in (a).

See **Answer** at the end of the chapter

6 Obtaining more information

Section overview

- In the examination, you may be required to comment on the limitations of the data or information which you are provided with, and draw 'inferences relating to its completeness, accuracy and credibility.' If you feel that the data available is unreliable, you should also be prepared to suggest how it could be improved, or what other sources of data might be available.

You may be required to analyse a statement or report, and on the basis of the information available, provide an explanation of the position, prospects and risk of a business. Having made your analysis or given your explanation, you should go on to consider the risk that your explanation may be incorrect because of limitations in the data or information available.

You would need to explain what these limitations are.

Data available for analysis may be unreliable, possibly because it is incomplete or because it comes from an unreliable source. In this situation, the accountant should consider whether the quality of the information can be improved. The learning objectives for this subject call for an ability to 'assess the extent to which the limited assurance and reasonable assurance engagements can identify and mitigate information risks in this context'.

In other words:

- What additional information might you be able to obtain?
- Where would the information be obtained?
- How reliable would it be? What would be the limitations of any additional information you can obtain? Would your additional information be able to provide reasonable assurance, or only limited assurance?

6.1 Limitations of the available data

Even though the exam question is unlikely to ask you specifically to comment on limitations in the data provided, you should be prepared to demonstrate that you are aware of any weaknesses in your analysis due to unreliable/incomplete information.

You should also be prepared to indicate what information you would like to obtain, but make sure that your suggestions are realistic.

- It is inappropriate to suggest the need for information that could not be obtained for practical reasons or which would be too expensive to obtain and not worth the cost.
- Any data obtainable on the industry and competitors will help to provide a benchmark for the performance of the business. However, the amount of information about competitors may be limited and you might need to indicate the sources of any such additional data.

Example

The financial information in a case study or scenario is likely to be in the form of a summary. You might recommend that:

- More detailed information would be useful, such as a breakdown of revenues or profits by product, country or business unit.
- Where you have been provided with historical information for analysis purposes at five-yearly intervals, data for the years in between would help assess the trend more accurately.
- Where average figures have been given, information about variations around the average might be useful, to indicate variability and risk.

6.2 Assurance engagements

Definition

Assurance engagement: An assurance engagement is one in which a practitioner expresses a conclusion designed to enhance the degree of confidence of the intended users other than the responsible party about the outcome of the evaluation or measurement of a subject matter against criteria.

The most common type of assurance engagement is the audit. However, there are a range of other assurance engagements an accountant can undertake. The basic principles and procedures for the performance of these assurance engagements are provided by Bangladesh Standard on Assurance Engagements (BSAE) 3000, *Assurance Engagements Other than Audits or Reviews of Historical Financial Information*. You should already be familiar with this standard from the Audit & Assurance paper at the Professional Level; however, we will include a brief reminder of its key points here.

BSAE 3000 distinguishes between two types of assurance engagement:

- **Reasonable assurance engagements**, which result in a **positive expression of opinion** and where the level of assurance given is deemed to be high (eg 'the management has operated an effective system of internal controls') and
- **Limited assurance engagements**, which result in **negative assurance** and where the level of assurance given is deemed to be moderate (eg 'nothing has come to our attention that indicates significant deficiencies in internal control')

Assurance engagements performed by professional accountants are normally intended to **enhance the credibility of information** about a subject matter by evaluating whether the subject matter conforms in all material respects with suitable criteria, thereby improving the likelihood that the information will meet the needs of an intended user. In this regard, the level of assurance provided by the professional accountant's conclusion conveys the degree of confidence that the intended user may place on the credibility of the subject matter.

There is a broad range of assurance engagements, which may include any of the following areas:

- Engagements to report on a wide range of subject matters covering financial and non-financial information
- Engagements intended to provide high or moderate levels of assurance
- Attest and direct reporting engagements
- Engagements to report internally and externally
- Engagements in the private and public sector

Specific examples of assurance assignments include:

- Assurance attaching to special purpose financial statements
- Adequacy of internal controls
- Reliability and adequacy of IT systems
- Environmental and social matters
- Risk assessment
- Regulatory compliance
- Verification of contractual compliance

Elements of an assurance engagement

An assurance engagement will normally exhibit the following elements.

(a) A **three party relationship** involving:

   (i) A professional accountant (the auditor or 'practitioner');
   (ii) A responsible party (the client company); and
   (iii) An intended user (eg investors, regulators)

(b) **Subject matter** (ie the information or issue to be attested)

(c) **Suitable criteria** (ie standards or benchmarks to evaluate the subject matter)

(d) An **engagement process** (the terms of the engagement and process)

(e) A **conclusion**

Planning

Planning an assurance engagement will normally include considering the following:

- Terms of the engagement
- Characteristics of the subject matter and the identified criteria
- The engagement process and sources of evidence
- Understanding the entity, the environment and the risks
- Identifying intended users and their needs
- Personnel requirements to complete the assignment

The practitioner should also:

- Obtain an understanding of the subject matter
- Assess the suitability of the criteria to evaluate or measure the subject matter
- Consider materiality and engagement risk

Obtaining evidence

The practitioner should obtain sufficient, appropriate evidence on which to base the conclusion. This may include:

- Obtaining representations from responsible parties
- Considering the effect of subsequent events

Conclusions

The professional accountant should express a conclusion that provides a level of assurance as to whether the subject matter conforms, in all material respects, with the identified suitable criteria.

The BSAE **does not require a standardised format for reporting**. However, it states that the assurance report will normally include the following elements:

- A title that indicates the report is an independent assurance report
- An addressee
- An identification of the subject matter (eg period covered, qualitative v quantitative; objective v subjective)
- An identification of the criteria (assertions, measurement methods, interpretations, regulations)
- Inherent limitations
- Specific users and intended purposes
- Responsible parties and responsibilities

- Statement that the work was performed in accordance with BSAEs
- Summary of work performed
- Conclusion
- Report date
- Name and location of practitioner giving the report

The professional accountant's conclusion provides a level of assurance about the subject matter. **Absolute assurance is generally not attainable** as a result of such factors as:

- The use of selective testing
- The inherent limitations of control systems
- The fact that much of the evidence available to the professional accountant is persuasive, rather than conclusive
- The use of judgement in gathering evidence and drawing conclusions, based on that evidence
- In some cases, the characteristics of the subject matter

Therefore, professional accountants ordinarily undertake engagements to provide one of only two distinct levels: a reasonable and limited assurance. These engagements are affected by various elements, for example, the degree of precision associated with the subject matter, the nature, timing and extent of procedures, and the sufficiency and appropriateness of the evidence available to support a conclusion.

6.2.1 Consulting engagements

Assurance engagements are associated with engagements that are initiated and paid for by one party, for the purpose of providing an independent opinion to someone else.

In the context of data analysis, obtaining better-quality information could be a **consulting engagement** rather than an assurance engagement. The key issue remains: What additional information can be obtained, how reliable will it be, and how would the additional information enable me to re-consider or adjust my conclusions?

6.2.2 Illustration: Analysis of a financial forecast

An accountant may be asked to comment on the implications of a financial forecast that has been prepared by the operations management of a client company.

The initial judgement of the accountant may be to explain the financial or strategic implications of the forecast, but question the reliability of the forecast. It may be possible to carry out a consultancy engagement to assess the reliability of the forecast.

The aim of the engagement would be to obtain sufficient appropriate evidence as to whether:

- Management's best-estimate assumptions on which the prospective financial information is based are **not unreasonable,** and
- The prospective financial information is **properly prepared** on the basis of these assumptions

The accountant would need to consider:

- The likelihood of material misstatement
- The competence of management regarding the preparation of financial forecasts (based, perhaps, on previous experience)
- The extent to which the forecast is affected by management's judgement
- The adequacy and reliability of the underlying data

The accountant should have **sufficient knowledge** of the business to be able to evaluate the significant assumptions that management have made.

Information in a financial forecast is subjective information. It is impossible for an accountant to give the same level of assurance regarding forecasts as for historical financial information.

Limited assurance can be given in the form of a negative opinion – there is nothing to suggest that the forecast is inappropriate.

Where an assurance engagement is for the benefit of management of the client company, a consultancy engagement might be more appropriate. In this type of engagement, the accountancy firm assesses the degree of reliability in the forecast and perhaps provides an alternative forecast based on different assumptions.

With any forecast, however, it is important to understand the assumptions and recognise that these may well prove incorrect.

6.3 Assurance and non-financial information

Although the focus of corporate reporting has traditionally been financial reporting, companies now disclose a much broader range of information; information which goes far beyond traditional financial reporting. For example, companies regularly now report non-financial information including:

- The business review or **management commentary** (see Chapter 1 of this Study Manual), and other statements which are contained in their annual report: corporate governance statements; information on risk management policies; internal controls or wider operating data
- Corporate responsibility reporting on environmental, social and economic performance ('triple bottom line')
- Reporting on matters of public interest: for example, carbon emissions, or quality of service provision. For example, reporting requirements imposed by regulators in the UK require water companies to disclose detailed operating data relating to water quality, leakages and customer service

Moreover, although this non-financial information does not form part of a company's audited financial statements, stakeholders want to know the information is **credible** and **reliable**. Therefore, there is also demand for external assurance over this non-financial information.

Providing this assurance over non-financial information will also help prevent an **expectation gap**. Such a gap could arise if stakeholders perceive that the auditors' work, and ultimately their opinion, extends beyond the information in the accounts to non-financial information contained in other elements of the annual report. Such information could include disclosures about oil and gas reserves, research and development pipelines (particularly for pharmaceutical companies) and audience size (for entertainment and media companies). This information is not audited, but nevertheless, it relates to key performance areas of the companies.

Management information

This demand for a broader range of non-financial information also means that companies may need to review or revise their management information systems. If, historically, these systems have been designed to provide financial information, they may not capture the additional non-financial information which companies now need to monitor and report.

Therefore, information systems may be another area in which external companies can provide assurance. In this case, the assurance sought could be that the technology systems, and the processes they support, are functioning as intended.

We will look at information and information systems in more detail in the next chapter of this Study Manual. However, in the context of data analysis, it remains important to consider whether the information systems that are generating the data being analysed, appear robust and reliable.

Worked example: Television networks

One of the major US television networks has seen external reports that indicate the following changes in TV viewing habits of US consumers.

- The Nielsen ratings for TV viewing show a large year-on-year fall in television ratings for programmes of all the major US networks.
- An independent consulting group has reported a survey finding that live and same-day viewing by people aged between 18 and 49 has fallen by 10% in one year, for programmes broadcast by the major TV networks in the USA.
- The TV companies believe that TV viewing is at an all-time high. The decline in live watching is offset by strong growth in viewing through digital recorders, on-demand videos and online streaming to computers and mobile devices.

Some major advertisers are now arguing that falling numbers of live viewers means that rates for advertising should be reduced. The TV companies are inclined to argue that changing viewing habits, from live viewing to time-shifting, means more viewers, and advertising rates should therefore increase.

What additional information may help to resolve the differences in opinion between advertisers and TV networks, and where might this information be obtained?

Solution/Discussion

It would be useful to know:

- Whether viewers who watch programmes at a later time, rather than live or same-day, are in the habit of fast-forwarding through advertising breaks, and whether this affects viewing numbers for advertisements (but not sponsorship of TV programmes)
- Whether advertisers have effective alternatives to TV as a medium for advertising

Information on these issues could be obtained by means of independent research, but the quality of the research and the information it produces could be challenged and disputed. In this example, additional information may therefore add little to the argument.

Case example: Assurance at Channel 4

The remit of Channel 4 television in the UK, as laid out in legislation by Parliament, requires it to be innovative, experimental, distinctive and diverse.

Channel 4 is unique in the way it is set up. It operates as a publicly owned, commercially self-sufficient, not-for-profit entity. This operating model differentiates Channel 4 from the publicly funded BBC and from commercially driven competitors, whose primary concern is with delivering shareholder value.

By contrast, Channel 4's sole concern is with the delivery of its remit, and its commercial and financial strategy is designed to support that remit.

Under the Digital Economy Act, Channel 4 is required to publish a Statement of Media Content Policy (SMCP), outlining how it has delivered against its remit in the preceding year, and how it plans to do so in the year ahead.

The SMCP is included in Channel 4's Annual Report, and includes graphics which monitor the corporation's performance against a 'basket of key measures' such as: investment in content (£m); the average daily hours of originated programming; and TV viewing share. The measures also include results from polls carried out by Ipsos MORI in relation to: the extent to which viewers feel Channel 4's presentation of news and factual programmes is independent (from government, or from the interests of big business); the extent to which Channel 4 takes a different approach to subjects compared to other channels; the extent to which it takes risks that other channels wouldn't; and the extent to which it portrays the viewpoints of minority groups in society.

However, although the SMCP does not form part of Channel 4's audited financial statements, the figures are independently assured by KPMG.

The KPMG partner in charge of the Channel 4 engagement pointed out that, 'Having independent and expert assurance can add additional credibility to the data in the underlying reports… One of our [KPMG's] roles is to ensure there is no cherry picking, as this can reduce the value of a performance report by turning it into a corporate public relations exercise.' (In other words, the independent assurance ensures that Channel 4 reports its performance across the whole basket of key measures, rather than selectively only including those measures in which it has performed well.)

The assurance work carried out by KPMG includes: examining and testing the systems and processes in place to generate, aggregate and report the key charts; assessing the completeness and accuracy of the key charts; assessing the accuracy of extraction of information from external information sources; and assessing the accuracy of all the calculations performed within Channel 4.

The KPMG reporting partner's comments about 'cherry picking' in the Channel 4 example above highlight one of the key criteria for assurance engagements: **neutrality**. The criteria selected to measure performance should be free from bias. Another important criterion for assurance engagements is **reliability** – selecting measures which allow consistent evaluation of information. For example, if similar entities use different criteria to assess the same aspect of performance, it will make it very difficult to make any meaningful (or reliable) comparison of performance between the two entities. This issue reiterates the points made in the case example earlier in this chapter about 'like-for-like' sales. If different stores calculate 'like-for-like' sales on different bases, and if the calculations vary from year to year, it will be very difficult to benchmark performance on a reliable basis.

7 Data analysis in the Strategic Business Management exam

Section overview

- This chapter concludes with a suggested approach to the analysis of the data you may undertake in the case study scenario in your exam. The 'What – How – Why – When – So what?' method described should already be familiar to you from your Business Strategy studies, but it is illustrated in the suggested solution to the interactive question which follows.

7.1 Key weaknesses in answers

One of the common weaknesses in candidates' answers in the Advanced Level exams is a lack of **meaningful analysis**.

The following list highlights weaknesses commonly identified in exam answers and suggests ways to address these:

1 **Restating facts or numbers without applying them to the context of the question**

A common failing is to explain **what** has happened rather than **why**, eg stating that sales have grown by 15% in the period but not indicating why they have done so.

Solution: Including the word 'because' in your answer changes the 'what' into a 'why'. In most cases a good answer passes the 'because' test, eg 'Market share has fallen from 35% to 29% ***because*** of the entry of a new lower-cost competitor.'

The 'because' should be related to specific information in the scenario, demonstrating that you have understood the relationship between the financial/quantitative information and the business issues.

2 **Failing to use the additional information from the scenario in answers, resulting in generic answers that could apply to any company, rather than the one in the scenario**

Solution: Make specific points, focusing on the particular organisation and relating to the circumstances in the scenario.

Eg 'Falling R&D expenditure may be a problem for XYZ Ltd because it has built market share on the basis of its innovative products.'

3 **Interpreting figures/results in isolation**

Solution: Link the figures/analysis, eg if market share has increased but gross margins have decreased, the company may have made a decision to reduce the selling price as part of a market penetration strategy.

4 **Focusing on a narrow range of measures**

Financial measures alone will not provide the full picture and are often the result of other factors, not the cause.

Solution: Your answer should, where possible, address a variety of performance indicators. Use the balanced scorecard headings to help you consider a wider range of measures. Remember that these measures will often help you understand what is causing the strategy to succeed or fail.

5 **Failing to use numerical analysis to support the rest of your answer**

The data analysis element may be one of the first requirements. Conclusions that you draw from this will help in answering later parts of the question.

Solution: Consider where else in your answer the analysis may be relevant / how you can 'make the numbers talk'.

Eg if the data analysis shows that the business is currently loss making and that sales and profitability are forecast to decline further, then the business cannot afford to do nothing. Any new strategy that is expected to address this decline or increase returns should be acceptable to the shareholders.

6 **Failing to explain trends in the data by identifying cause and effect relationships**.

Solution: Examine the information from different perspectives. This may, for example, include analysing information into ratios or percentages based on the data provided.

Eg where sales revenues are growing by (say) 10% per year, but the number of branches/outlets is growing by 15% per year, then calculating the sales per branch/outlet will show that sales per branch is, on average, falling. Thus, growth in overall sales revenue may be due to investment in more outlets, rather than generic growth in sales per branch because of improved efficiency or stronger market conditions. Alternatively, sales revenue growth might be analysed in relation to volume growth, changes in selling prices and changes in sales mix. Analysis of this data may reveal the relative causes (quantitatively) of sales revenue growth from each of these underlying factors.

7 **Failing to achieve a reasonable balance between numerical and descriptive analysis**

Some weak answers are almost entirely descriptive. Other weak answers include enough calculations, but their descriptive analysis is little more than stating which numbers have gone up and which have gone down.

Solution: Both numerical and descriptive analysis are important and need due emphasis. Two possible approaches are:

(1) Set out a comprehensive numerical analysis at the beginning of the answer or in an appendix with workings (eg in a table). Then produce the descriptive interpretation of these numbers.

(2) Mix the numerical analysis with the descriptive analysis by producing calculations as each issue arises.

In general approach (1) tends to produce better answers with a more systematic evaluation of the issues. The numerical analysis tends to be more comprehensive and better thought out, with clearer workings. However if you use approach (1) make sure that you are careful with your time allocation. If you spend too much time on calculations, you may not have enough time to produce sufficient descriptive analysis.

8 **Failing to understand how BFRS reported profit may fail to reflect the underlying performance of the business**

Solution: Question whether changes in profit, as measured by BFRS, reflect changes in underlying performance. Consider for instance, that good strategic decisions may take some time to be reflected in reported profit, which may even fall in the short term.

7.2 Recommended approach

In the light of these weaknesses, the following is a suggestion for the approach to adopt when tackling data analysis:

- Step 1: Review scenario and requirements
- Step 2: Decide what analysis is appropriate
- Step 3: Produce the necessary calculations
- Step 4: Interpret your analysis
- Step 5: State the additional information required

The steps that cause most problems are Steps 3 and 4.

7.3 WHAT, HOW, WHY, WHEN, SO-WHAT analysis

It is difficult to produce a universal approach, but one tool which includes both numerical and descriptive elements is: **WHAT-HOW-WHY-WHEN-SO WHAT Analysis.**

WHAT	Look at WHAT has happened overall (eg revenue has increased by 21%).
HOW	'HOW' seeks to identify the reasons why the 'WHAT' element has occurred (eg sales prices have risen by 10% and monthly sales volumes have risen by 10% following the price change).
WHY	Look for the underlying **causes** of the HOW element, which may be part of the data provided in the question (eg there have been significant product improvements introduced during the year, with additional features compared to competitors. This has meant that a higher price can be charged but has also resulted in an increase in demand, despite this increased price).

	'WHY' is ultimately more important than 'WHAT' in terms of analysis. Explaining what has happened is a necessary starting point, but you then need to use your analytical skills to identify reasons and provide explanations for what has happened. Look for the links between cause and effect. Also, do not simply consider facts in isolation. Think about whether two or more different issues may be attributable to a single cause, or whether a number of different factors are contributing to a single issue/outcome.
WHEN	If you're assessing the impact of changes in strategy over time or in making comparisons, it is important to know WHEN changes occurred. (eg If the price and volume changes above occurred half way through the year, then the increase in sales revenues for the current year may be limited to say 10.5%, but the changes will be more significant in next year's figures).
SO WHAT	The above steps analyse and interpret the nature of the data provided and attempt to identify and explain the underlying causes of any changes in the data. The next stage is to ask the question, '**So, what** are the **consequences** of our analysis for deciding on the future business strategy?' (eg what are the consequences for profit of the 10% increases in sales price and sales volume after considering the variable cost increases arising from the product improvements and volume increases? How have competitors responded with price changes and improvements in their own products, which may make the consequences next year different from that which occurred this year?)

7.4 Issues with accounts

When carrying out data analysis, you will need to use what you've learnt specifically about analysing financial statements, in particular:

- Distortions and creative accounting policies, such as income smoothing or understated provisions
- The factors determining important figures in the accounts, in particular, operating profit

Adjustments may be needed to the figures reported in the financial accounts before data analysis can be carried out. These may include re-measurement to market value and recognising assets or liabilities that are not included in the accounts. If you are analysing the income statement, you may need to strip out non-operating or non-recurring items from results to be able to make a fairer comparison over time.

Interactive question 4: WG Ltd [Difficulty level: Intermediate]

Introduction

WG Ltd was formed four years ago, following the merger of two large pharmaceutical companies. Prior to the merger, the two companies had been competitors: they believed that by combining forces, the shareholders of each company would benefit from increased profits arising from the rationalisation of manufacturing facilities, distribution networks, and concentration of resources towards more focused research and development.

With operating outlets in Europe, Asia, the United States of America and Africa, WG Ltd regards itself as a global company. It employs approximately 50,000 people worldwide and has developed a varied portfolio of products. Its profits before tax last year increased by 20% and represented approximately 35% of revenue. The company declared that its earnings and dividends per share in the same period increased by 15% over the previous financial year.

All manufacturers of pharmaceutical products claim that their pricing policies need to be set at a level to achieve high profitability in order to attract funds from investors. They argue that this is necessary to meet their high research and development commitments. In recent years, WG Ltd and other pharmaceutical manufacturers have encountered public and governmental challenges to their high levels of profitability.

WG Ltd encounters strong competition from other world-class pharmaceutical manufacturers but these are few in number. High research and development costs present a major obstacle to potential competitors tempted to enter the industry.

Mission and objectives

The directors of WG Ltd have defined their overall corporate mission as being to, 'combat disease by developing innovative medicines and services and providing them to healthcare organisations for the treatment of patients worldwide'.

The directors have confirmed their main objective is to sustain profitability while achieving the company's overall mission. They have also explained that WG Ltd aims to work towards eliminating those diseases for which the company is engaged in providing treatments. Achievement of the profitability objective is continually threatened by patents coming to the end of their lives. Patents give the sole right to make, use and sell a new product for a limited period.

Product development

A large proportion of the company's turnover in recent years has been derived from one particular drug. The patent for this drug expires next year and it is expected that its sales at that time will represent no more than 10% of total revenue. Four years ago, the sales of this drug produced almost half the company's entire revenue.

A new product, Coffstop, has now completed its rigorous development phases and is being marketed to pharmaceutical stores throughout the world by WG Ltd. It is in competition with a similar drug, Peffstill, produced and marketed by a direct competitor of WG Ltd. Medical research and opinion has concluded that Coffstop is generally more effective than Peffstill in treating the condition for which they are intended. Both drugs are available over the counter from pharmacies. The directors of WG Ltd are optimistic that Coffstop will become very popular because of its improved effectiveness over other market products.

The retail market price of Coffstop is CU1.50 per bottle, compared with CU10 per bottle of Peffstill. However, the recommended dosage of Coffstop is six times more than that for Peffstill. The bought-in costs per bottle to the retail pharmacist are CU0.50 and CU7.40 for Coffstop and Peffstill respectively. Initial indications to the management of WG Ltd are that retail pharmacists tend to prefer to stock Peffstill on the basis that it achieves 2.6 times the level of gross contribution per bottle compared with Coffstop.

It is estimated that the cost to the retailer of holding Coffstop is CU0.40 per bottle; and CU0.80, for Peffstill. The availability of shelf space is a limiting factor for most retailers. The shelf area occupied by each bottle of Coffstop is 18 square centimetres; and 60 square centimetres, for each bottle of Peffstill. Early indications show that the average weekly sales volume for retail outlets stocking both products, are 120 bottles of Coffstop and 20 bottles of Peffstill.

Market development

WG Ltd has experienced slow growth in its mature markets of Western Europe, North America and Japan. These markets contribute 80% of overall revenue but their governments have reduced expenditure on pharmaceutical products in recent years. The company has encountered a rapid sales increase in its expanding markets of Eastern Europe, South America, the Asia Pacific region, India, Africa and the Middle East. The directors of the company hold the view that increasing population growth in these markets is likely to provide substantial opportunities for the company over the next two decades.

Research and development

Almost 15% of WG Ltd's revenue last year was spent on research and development. WG Ltd has the largest research and development organisation of all pharmaceutical companies worldwide.

Much research is sponsored by national governments and world health organisations. A major piece of research which has recently been undertaken relates to new treatments for malaria, as the disease is now demonstrating some resistance to existing treatments. WG Ltd has established a 'donation programme' for the new drug in virulent areas for the disease. This means that the company is donating batches of the drug to the health organisations in these areas. The cost of this programme is offset by the sales of the new drug in other areas of the world by making it available to people proposing to travel to the regions where malaria is widespread.

Requirements

On the basis of the information in this report, analyse the main issues facing WG.

See **Answer** at the end of this chapter.

Summary and Self-test

Summary

Financial statements provide a vital source of information about a company's performance, but data analysis might also involve internal data or management information, or data from externally-produced reports. The data to be analysed could be non-financial as well as financial.

When analysing data, it is important to consider how reliable that data is, and therefore how much reliance can be placed on it.

The data or information in reports can be classified into three broad types: strategic, financial and operational.

Strategic data analysis could be particularly important in the context of strategic planning: for example highlighting changes in the business environment; the state of the industry; competitor analysis; analysis of resources and competences, and benchmarking.

Financial analysis could relate to profitability, cash flow, funding and capital structure, or investment appraisal. In addition to performing relevant calculations, it is very important to discuss the strategic or operational significance of your findings from your calculations.

The 'What – How – Why – When – So what' method is suggested as an approach for analysing data in the context of the exam case study scenarios.

Although some operational data will be financial (eg activity costs) much operational data is likely to be non-financial (eg process efficiency, quality management). Operational data is very important from a control perspective.

Companies are now disclosing an increasing amount of non-financial information which does not form part of their audited financial statements. Accordingly, there is an increase in demand for external assurance over this information, to increase stakeholders' confidence about the credibility and reliability of the information.

Self-test

Self-test question 1

Cumulus Limited

Cumulus Limited has obtained finance to convert a former industrial site in Chittagong into an outsourced data centre. The company has received a report from consultants containing the following information.

Another company that opened a larger outsourced data centre four years ago in Khulna has so far leased about one-eighth of its capacity.

Private equity firms are investing in outsourced data centres amid increasing interest in cloud computing. Most outsourced data centres (providing over 80% of total capacity) are located in Dhaka, where connectivity is fastest.

The perceived benefit of locating a centre in a region where average temperatures are cooler is that colder temperatures reduce the high costs of keeping IT equipment cool. Lower energy costs, lower costs of land and lower salaries are all reasons why Cumulus expects to offer its services at a lower price than Dhaka rivals.

The business strategy of Cumulus is to sell IT capacity wholesale to a small number of large users. A recent trend in the market is growth in demand for co-location facilities, where larger numbers of users are willing to rent smaller quantities of storage space alongside other users.

Technological developments continue to reduce the physical size of storage capacity.

At the moment, Cumulus has no customers signed up, and does not expect to win any until its centre is open and functional.

Requirement

Analyse the implications of this data for the senior management of Cumulus.

Self-test question 2

BWY Ltd

BWY Ltd is a listed company, based in Erewhon, which builds private houses and apartments. These range from one bedroom apartments to five bedroom houses.

The housing market in Erewhon has experienced substantial volatility in the past 20 years, both in terms of the number of houses being sold, and the prices at which comparable houses are sold.

In the early 1990s there was a price slump, during which prices declined significantly. However, by the late 1990s price had stabilised, and then between 2000– 2006 there was a sustained and substantial increase in prices. During this time, the average price of houses in Erewhon more than doubled, although there were significant regional variations across the country.

In 2007 the market began to slow down again, and the number of sales transactions began to fall. The average price of houses peaked in early 2007, and then began to fall as well.

The credit crunch and global economic slowdown have meant that the volume of transactions and house prices have remained depressed since 2008.

The supply of private properties in Erewhon, like most other countries, can be split into two sectors. The first is the 'new build' sector consisting of new houses and apartments which are sold to customers by building companies such as BWY. The second sector comprises private individuals selling existing properties to other individuals, often using an intermediary (an estate agent or realtor) to advertise and administer the sale process. In addition to the private property markets in Erewhon, there is also a supply of social housing, owned by local authorities and housing associations and rented out to tenants at subsidised rates.

In the private property market, most buyers borrow a large proportion of the money they need to purchase their houses, in the form of a mortgage. A consequence of the recent credit crunch has been a reduction in mortgage availability as lenders have withdrawn some of their mortgage products. However, mortgage interest rates still remain relatively low, reflecting the low base rate of interest in Erewhon at present.

The number of 'new build' properties for sale in Erewhon has maintained a long term annual average of about 160,000, although in the boom period between 2000-6 this figure exceeded 200,000 per year. The total number of property transactions (including 'new builds' and re-sale) can vary quite significantly each year, but in recent years it has been around 1 million.

BWY has attempted to establish a reputation for building good quality houses with quality fittings that are not provided by many competitors. BWY has also held itself out as being an environmentally friendly company by using recyclable materials and refusing to build on land where there is significant environmental cost. BWY charges a price premium of about 5% over most other builders for similar size houses.

Over the last decade, BWY has acquired a large number of plots of land (a 'landbank') which it holds prior to developing. However, before BWY can build on this land it requires planning approval from the relevant local authorities. Historically, BWY has made some major gains on the land it has held. These gains have ultimately been reflected in high profits on the sale of houses as BWY's costs have risen considerably more slowly than its selling prices.

BWY's results, and those for PMN, the market leader in Erewhon, for the year ended 31 December 2011 show the following:

	BWY	PMN
Houses and apartments sold	7,450	14,850
Revenue (CU million)	1,428	2,613
Profit before tax (CU million)	174	427

The housing industry in Erewhon faces a lot of uncertainty in the next few years. Some analysts have predicted house price decreases of around 25%, while other analysts have predicted a small increase in prices. There is also uncertainty about the expected volume of house sales, although most analysts expect this to remain relatively low.

The board of BWY is seeking to develop a new strategy to address the issue of future uncertainty in the housing market in Erewhon. One suggestion put forward at a recent board meeting is to expand into the countries around Erewhon by building houses in them. To date, BWY has only built houses in Erewhon.

Requirement

(a) Using the PEST model, discuss the impact of external factors on BWY, and explain the potential effects of each factor on the company's future profitability.

Note: Do not discuss any strategies for expansion in this part of the question.

(b) Evaluate the position and performance of BWY compared to PMN.

Note: Your evaluation should apply, and critically appraise, the Boston Consulting Group (BCG) Matrix, but should not be restricted only to this model.

(c) Assess the role that risk and uncertainty could play in deciding whether or not BWY should expand into the countries around Erewhon.

Self-test question 3

Flyway Airline (Flyway) is the national airline of Ostland. It was originally owned by the government but was listed on the local stock exchange when sold to private investors more than 20 years ago. The airline's objective is to be the best premium global airline.

Flyway provides long- and short-haul services all over the world and is based at its hub at Ostcity airport. Flyway has been hit by a worldwide reduction in air travel due to poor economic conditions. The most recent financial results show a loss and this has caused the board to reconsider its position and take action to address the changed environment.

Flyway has cut its dividend in order to conserve cash and it is trying to rebuild profitability by reducing costs by 14%. The airline is capital intensive as it maintains a large fleet of modern aircraft. Two major costs for the airline are staff and fuel. In trying to renegotiate working conditions and pay, the management have angered the unionised workforce. There has already been some strike action by the unions representing the aircraft crew and ground staff and more is threatened. They are upset about changes to pension provisions which will require them to make larger contributions and also, a reduction in the number of crew on each aircraft, which they believe will require them to work harder and so they want a compensating pay-rise.

Additionally, the board has been considering taking advantage of new technology in aircraft engines by making a large investment (CU450m) in new low-noise, fuel-efficient aircraft in an effort to reduce the environmental complaints surrounding air travel and also cut costs.

The management accountant has provided the board with data below on Flyway and two of its main competitors. Kayland Air is a government owned and run airline in the neighbouring country of Kayland. It has a similar mix of business to Flyway and targets a similar market. Eazee Air is currently one of the most successful of the new privately-owned airlines that have gained significant market share over the last 20 years by offering a cheap but basic short-haul service to customers in and around Ostland. Eazee Air sub-contract many of their activities in order to remain flexible.

Data provided by the board (based on figures for the most recent calendar year):

		Flyway	*Kayland Air*	*Eazee Air*
Passengers ('000s)		23,649	38,272	35,624
Passenger kilometres (millions)		79,618	82,554	40,973
Revenue	CUm	5,430	7,350	2,170
Costs				
Fuel	CUm	1,480	1,823	535
Staff	CUm	1,560	2,998	238
Staff numbers		32,501	56,065	5,372
Operating profit	CUm	630	54	127
Number of aircraft		182	361	143
Average aircraft size (seats)		195	163	125
Seat kilometres (millions)		100,654	105,974	46,934

Note: A seat kilometre is generated for every one kilometre flown by an *available* seat on the company's aircraft.

In preparation for the next board meeting, the CEO has asked you to calculate some suitable performance measures and explain the results.

Requirement

Using the data provided, analyse the performance of the three airlines using appropriate performance indicators, and comment on your results.

Answers to Interactive questions

Answer to Interactive question 1

Note: The suggested solutions to this question are illustrative and based on the author's assessment. Your views may be different, but they should address the key issues. Here, the condition of the UK industry is almost certainly the key issue because this is currently the source of most of the group's revenue.

Part (a)

Strategic implications

The most significant information in the report is probably that the UK business of the group, which accounts for over two-thirds of total revenue, is under pressure. Customers are more price conscious and discount stores seem to be successful. Treadway has cut prices and hired more staff, but sales are flat in real terms and profit margins are falling.

The positive aspects of UK business appear to be the performance of smaller convenience stores and on-line food shopping, but there is no information on revenues or profit margins for these aspects of operations.

The management of Treadway needs to consider whether the supermarket industry in the UK may have reached, or be nearing, capacity. If it is, the challenge is to maintain profitability in the UK business until alternative strategies for growth can be developed and implemented.

Part (b)

Other information to consider

Other aspects of the information that should be considered are:

- The potential for growth in either Asia or the rest of Europe. Asia may seem to offer higher growth prospects, but there is insufficient information about conditions or prospects in either of these two regions to make a firm judgement.
- The USA accounts for just 1% of group sales globally and is making losses. It would seem appropriate to consider disinvestment and pulling out of the US market. Presumably this would result in write-off costs, but we do not know what these might be, or whether a buyer could be found for the US business.
- By cutting back investments in superstores, the group expects to increase free cash flows. What should be done with the money? One option would be to increase annual dividend payouts, which may boost the share price and so the group's P/E ratio.
- Lower investment in new stores may improve annual operating margins, by reducing operating costs. Depending on what the group does with its spare cash, there may be prospects for improvements in return on capital.

These judgements have been based on incomplete information and assumptions about future sales growth in the UK that may be too pessimistic. Sales growth may recover and consumer preferences for discount products may be relatively short-term in nature.

However, the risk of a long-term slow-down in the supermarket industry in the UK suggests that the group should urgently review its strategy and consider alternative ways of achieving long-term growth. More information is needed about:

- Market conditions and growth prospects in the rest of Europe and Asia
- The profitability of online sales and convenience stores in the UK, and prospects for growth
- Prospects for the UK supermarkets industry. The forecast of no real growth may be correct, and the switch by consumers to lower-price or discount products may well have occurred. If this is the case, other supermarket groups in the UK should be suffering in the same way as Treadway. Competitor analysis, and comparisons of performance with other supermarket groups, could provide useful information in support of the assumptions in the report.

Answer to Interactive question 2

Approaching the question:

It is important you recognise that the main focus of this requirement is on the value of using different indicators, rather than on CMNH's performance as such. In other words, you need to consider why monitoring liquidity and gearing (in conjunction with profitability) is important; rather than simply looking at CMNH's liquidity and gearing positions. For example, why would it be useful for CMNH to monitor its ability to pay its liabilities when they become due?

Although you are asked to 'illustrate your answer with suitable calculations', this does not mean that you should simply calculate a sequence of different ratios. The calculations you perform should be used to support your answer, rather than becoming your answer in their own right.

Finally, in relation to gearing – remember that are two aspects of gearing: financial gearing, and operational gearing. The requirement doesn't limit you to dealing with one aspect or the other, and therefore, you should have considered both in your answer. In CMNH's case, the question of monitoring the level of fixed costs compared to variable costs (operational gearing) seems to be particularly important.

Profit-based measures – It appears that CMNH's current performance measures (operating profit margin; earnings per share) are primarily focused on the amount of profit the business is generating. However, they have not identified the problems which CMNH is now facing, even though these problems could potentially threaten the survival of the business overall. Profit-based measures can often be insufficient to highlight issues relating to an **organisation's survival**, either in the long term or the short term.

Liquidity

Liquidity – CMNH's liquidity relates to the level of funds it has readily available in order to pay its liabilities as they become due; for example, having sufficient cash to pay its rents, or to pay other suppliers. However, CMNH struggled to meet its most recent rental payment, which suggests that it has liquidity problems.

CMNH's Liquidity – At the end of the year just ended, CMNH's current assets were CU64m, but its current liabilities were CU104m. Therefore, its **current ratio** was 0.62. The fact that this ratio is significantly less than 1 explains why CMNH is having trouble making payments (such as its rental payments) when they are due. Its current liabilities are significantly greater than the funds it has available to pay them.

Furthermore, at the end of the year, CMNH has no ready cash.

As CMNH is a service company rather than a manufacturing company, it is unlikely to hold a significant level of inventory. Therefore, given that CMNH has no ready cash, it seems likely that the vast majority of CMNH's current assets are receivables.

Receivable days – The importance of receivables to CMNH's current assets suggests that receivable days should be a key performance measure for the company. If it can collect the amounts it is owed from residents as quickly as possible, this should help increase the amount of funds it has available to pay for its liabilities.

Currently, however, it appears that CMNH may be having some problems collecting the amounts owed to SC. SC's receivable days are 68 [(47/253) × 365], compared to only 9 for GC [(17/685) × 365].

Gearing – Whilst liquidity issues can often be a problem in the short term, looking at gearing can also highlight potential issues in the **longer term**. In this respect, monitoring its gearing helps an organisation **measure risk**.

Gearing indicates the level of an organisation's fixed regular liabilities compared to the cash generators which will enable that organisation to cover its liabilities.

Financial gearing

Financial gearing – Financial gearing is measured by the ratio of debt to equity. Debt is a fixed liability for an organisation (for example, the annual interest payments which are due on loans), and equity is the capital equivalent which needs to generate the funds necessary to cover the liability (for example, to pay the interest due).

If the gearing ratio is high, this indicates that an organisation has to cover large fixed liabilities from only a small equity investment. As a result, the business could be at financial risk.

As well as looking at the gearing ratio itself, a second indicator, which could be useful in relation to financial gearing, is **interest cover**. Interest cover compares an organisation's profit before interest to the level of interest payable; again indicating whether it is generating sufficient returns to cover its fixed liabilities.

Gearing ratio – CMNH's debt [long term borrowings of CU102m] is currently 54% of its equity [share capital + retained earnings: CU189m]. A gearing ratio of 54% by itself should not be a particular cause for concern, because it is still relatively low.

Interest cover – However, CMNH's interest cover appears to be more of a concern. CMNH's operating profit was the same as the interest CMNH had to pay for the year just ended.

CMNH appears still to have a relatively good relationship with its bank, such that the bank agreed to increase CMNH's overdraft facility in order to enable to CMNH to make its most recent rental payments. However, if CMNH doesn't generate sufficient earnings to cover its interest payments, this could be fatal for its relationship with its bank, and will also seriously damage its chances of receiving any further financing.

Operational gearing

Operational gearing – Operational gearing (or leverage) compares the ratio of fixed costs to variable costs in an organisation, by comparing contribution to operating profit (PBIT). Operational gearing helps to identify the level of **business risk** in an organisation.

If an organisation has high operational gearing, this suggests that it also faces a high level of business risk. High operational gearing means that an organisation's fixed costs, as a large proportion of its total costs, are also high. This is risky because, although variable costs will fall if revenue falls, fixed costs will not. Therefore, an organisation with a high level of operational gearing may find itself unable to cover its fixed costs if its revenue falls.

This inability to cover fixed costs appears to explain why the CFO feels that gearing needs to be addressed as a key issue; because it seems likely CMNH has a **high level of fixed costs**, which in turn means it has a high level of operational gearing.

Rent payments are a fixed cost for CMNH, and they alone take up 27% [CU257m/CU938m] of the company's total revenue. In addition, it seems likely that the central costs and the costs of permanent staff in the care homes will be relatively fixed.

The danger for CMNH of having a high level of operational gearing is that if its revenues drop, then it will quickly become loss-making, given that it was only just breaking even at the end of the last year. Again, this reinforces the need to keep a close watch on CMNH's gearing levels.

Operational gearing ratio – If we treat rent costs, payroll costs and central costs as all being fixed (or relatively fixed), then the ratio between CMNH's fixed costs and variable costs (running costs) is 7.5:1 [536 + 257 + 30 = 823 : 110].

This ratio is very high, and so should also be viewed as a concern for CMNH.

In this respect, it is important for CMNH to see if it can change the nature of any of the costs within its business. In particular, it may be possible to use temporary or contract staff in its homes rather than permanent staff. Such a change would mean that staff costs essentially then become variable costs. However, using temporary staff may also compromise the **quality of service** CMNH provides to its residents, which would not be acceptable to the residents, or their families.

Answer to Interactive question 3

Part (a)

Competitive performance

Over the last four years, **market share** (the business's share of the revenue of all restaurants in the locality) has **increased** year on year from 9% in 20X1 to 18% in 20X4.

	20X1	*20X2*	*20X3*	*20X4*
Market share	(83/895) 9%	(124.5/1,234) 10%	(137/980) 14%	(185/1,056) 18%

The restaurant is therefore taking an increasing proportion of the area's restaurant business, doubling its market share over the four-year period.

The number of proposals submitted to cater for special events has increased dramatically, from 10 proposals submitted in 20X1 to 38 submitted in 20X4, whilst the **percentage of contracts won as a percentage of proposals submitted** has shown remarkable **growth**.

	20X1	*20X2*	*20X3*	*20X4*
Contracts won as % of proposals submitted	20%	29%	52%	66%

The restaurant appears to be **increasingly effective in winning business** in this developing area.

Financial performance

	20X1	*20X2*	*20X3*	*20X4*	*20X1 – 20X4*
Change in revenue		+50%	+10%	+35%	+123%
Change in profit		+84%	+104%	+31%	+393%
Profit margin	14%	17%	32%	31%	

The analysis above shows **continuous growth in revenue** and an even **stronger growth in profitability**. The **increase in profit margins** may be a result of **improved resource utilisation**, with fixed costs as a percentage of revenue falling.

It is clear that **20X2** was a **successful** year compared with 20X1, and that **20X3** results were **even better.** While there was a significant increase in revenue in **20X4**, the increase in profitability was less than in previous years and the **profit margin fell** (admittedly only by 1%). This could indicate the need for **tighter cost control**.

Quality of service

Just under 7% ((5×52)/3,750) of meals served in 20X1 were to regular customers, compared with over 20% ((26×52)/6,700) in 20X4. The business, therefore, has a **growing number of regular customers** who can be assumed to be happy with the price, level of service, quality of food or, indeed, the total package offered by the restaurant.

The data about **complimentary letters, written complaints** and **cases of food poisoning** does **not paint a clear picture** about quality of service as no definitively clear trends are evident, even when the number of meals served is taken into account.

	20X1	*20X2*	*20X3*	*20X4*
Meals served per complimentary letter	3,750	1,275	2,067	1,117
Meals served per written complaint	469	425	443	479
Meals served per reported case of food poisoning	938	1,020	886	957

Without a yardstick such as rates achieved by competitors, it is therefore **difficult to draw firm conclusions** on the quality of service provided by the restaurant, especially as the number of customers almost doubled over the period. More accurate information could possibly be gathered from a large scale customer satisfaction survey.

Flexibility

One measure of a business's flexibility is **how well it copes with varying levels of demand**. The restaurant's average service delay at peak times shows no clear trend but has fluctuated widely from 47 minutes in 20X2 to less than a third of that in 20X3. When these figures are analysed in conjunction with the average number of customers at peak times, however, it is clear that performance was particularly poor in 20X2 (with a low level of customers but the longest delay), while performance in 20X3 was better. Overall, however, it is clear that there are **problems in flexing resources to meet demand at peak times.**

The number of **items on offer each day,** the **new meals introduced** during the year, the **special theme evenings introduced** and the **weekly opening hours** also indicate improving levels of flexibility, reflecting the **increasing choice available to customers**. The number of items on offer has more than doubled over the four-year period, from 4 to 9, the number of new meals introduced has varied between 8 and 27, the number of special theme evenings has increased from 0 to 13, and opening hours increased in 20X3.

Resource utilisation

This is usually measured in terms of **productivity** (output relative to some form of input). Given the information available and assuming the restaurant is open 52 weeks a year, one measure of productivity is **total meals served**/**opening hours**. This ratio has steadily increased from 2 in 20X1 to 3.6 in 20X4.

And **levels of non-productive time** (measured by idle time rates and proportion of operating hours with no customers) **declined**.

	20X1	*20X2*	*20X3*	*20X4*
Idle hours	570	540	465	187
Opening hours (weekly × 52)	1,872	1,872	2,080	1,872
Idle time %	30%	29%	22%	10%
Operating hours with no customers as % of opening hours	20%	16%	9%	7%

In conjunction with the increase in the number of meals served (the year-on-year increases being 36%, 22%, and 8%), these measures would tend to indicate overall improvements in resource utilisation.

The **increase in capacity** by 60% in 20X3 allowed more customers to be seated during peak times (although we do not know if this was due to increasing floor space or to seating more customers in the same space), but it was **not matched by similar increases in overall activity level**, and did in fact correspond with a **drop in the number of meals served per seat.**

	20X1	*20X2*	*20X3*	*20X4*
Meals served per seat	150	204	155	168

Weekly **opening hours** were **increased** in 20X3, but as the figures above demonstrate, there was **no corresponding increase in meals served per seat**.

Innovation

The business appears to have been **particularly successful in this area**, with attempts at innovative ways of satisfying customer needs including the introduction of **special theme evenings**, **increased items on offer** and the successful development of **catering for special events**.

A number of **new meals** have also been **introduced**, although the degree of experimentation has varied considerably from year to year.

Part (b)

Additional information for assessing performance

Competitiveness

(i) Any similar data from one or more restaurants in the locality would enable the business to determine how well it was performing in relation to competitors.

(ii) It would also be useful to have data about total meals served in all restaurants in the same price band in the locality in order to assess market share in terms of volume.

(iii) More general information about national trends in eating out and restaurant prices, and market research (particularly customer surveys) on similar restaurants would provide a broader context to the performance assessment.

(iv) Details of the cost of catering for special events would allow the profitability (or otherwise) of this area of business to be determined.

Financial performance

(i) Cost data on labour, food and overheads, which is missing at the moment, would enable a more in-depth profitability analysis.

(ii) Details of assets would enable the calculation of ROCE.

Quality of service

(i) Especially useful would be any customer feedback received by or systematically collected by the restaurant (in addition to the complaints and compliments already detailed).

(ii) Any reviews of the restaurant that might have appeared in guides, newspapers and so on would provide an expert's analysis of the service offered.

(iii) Data on intangible factors, such as the courtesy of staff, ambience of the restaurant, and so on would enable a fuller assessment of the quality of service.

Flexibility

(i) Details of the ease with which the restaurant deals with requests for non-menu items (such as those connected with special dietary needs) would give additional information with which to assess this area.

(ii) It would be useful to know whether any staff training to promote multi-skilling (which should improve the business's ability to cope with fluctuations in demand) has ever, or could, take place.

Resource utilisation

(i) A number of useful measures could be calculated if information about staffing levels was provided (eg meals served per hour per member of the waiting staff or revenue per member of staff).

(ii) If information about floor area was also provided, measures such as revenue per square metre could be calculated.

(iii) It would be useful to know how seat numbers were increased; for example, increasing the restaurant seating space available, or more adding seats in the same space.

Answer to Interactive question 4

Suggested approach to a solution

An approach to developing a solution is suggested here. You may prefer to take a different approach, but you should be able to consider all the relevant information provided, identify the most important issues, and draw conclusions.

Stage 1: Make notes of the relevant facts

Making notes is a method of reviewing the facts. In the table below, the notes are organised according to the checklists suggested in this chapter. In this example, however, issues in the broader business environment do not seem to be a significant issue.

External environment	
Political	-
Economic	-
Social	-
Technological	-
Environmental	-
Legal	Increase in legal actions against drug companies
Industry environment	High R&D costs
	Patents to protect intellectual property: importance of patent protection for the business of major drugs companies
	Rigorous development and testing for new products
	Government and public challenges to high levels of profit
	National governments and health organisations sponsor most research: donation programmes
Competition	Strong competition between firms, but few firms
	High barriers to entry
	No substitute products for patented drugs
	Peffstill a serious competitor for Coffstop
Internal strengths and weaknesses	Main revenue earning drug: patent ends next year. Loss of up to 10% of revenue?

	No other major product, apparently. Why is R&D not more effective in producing innovative products? More information needed about patents and product portfolio
	More spending on R&D than competitors
	Difficulty in finding retail outlets for Coffstop
Financial	Fall in revenue growth to 5% annually from 15%. Are there any forecasts for future sales?
	Profit before tax 35% of sales, profit after tax 15%. So tax 20% of sales?
	This is surprising. Is the data reliable?
	Fall in revenue but 15% increase in earnings and dividends? How was this achieved?
	R&D costs = 15% of revenue last year
	Detailed figures for profitability of Peffstill and Coffstop for retailers: calculations of profitability required.
Operational	Data on performance restricted to financial data, see above

Deciding the method of analysis

The notes should give you some ideas about the approach to take to the analysis.

Here, we suggest that the main issue is the need for WG to continue to develop successful new products which can be patented. We know that a 'best seller' will go out of patent next year, so that other companies will be able to make and sell the product, probably more cheaply. Issues such as the performance of R&D and competition will be included in the analysis.

A further issue to consider is the financial performance of the company and prospects for the future.

Another issue, although perhaps one of lesser importance, may be the risk of action by national governments to reduce the large profits of drugs companies.

Calculations

Detailed calculations can be produced for the relative profitability of Coffstop and Peffstill. The focus here should be on profitability for retailers, and identifying the key measure of performance. It is not profitability per unit sold. It is the gross profit per week per square centimetre of shelf space.

	Coffstop	*Peffstill*	
	CU	CU	
Recommended retail price	1.50	10.00	
Bought-in cost	0.50	7.40	
Gross contribution per bottle	1.00	2.60	= the 1: 2.6 ratio in the data
Holding cost per bottle	0.40	0.80	
Net contribution per bottle	0.60	1.80	
Sales per week (bottles)	120	20	
Total net contribution per week	CU72	CU36	
Shelf space per bottle (square centimetres)	18	60	
Contribution per square centimetre of shelf space	CU4.00	CU0.60	

Interpretation

The 'What-How-Why-When-So What' approach to analysis can be used.

WHAT?	1. Concern about future profitability: need for successful new products 2. Possible doubts about future growth in revenue, earnings and dividends 3. Possible risk of government action to reduce profits
HOW?	1. Patent of successful product running out Problem with selling Coffstop to retailers 2. Fall in rate of revenue growth, but stronger earnings and dividend growth last year 3. Government and public concern about high profit margins: governments are sponsors of R&D
WHY?	1. Analyse problems of product portfolio and failure of R&D to develop major new drug, in spite of high spending on R&D. Is this a key strategic problem for the company? Failure of company to explain higher profitability of Coffstop to retailers. Need to correct this failing, but why did it happen? 2. In spite of high profit/sales ratio, it is not clear how earnings could increase by 15% when the rate of sale growth slowed to 5%. Is it possible that the company cut R&D spending? Or possibly gains from favourable currency movements? Some discussion of the apparently high rate of tax also appropriate. 3. Governments may be concerned about high profitability of drugs companies. Legislation against patent unlikely. Governments may cut sponsorship of R&D or may ask for better terms in donation programmes. But at the moment, this is not the main problem for the company. Need to keep the matter under review.
WHEN?	Action to promote Coffstop is urgent, especially if it may become a major product for the company. An assessment of future financial prospects and the effectiveness of R&D are also urgently required.
SO WHAT?	The company needs a continual cycle of innovation, product development and successful patenting. Without this, its future financial stability and survival could come into question.

Limitations in the data

More information would be useful for analysis:

- A more detailed analysis of revenues and profitability in recent years, including an explanation of tax charges
- More information about the company's current product portfolio, sales and profitability of each product (historical and projected) and remaining patent lives
- A report from the head of R&D about development projects in hand and an analysis of historical performance – new products developed and product histories. (It is important to establish whether the R&D department is as effective as it should be.)

Conclusion

Your views on this example may differ, and you may prefer to approach an answer in a different way. This suggested solution tries to demonstrate, however, the advantages of a structured approach to data analysis.

Answers to Self-test

Answer to Self-test question 1

Cumulus Limited

The major question is whether the current strategy of Cumulus will succeed, and whether the company will survive. If not, it should look for ways to either change its strategy or cancel the project entirely.

The company is targeting customers who will rent large quantities of space in its centre. The big growth in demand could be for co-location services in cloud computing.

The company hopes to attract customers by offering lower prices. Dhaka-based service providers can offer faster connectivity. This may be important for users with regular links to institutions in Dhaka's financial centre.

Reductions in the physical size of storage may raise questions about whether a large centre will ever be filled to capacity.

The slow uptake in demand for the services of the company suggests that sales revenue growth for Cumulus may be slow and insufficient for breakeven for quite a long time.

Answer to Self-test question 2

BWY Ltd

Part (a)

Political factors

Planning approval – BWY requires planning approval from the relevant authorities to build houses on its land banks. Consequently, if planning regulations become stricter, it may become harder for BWY to get the approvals it needs. And if it does not get planning approval to develop its land banks, its future revenues will fall.

Social housing – Social housing could possibly be seen as a substitute to private housing, and it seems that BWY currently only builds properties for the private markets. Given the continued uncertainty over the state of the private housing market in Erewhon, BWY could consider tendering for social housing contracts, but this may not fit with its current strategy, of building higher quality and more expensive housing than its competitors.

Environmental policy – BWY has established a reputation as an environmentally friendly company. If the government introduces any new building regulations or requirements, this may influence people to buy from BWY rather than competitors due to BWY's existing reputation.

Incentives to boost the housing market - Although the scenario doesn't specifically mention any incentives, it is possible that the government could take action to try to boost the housing market. For example, by reducing the costs associated with moving house, such as stamp duty. Any such incentives which boost demand should help BWY increase revenues and in turn, profitability.

Economic factors

Interest rates - Interest rates are a major influence on the demand for houses because they affect the cost of repaying a mortgage. Interest rates - and therefore the costs of servicing debt - are currently low by historic standards and so this might be expected to increase the demand for houses, and therefore BWY's profitability.

Mortgage availability - However, at the same time, it has become harder for borrowers to obtain mortgages, as lenders have withdrawn some of their mortgage products. In turn, this has reduced demand in the private housing market.

Economic slowdown and economic uncertainty – The general uncertainty around the state of the economy is also likely to reduce demand for housing. For example, unemployment, or the fear of unemployment, may make people reluctant to buy a new house.

In this way, the level of economic growth and prosperity in Erewhon as a whole will affect both the demand for houses and their price. The current economic slowdown is likely to have reduced both demand and price, which will have an adverse impact on BWY's revenues and profits. The impact on BWY may be exacerbated because its prices tend to be around 5% higher than other builders, and the economic slowdown is likely to have made buyers increasingly price conscious.

Geographical variation – However, it is possible that the housing market is more buoyant in some areas of Erewhon than others. Variations in regional prosperity may influence demand and house prices in different locations, so it is possible that BWY's sales in some parts of Erewhon may continue to be more buoyant than in other parts of the country.

Social factors

Demographic trends – BWY builds a range of properties, from one bedroom apartments to five bedroom houses. The scenario does not provide any details about demographic trends in Erewhon but these are likely to affect demand for different types of houses. For example, an increase in people living alone (rather than as families) will increase the demand for properties overall, but this demand is likely to be for apartments or smaller houses at the expense of larger, family houses. We do not know the relatively profitability to BWY of selling these different types of property, however.

Social trends – The scenario identifies the split between the 'new build' housing market, and the secondary market. However, there is no indication as to how the relative popularity of the two markets is likely to vary in future, although a shift in trend for either 'new build' or older houses may affect pricing in the two markets separately. For example, if there is a relative increase in the demand for 'new build' houses, this should translate into an increased demand for BWY's properties, and in turn, lead to an increase in its profitability.

Other social trends could also affect demand for BWY's properties; for example, if people are looking for houses in city centres compared to suburban or rural locations. Depending on how well the location of BWY's current developments matches with buyers' current trends, this could either improve or reduce profits.

Technological factors

There is little indication in the scenario about how technological developments will affect BWY's future profitability, although it is possible that improvements in building technology may reduce costs and improve profitability overall.

Part (b)

BCG matrix

The BCG matrix considers two variables: market growth (as an indicator of the stage of a market in its life cycle) and relative market share (as an indicator of a business unit's strength compared to the market leader).

Market growth and attractiveness

The BCG matrix normally assumes that the market growth indicates the attractiveness of an industry as a source of future profits, and the expected level of these future profits helps a company make market entry or exit decisions.

However, where there is future uncertainty, as with the house-building market in Erewhon, it is not clear what the rate of market growth will be, particularly in the near future. Given the cyclical nature of demand in the industry, market growth is likely to vary over time, making it difficult to place a business unit in the matrix.

Market strength

In terms of revenue generated, BWY has about half of the relative market share of the market leader, PMN (7,450 / 14,850 houses built). Therefore, BWY would be classified as having a low market share, according to the matrix.

However, simply comparing BWY's sales to PMN does not give the full picture of its position in the industry.

Although PMN is the market leader, it only has a market share of about 9% [14,850 / 160,000] of the 'new build' market. However, even this exaggerates PMN's influence in the housing market as a whole, because the new build sector only accounts for about 15% of the total house transactions in a year (around 1 million sales).

Therefore, unlike many market leaders, PMN is unlikely to have a dominant effect on competitive conditions in the market. So, a comparison to the market leader as an indicator of market strength is not necessarily a very useful model in the housing industry. Nonetheless, in this instance, the indication that BWY will have low market strength seems justified.

Other factors

While the BCG matrix may not be very instructive in this case, we can still make some useful comparisons by comparing BWY's financial performance with that of PMN.

	BWY	PMN	BWY versus PMN
Houses and apartments sold	7,450	14,850	50.2%
Revenue (CU million)	1,428	2,613	54.6%
Profit before tax (CU million)	174	427	40.7%
Costs (revenue less profit) (CU m)	1,254	2,186	57.4%
Average price per property	191,678	175,960	8.9%
Average profit per property sold	23,356	28,754	-18.8%
Cost per property	168,322	147,206	14.3%

The difference in average price per property between BWY and PMN is greater than the 5% which BWY normally charges as a price premium.

This may be because PMN sells its properties at below the market average prices. However, it could also reflect a difference in the product mix between the two companies, with BWY selling a greater proportion of larger, higher value properties.

Despite this, however, PMN is more profitable because it appears to be more cost efficient than BWY. Although BWY charges 8.9% more per house, its costs are 14.3% higher.

However, it is important to appreciate these figures only relate to one year in isolation. To get a more representative picture of the performance of both companies, it is necessary to look at the equivalent figures for a number of years.

Part (c)

Although there is a high degree of uncertainty about the housing market in Erewhon in the next few years, it seems likely that BWY's opportunities for growth, if it continues to trade solely in Erewhon, will be limited.

Shareholder expectations – BWY is a listed company, so it is possible that the directors are considering a new market strategy in response to pressure from the shareholders; for example, that shareholders want the company to show increased growth. In this context, it is important for the directors to consider the risks involved in the potential expansion, alongside the levels of return and growth it could generate.

Market development – It appears that BWY's new strategy is based on a market development strategy. However, the fact that it has so far only built houses in a single market (Erewhon) suggests that, historically, it has only grown by market penetration. A market development strategy carries a higher level of potential risk, but equally, it could also bring greater rewards (in terms of growth).

Risk appetite – It is likely that BWY's different stakeholders will have different attitudes to risk. Equity investors will want to see a return on their investments, but their perspective to risk may differ from BWY's managers or employees. Therefore, the directors need to consider whether the strategy is consistent with the key stakeholders' attitudes to risk. It is important that any business strategy BWY chooses (and subsequently the performance targets it sets) are consistent with its attitude to risk.

Shareholder returns – Any decision to expand into the neighbouring countries around Erewhon is likely to represent a major capital project for BWY. However, before the decision is approved, the board will need to be satisfied that it will generate a positive return for the company. There is inevitably a degree of uncertainty over the future returns the project will generate, and this needs to be reflected in the forecasts; for example, by reflecting the level of risk in the discount factors used to discount future cash flows.

Before it decides to move into neighbouring countries, there are also a number of practical issues BWY needs to address in relation to current uncertainty around the proposal:

Researching potential markets – The plan will be most successful if the property markets in some of the countries around Erewhon are more buoyant than Erewhon's own market. The scenario does not mention this, and the directors will need to research the market structure and growth potential of possible target countries before deciding to enter them.

Spread risk – If the expansion is successful, then BWY will be less dependent on the housing market in Erewhon and the economy of a single country.

However, moving into a new country brings risks of its own, not least because it will mean that BWY has to manage operations in a new country which it has never done before. For example, there could be language and cultural differences between the two countries, which could mean the performance of the new venture is not as successful as BWY's directors had hoped.

Answer to Self-test question 3

The following performance indicators could be used to analyse the three airlines:

	Flyway	**Kayland Air**	**Eazee Air**
Operating profit margin	630 / 5,430	54 / 7,350	127 / 2,170
	11.6%	0.7%	5.9%
Capacity utilisation (load factor)	79,619 / 100,654	82,554 / 105,974	40,973 / 46,934
	79.1%	77.9%	87.3%
Revenue / staff member (CU000s)	5,430 m / 32,501	7,350 m / 56,065	2,170 m / 5,372
	167	131	404
Fuel cost / seat kilometre (CU)	1,480 m / 100,654 m	1,823 m / 105,974 m	535 m / 46,934 m
	0.015	0.017	0.011

Operating margin – Flyway has the highest operating margin of the three airlines (11.6%), which suggests it is being run efficiently overall. We might expect Flyway to achieve a relatively high margin because it appears to be pursuing a **differentiation strategy**. However, Kayland Air, which appears to be pursuing a similar strategy, generates an operating profit margin of less than 1%, despite being a larger company than Flyway.

Capacity utilisation – By showing, on average, how full each airline's aircraft are, this indicator shows how well the airlines are using their asset base (ie their aircraft). Flyway and Kayland's performance is similar in this respect, but Eazee's is significantly better. This is likely to be because Eazee (a low cost airline) is pursuing a **cost leadership** strategy. Flyway might consider reducing its prices to try to improve capacity utilisation, but it needs to do so in the context of its overall strategy. If it reduces prices too much, it may end up compromising the quality and service it offers to passengers, but these elements are crucial to its strategy as a differentiator.

Revenue per staff member – This is an important measure in the context of the recent disputes over working conditions and pay. Flyway's staff appear to be performing better than Kayland's, which, in turn, might strengthen their claims for a pay rise.

The comparison between Flyway and Eazee Air's performance for this measure may be less meaningful. Eazee **outsource** many of their activities, meaning their staff numbers will be significantly lower than Flyway, which carries out the corresponding activities **in-house**.

Fuel costs – The board's interest in new fuel-efficient aircraft indicates that reducing fuel costs is an important concern for Flyway. Again, Eazee appears to be controlling its fuel costs better than Flyway or Kayland. This might be because it has more **fuel-efficient planes**, which would support the board's argument for Flyway investing in new aircraft. Alternatively, however, Eazee may have negotiated more favourable fuel contracts with its suppliers, or be using lower grade fuel.

Tutorial note: It is important to use fuel cost per *seat* kilometre as the performance indicator here rather than fuel cost per *passenger* kilometre, because we are looking to monitor the fuel efficiency of the aircraft, rather than the airline's ability to fill their aircraft with passengers.

CHAPTER 9

Information strategy

Introduction

Topic List

Introduction

Learning objectives

	Tick off
• Develop outline proposals and advise on outline requirements for information technology applications to support business strategy, for example in the context of e-commerce, e-business and virtual arrangements	☐
• Use management accounting information (for example costs, prices, budgets, transfer prices) and management accounting tools (for example, break-even, variances, limiting factors, expected values, ABC, Balanced Scorecard) to evaluate short and long-term aspects of strategy	☐
• Explain and appraise how management information systems can provide relevant data to analyse markets, industry and performance	☐
• Demonstrate and explain methods for determining the value of information in the context of developing an information strategy	☐
• Assess financial and operational data, and information from management information systems, drawing inferences to its completeness, accuracy and credibility, and provide an evaluation of assurance procedures in evaluating information risks	☐
• Demonstrate and explain how businesses capture, analyse and utilise information to develop competitive advantage	☐

Knowledge brought forward

The *Business Strategy* syllabus looked at the way management information and information systems support an organisation's overall business strategy and competitive advantage. It also highlighted that organisations need information for a range of purposes, including: planning, control, performance measurement and decision-making.

In Chapter 4 of this Study Manual, we highlighted the importance of having relevant and reliable performance information in order to manage performance. In this chapter, we will now consider the information systems which could provide that information, and how the resulting information can be used by staff and managers in organisations.

Examination context and syllabus links

It is unlikely that a question will focus solely on information systems in their own right, although information systems and e-business may play a key role in the successful implementation of a strategy.

However, while information *systems* themselves are important to an organisation, the *information* which they provide is perhaps even more important. Managers need information for decision-making and control. For example, in order to measure performance against targets or KPIs (see Chapter 4) managers need to have appropriate information about the areas of performance under review.

In this context, you might be expected to comment upon the information available for decision-making or control in a scenario – is there enough information available? Is the information at the correct level (eg strategic, tactical or operational)? What other information is needed? Where might the business obtain relevant information? Is the information system adequate to fulfil the functions required of it by the business? How can the organisation use information to generate competitive advantage?

An underlying consideration for information strategy is that an organisation's information systems should provide the appropriate type and amount of information which management need to select, implement and control its chosen business strategy. This also means that the information strategy needs to be aligned to the business strategy, in terms of the type of information available. (For example, if an organisation is pursuing a differentiation strategy based on the high quality of its product then information about aspects of product quality will be very important to it.)

In addition, the level of detail, the form of the information, and its timing should be appropriate to the role of the person(s) who receive it.

Make sure you do not overlook the importance of IT/IS to strategy. Very often an organisation's ability to deliver a strategy may depend on having sufficient IT capabilities to do so. Equally, an organisation's IT capabilities may be instrumental in shaping its strategy. For example, does it have sufficient IT infrastructure to support an e-commerce strategy?

Remember, in Chapter 1 we noted how an organisation's resources and capabilities contribute to its competitive advantage. In this context, it is worth noting that the way an organisation manages and uses information could, in itself, become a source of competitive advantage – for example, if the organisation is able to respond to market trends or opportunities more quickly than its rivals on the basis of the information it gathered about those opportunities. Equally, gathering data and information about customers and customer requirements could also be useful in increasing the value an organisation's customers place on its products and services, as we noted in the context of customer relationship management (covered in Chapter 5 of this Study Manual).

1 Information technology and strategy

Section overview

- Strategic information is used to plan the objectives of an organisation, and to assess whether those objectives are subsequently met. Therefore it is important that organisations have an information systems strategy so that it can meet its information requirements.
- Organisations often have to consider three different strategies in relation to information: information systems (IS) strategy, information technology (IT) strategy, and information management (IM) strategy.
- Not only have developments in IT facilitated the introduction of a range of management information systems, they have also had a significant impact on corporate strategy itself (for example, by transforming the value chain).

1.1 Information and strategy

Strategic information is used to plan the objectives of the organisation, and to assess whether the objectives are being met in practice. Therefore it is important that organisations have an information systems strategy so that it can meet its information requirements.

As we have seen in Chapter 4, organisations have to consider three different strategies in relation to information: information systems (IS) strategy, information technology (IT) strategy and information management (IM) strategy.

We can summarise these three strategies in very simple terms by saying that IS strategy defines **what** is to be achieved; IT strategy determines **how** hardware, software and telecommunications can achieve it; and the IM strategy describes **who** controls and uses the technology provided.

The relationship between IS, IT and IM is important, however. In order for a company's IS strategy to be successful, the company will need sufficient IT resources (including hardware, software, network resources and suitably skilled staff) in order to implement and support the strategy.

A company does not necessarily have to own resources in-house, though; an alternative would be to outsource IT services and departments to a specialist IT company. However, before making such a decision, an organisation needs to consider how critical its IT services are to its overall operations. If IT services are critical to the organisation's operations, and to its competitive advantage, the organisation should try to keep its IT services in-house rather than outsourcing them.

1.2 IS, IT and strategy

An organisation's information systems may not only support business strategy, they may also help determine corporate/business strategy. In particular:

(a) IS/IT/IM may provide a possible source of competitive advantage. This could involve new technology not yet available to others or simply using existing technology in a different way.

(b) Information systems may help in formulating business strategy by providing information from internal and external sources.

(c) Developments in IT may provide new channels for distributing and collecting information and/or for conducting transactions. The most fundamental illustration of this has been the way the internet has opened up opportunities for e-business and e-commerce.

When considering IS/IT in a strategic context it could be useful to consider how they contribute to an organisation's current strategic position. One way of doing this could be through a SWOT analysis.

For example:

Strength: A business might have a sophisticated customer database which allows it to send out targeted marketing messages to customers. A retailer might have an inventory management system which automatically re-orders stock lines according to sales being recorded in the shop tills, thereby allowing it to minimise the levels of inventory it needs to hold.

Weakness: A business' ordering system (either online or manual) is unreliable, and so customers cannot be confident that the goods they order will be delivered correctly or within an acceptable time scale.

Opportunity: If a business does not currently have a website which allows customers to purchase items online, the opportunity to develop such a website could provide a significant boost to its sales.

Threat: Conversely, if a competitor has recently upgraded their IT systems with the result that they can now offer a greater range of services to their customers and provide them with improved levels of service, this could pose a threat to an organisation because customers may switch to using the competitor instead.

1.2.1 Developing an IT strategy

When formulating an overall information technology strategy, the following aspects should be taken into consideration:

- What are the key business areas which could benefit most from an investment in information technology, what form should the investment take, and how could such strategically important units be encouraged to use such technology effectively?
- How much would the system cost in terms of software; hardware; management commitment and time; education and training; conversion; documentation; operational manning; and maintenance? The importance of lifetime application costs must be stressed – the costs and benefits after implementation may be more significant than the more obvious initial costs of installing an information technology function.
- What criteria for performance should be set for information technology systems? Two areas can be considered: the technical standard the information system achieves and the degree to which it meets the perceived and often changing needs of the user.
- What are the implications for the existing work force – have they the requisite skills to use the new systems, can they be trained to use the systems, and will there be any redundancies?

1.2.2 IT and its effect on management information

The use of IT has permitted the design of a range of information systems. Executive Information Systems (EIS), Management Information Systems (MIS), Decision Support Systems (DSS), Knowledge Work Systems (KWS) and Office Automation Systems (OAS) can be used to improve the quality of management information.

IT has also had an effect on **production processes**. For example, Computer Integrated Manufacturing (CIM) changed the methods and cost profiles of many manufacturing processes. The techniques used to **measure and record costs** have also adapted to the use of IT.

1.3 How IT is changing corporate strategy

It should be obvious that information systems and information technology should **support** corporate strategy, but there are also a number of ways IS/IT can **influence** corporate strategy.

In 1985, the *Harvard Business Review* published an article by Michael Porter and Victor Millar aimed at general managers facing the changes resulting from the rapid and extensive development of information technology. Although it was written a number of years ago, the article still has great relevance to the **strategic employment of information systems** and the use of information technology. It dealt with three main interlinked topics:

- The ways in which IT had become **strategically significant**
- How the **nature of competition** had changed
- **How to compete** in the new, IT-influenced environment

1.3.1 The strategic significance of IT

IT transforms the **value chain**.

Porter and Millar's article remarks that each of the value chain activities has both **physical** and **informational** aspects and points out that, while until quite recently technical advances were concentrated in the physical aspects, **current improvements tend to be IT driven**.

Simple improvements are made by faster and more accurate processing of existing forms of data, and more dramatic ones by creating new flows of previously unavailable information. This has a particular effect on the linkages between the various activities and extends the company's **competitive scope**, which is the range of activities it can efficiently undertake.

Porter and Millar provide a diagram of the value chain in which they give examples of the ways IT was influencing the various activities at the time the article was written (1985). Although the technologies themselves have developed since then, the ideas in the model are still relevant today.

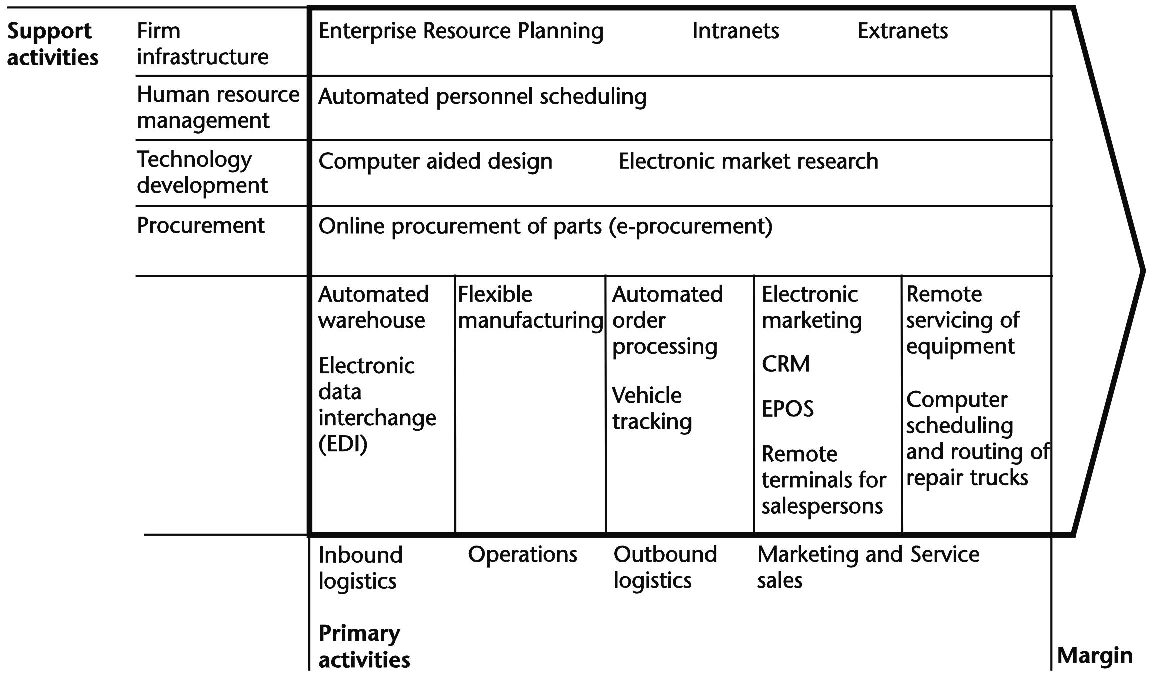


Figure 9.1: The impact of IT on the value chain

Slack *et al* in their text, *Operations Management*, also highlight that e-business has an impact in many areas of operations management:

- **Purchasing**: orders (EDI), funds transfer (EFT) and supplier selection
- **Production**: production planning and control, scheduling, inventory management, quality control
- **Marketing/sales and customer servicing**: opening new sales channels, internet sales, third-party logistics, customer services, CRM
- **Warehousing**: inventory management, forecasting

However, as well as thinking specifically how IT can affect the value chain, you should also be prepared to consider how IT and e-business have affected business more generally.

For example:

The use of computer aided design can lead to the faster production of new products and designs. Organisations could either use this speed as a basis for making designs cheaper (cost leadership) or, for example, in the clothing and fashion industry, as a means of getting the latest fashions to market more quickly than their rivals (differentiation).

Websites and email have changed the nature of communication between organisations and customers.

The internet has also changed the nature of the supply chain and channel structure – for example, by allowing customers to book flights and hotel rooms for their holidays directly from the airline company and the hotel online, rather than having to use travel agents.

Interactive question 1: Antiques dealer [Difficulty level: Intermediate]

GLS is a long-established retailer which specialises in the sale of antiques. GLS is owned by a married couple who both work in the business. They have no employees. Their premises consist of a large modern shop and there is an apartment above this in which the owners live. Over the last five years the local area has become very fashionable and the shop is now surrounded by smart restaurants, cafes and up-market fashion outlets. This area has also become a very popular place to live which has meant that property values have increased substantially. The owners believe that if they disposed of their premises they would make a substantial capital gain. The owners have noticed that the fixed costs of their property, including insurance, local tax, security and maintenance, have risen very sharply during the last five years.

Since establishing the business 30 years ago the owners have developed their expertise. They now have a national reputation in the antiques trade and many repeat customers. They traded profitably each year from the start of the business until two years ago, but in the last year have made an operating loss for the first time. The owners are often consulted by other antiques traders and collectors by letter and telephone and they have developed a considerable income stream by charging for their advice. However, they have found that their business location is becoming increasingly problematic. Although the popularity of their area of town has increased and led to many more people living and visiting the area, unfortunately for the owners most of these people are not interested in antiques. They are young people who like the area but do not have the disposable income to spend on antiques.

A further problem is that the shop is not situated in a large city and it is very inconvenient for many antiques traders and collectors to visit. The owners believe the location has recently restricted the success of their business. The owners know that a very popular development in the antiques trade has been the establishment of 'Antiques Fairs' where antiques are bought and sold. Some of these have established international reputations and have many thousands of visitors. However, because of GLS's location and the need to keep their shop open, the owners do not attend these. The owners recently set up a website which has basic information about their business on it such as their address, telephone number and the opening times of their shop. The website has received a large number of hits but it does not seem to have increased sales.

Requirements

(a) Analyse the strengths and weaknesses of GLS's current business using the value chain model.

Note: You are not required to draw a value chain diagram in any part of your answer to this question.

(b) Evaluate how the introduction of e-commerce could affect GLS's value chain.

See **Answer** at the end of the chapter.

1.3.2 IT and competitive strategy

IT **enhances competitive advantage** in two principal ways:

- By **reducing costs**
- By making it easier to **differentiate products**

One example of IT-driven cost reduction is the way service industries (eg shops, airlines) have introduced self-service tills or check-in facilities in place of 'staffed' facilities.

However, although IT can be used to reduce costs, it is perhaps debatable whether this generates a long-term competitive advantage. For example, businesses increasingly use virtual conferencing as a means of cutting costs and imposing operational efficiency due to the ease with which data can be shared. However, if all the firms in an industry start using virtual conferencing, will this actually generate any competitive advantage for any individual firms in that industry? Similarly, with the example of self-service check-in facilities, most, if not all, airlines now offer this facility and so it is no longer a source of competitive advantage.

Differentiation. One way an organisation might seek to differentiate itself from its competitors is by meeting customers' needs and requirements more closely than their competitors. The greeting card company Moonpig has adopted such an approach by allowing customers to design their own cards online.

IT could also enhance competitive advantage by forming the basis of complete **new businesses**. It makes new businesses technically feasible, it creates derived demand for new products, and it creates new businesses inside old ones. The impact of Apple's iPod gives examples of all three effects. The device itself is based on the MP3 file format, a large iPod ecosystem of accessories has been created, and the product itself represents a departure from Apple's previous hardware and software strategies.

1.4 IT networks

'Information technology' includes any devices which collect, manipulate, store or distribute information.

Networking information technology

In an IT context, networking means linking two or more devices together in some way so that data can be shared among them. These networks can be categorised in terms of the geographical area they cover:

WAN: wide-area network. WANs are used to connect users and computers in one location with users in another location, so that users in different locations can relay data and information to each other.

LAN: local-area network (usually within an office or department)

In turn, LANs are connected to a WAN through a router, which can be either wired or wireless.

Networks allow decentralised computers and devices to communicate with each other. This enables databases and applications software to be shared, and provides flexibility (for example, by allowing users to access information from different places).

For example, home workers can connect up to an organisation's systems using **virtual private network (VPN)** links which treat the home workers as if they were on site.

However, there are also constraints and risks around IT networks. The costs of installing wired networks can be very high, while there may be security issues with wireless networks.

The increased importance of hardware, software and networks in supporting companies' strategies also highlights the importance of having proper controls over them – for example, to safeguard the integrity of corporate networks and databases.

Technology and data

When considering the IT architecture in a company, it is important to distinguish between the following components:

Technology platform – the internet, intranets, extranets and other computer systems and software which provide a platform which supports the strategic use of IT for e-business and e-commerce

Data resources – databases which store data and information for business processes and decision support

When considering whether a company's IT applications can support its business strategy, it is important to consider not only the technology platform but also its data resources.

Nonetheless, developments in information technology have had a significant impact on the operations, costs, work environments and competitive positions of many companies.

Enterprise software could be particularly useful to organisations in a business management context in relation to **enterprise resource planning**, **supply chain management**, and **customer relationship management**. **Business intelligence** software (eg data mining, analytics) could also be particularly useful for providing management with information.

Evaluating enterprise software

The increased importance of IT and software to business operations means that selecting the right systems and software is becoming increasingly important for organisations.

Aspects which an organisation should consider when selecting IT systems/software include:

- **Reliability** – assurance about the integrity and consistency of the application and all of its transactions
- **Interoperability** – the system's ability to interface and share data with other systems (including external systems)
- **Leveragability** – the ability to access stored data and other system resources at all times and from everywhere within the enterprise
- **Scalability** – the ability to continue to provide the required quality of service as the load or usage increases
- **Security** – the ability to allow certain users access to application functions and data while denying access to other users

- **Maintainability and manageability** – the ability to correct flaws in the system and to ensure the continued health of the system without adversely affecting other components of the system
- **Portability** – the ability of the software to run on a variety of hardware and operating systems

1.5 The internet, intranets and extranets

The internet has been the most influential technology in the last few decades: e-commerce could simply not exist without the internet.

Intranets use the same technologies as the internet, but access to them is restricted to computer networks within an organisation. The purpose of intranets is to allow the secure sharing of information to any part of an organisation, its system and its staff.

Extranets link organisations together through secure business networks using internet technology.

Extranets are particularly useful for various aspects of **supply chain management**; for example, details of orders placed with suppliers, orders received from customers, payments to suppliers or payments received from customers can all be transmitted through extranets. Similarly, banks can also be incorporated in these networks.

Using networks in this way is often called **Electronic Data Interchange** (EDI).

1.5.1 e-business and e-commerce

e-business is the use of internet-based technology to either support existing business processes or to create entirely new business opportunities.

Where these internet-based operations or processes are connected to a buying or selling activity, they become **e-commerce.**

e-commerce strategy

Most experts agree that a successful strategy for e-commerce cannot simply be bolted on to existing processes, systems, delivery routes and business models. Instead, management groups have, in effect, to start again by asking themselves fundamental questions.

- What do customers want to buy from us?
- What business should we be in?
- What kind of partners might we need?
- What categories of customer do we want to attract and retain?

In turn, organisations can visualise the necessary changes at **three interconnected levels:**

Level 1 – The simple **introduction of new technology** to connect electronically with employees, customers and suppliers (eg through an intranet, extranet or website)

Level 2 – **Re-organisation** of the workforce, processes, systems and strategy in order to make best use of the new technology

Level 3 – **Re-positioning** of the organisation to fit it into the emerging e-economy

So far, very few companies have gone beyond levels 1 and 2. Instead, pure internet businesses such as Amazon, have emerged from these new rules: unburdened by physical assets, their competitive advantage lies in **knowledge management** and **customer relationships**.

1.5.2 M-business

In addition to e-business, we should also recognise the increasing importance of accessing computer-mediated networks from mobile devices while on the move (eg mobile phones, personal digital assistants or tablet computers).

1.5.3 Virtual arrangements

Network technologies are used by organisations to integrate workers across sites and working at home. Developments in broadband, particularly improved capacity and better data security, have improved the ability to communicate across sites and from **home**. Broadband telecommunications systems allow 'remote' computer users to communicate with each other, and to send and receive information.

A virtual organisation can be seen as an extension of the idea of network organisations, although truly virtual organisations do not have any physical presence at all.

There is some disagreement among academics as to a precise definition of the virtual organisation, but a consensus exists with regard to **geographical dispersion** and the centrality of **information technology** to the production process.

Virtual organisations use networks to link people, assets and ideas, enabling a virtual organisation to ally with other organisations to create and distribute products and services without being limited by traditional organisation boundaries or physical locations. In a virtual network, one organisation can use the capabilities of another without being physically tied to that organisation.

The virtual organisation model is useful when a company finds it is cheaper to acquire products, services or capabilities from an external vendor, or when it needs to move quickly to exploit new market opportunities but lacks the time and/or resources to respond to the opportunities on its own.

An organisation is not a virtual organisation merely because it uses IT extensively and has multiple locations. Nevertheless, the ability to share information between members of a virtual organisation is likely to be critical to its operation.

Case example: Li & Fung

A number of fashion companies use the Hong Kong-based company Li & Fung to manage the production and shipment of their garments. Li & Fung handles product development, raw material sourcing, production planning, quality assurance and shipping. However, Li & Fung does not own any fabric, factories, or machines, and it outsources all of its work to a network of more than 7,500 suppliers in over 30 countries around the world.

Customers place orders to Li & Fung over its private extranet. Li & Fung then sends instructions to appropriate raw material suppliers and factories where the clothing is produced.

Li & Fung's extranet tracks the entire production process for each order.

Working as a virtual company allows Li & Fung to remain flexible and adaptable so that it can design and produce the products ordered by its customers at short notice to keep pace with rapidly changing fashion trends.

Case example: Amazon

Amazon.com is another example with is often cited as a virtual organisation.

Customers come to the Amazon website via Internet Service Providers (ISPs), often from links on other (affiliate) web sites. Although Amazon processes the customers' orders, it does not hold much inventory itself. If a customer orders a book through Amazon it is likely the book will be despatched from the publisher's warehouse, and the delivery will be handled by a logistics or mail company. Nonetheless, the customer feels they are dealing with one organisation (Amazon) and not many different companies.

But for this relationship to work, Amazon needs information from its partners – for example, it needs to know inventory availability and an estimate of delivery times so that it can provide this information for the customer when they make their order. Equally, Amazon needs to be confident that its partners will deliver the service they have agreed to provide (for example, if a partner says inventory will be available in 48 hours, then it needs to be available in 48 hours).

1.6 e-business strategies

We can identify three broad types of e-business strategy which a company can employ to help it gain a competitive advantage:

Cost and efficiency improvements: focus on improving efficiency and lowering costs by using the internet and other digital technologies as a fast, low-cost way to communicate and interact with customers, suppliers and business partners (eg use of email to communicate with customers; or EDI to communicate with suppliers)

Performance improvement in business effectiveness: make major improvements in business effectiveness – for example, the use of intranets can substantially improve information sharing, collaboration and knowledge management within a business or with its trading partners

Product and service transformation: developing new internet-based products and services, or supporting entry into new markets (including e-commerce which enables access to a global marketplace)

1.7 IT and competitive advantage

Throughout this section, we have alluded to the potential which IT has as a source of competitive advantage for companies. However, it is important to note that companies only achieve competitive advantage by doing something different from their competitors, and they only achieve sustainable competitive advantage by doing something which their competitors cannot replicate over time.

For example, the first airline company to introduce self-service check-in kiosks gained a competitive advantage (or source of differentiation) by doing so. However, all the major airlines companies now have self-service check-in kiosks so they are no longer a source of competitive advantage. By contrast, not having them would place a company at a competitive disadvantage.

Equally, when the first logistics and shipping company allowed customers to track their packages via the Web, this innovation was seen as a source of competitive advantage. Now, however, we expect to be able to track orders with all logistics and shipping companies.

Both of the examples above illustrate the importance of IT to modern business strategy. However, they also illustrate that the majority of innovations which confer competitive advantage on the companies which adopt them first are subsequently shared and become routine.

In this respect, we can divide IT investments into two broad categories: strategic IT and utility IT.

Strategic IT represents spending on new capabilities which directly supports new business strategies and innovations; all the remainder of IT spending is utility spending.

Customised applications and application platforms

In the same way that we can distinguish between strategic IT and utility IT, we also need to distinguish between customised applications and generic software.

Although packaged software is vital to many businesses, gaining any competitive advantage or differentiation from a generic package is very difficult (because competitors can also use the package). Therefore, strategic IT investments are most often based on custom applications.

Crucially, a company needs its application platform to support current technologies. Therefore, a company's choice of application platform (such as the Microsoft application platform) can be a key part of creating competitive advantage.

Extended case study

In this section we have suggested a number of ways information systems and information technology can have an impact on, and can support, business strategy and operations. The following case study (about Tesco) illustrates how some of these ways have been manifest in practice.

In particular, note how the impact of IS/IT affects strategic, tactical and operational levels within the company.

Case example: Tesco

e-commerce

The increasing popularity of online shopping prompted Tesco to start operating online in 1994. Growing its online business in all its markets is now a strategic priority for Tesco, as it aims to become a multi-channel retailer wherever it trades. Tesco's online sales now exceed £2 billion per year.

Tesco's 2012 Annual Report notes that 'Customers increasingly expect to be able to shop where, when and how they want: the boundary between stores and online is blurring.' The Click & Collect service provides a good illustration of this: customers can order products online ('click') and then subsequently 'collect' them from physical stores when it suits them.

Equally important, however, is the recognition that digital technology allows Tesco to meet the 'on the go' needs of its customers, such that customers can shop on the move using their smartphones as easily as on their computers at home.

Support infrastructure

In 2012, Tesco invested in a £65 million, state-of-the-art data centre to support the expansion of its web operations outside the UK. The retailer signed a 15-year contract with data centre operator, Sentrum, to host the equipment that will power Tesco's online and banking business. As Tesco's IT director noted at the time, the data centre is a major building block in the company's ability to deliver technology to its customers and colleagues.

Sentrum will host the infrastructure for the Tesco.com website, the Tesco group's management information systems and food replenishment systems. Importantly for Tesco, the deal not only improved the resilience of the infrastructure behind its online retail and banking business, but also provided it with the flexible capacity to meet the business' needs over the next ten years.

However, agreeing the contract with Sentrum also represents a change in strategy for Tesco a company which had previously preferred to build and manage its own data centres.

Loyalty Scheme ('Clubcard')

Offering loyalty points to customers whenever they make a purchase using their Clubcard may help build brand loyalty, but the Clubcard is also an important part of Tesco's relationship marketing strategy.

When customers make purchases using the Clubcards, Tesco's EPoS (electronic point of sale) tills link the purchases to the Clubcard enabling Tesco to collect detailed information about each customer's individual buying habits. Having such details then opens up possibilities for individually tailored promotions (for example, money off coupons for products which customers have bought previously or which complement products they have bought previously).

EPoS tills

Speed of customer service is vital in any busy store, and it is quicker for sales assistants to scan a bar code over a bar code reader than to type in details of each product from a customer's shopping trolley.

However, EPoS tills also provide lots of valuable information for a supermarket relating to inventory management.

Bar codes – When the bar code of a product is scanned through the till, the inventory records are updated to show that stock levels of that item have been reduced as a result of the sale. In turn, this can provide valuable information about the need to restock shelves with the item, and, in time, for replacement stocks to be received from the supplier. The aim is to avoid having stock outs (where stores run out of stock of an item).

Sales information from the till can also be used to show which products are selling well, and which products not – so that, for example, so that they may need a promotion to boost sales.

RFID tags – For many of Tesco's non-food items (eg DVDs), suppliers put RFID tags on the cases so that they can be tracked through the supply chain from distribution centres and into the stores. The RFID tags also act as a security control in stores, setting off a security alarm if a customer attempts to leave the store with an items which hasn't been processed at the checkout.

Personal Digital Assistants (PDAs) – Tesco's inventory control staff use networked PDAs to provide an extra level of control over their inventory replenishment process and to ensure that products are available on shelves. The PDAs record current inventory levels and this information is transmitted back to the inventory records. In this way, the PDAs provide Tesco with a way of checking that inventory levels it actually has in its warehouses or on store shelves agree to the levels it thinks it should have according to its inventory records.

Capacity management

Number of tills open – (to avoid long waiting times at checkouts). Infrared technologies count the number and type of customers (eg individual shoppers or family units) entering the store, track their movements round the store, and predict the likely demand at the checkouts up to an hour in advance, so additional tills can be opened if necessary to prevent long queues building at the checkouts.

Self checkouts

Till technology has also enabled self-service checkouts to be introduced alongside (or, in some cases, instead of) staff check-outs.

In 2010 the Tesco Express in Kingsley, Northampton became Britain's first entirely self-service shop. It had five self-scan tills overseen by a single member of staff and no staffed checkouts. The service was designed to increase efficiency and speed up the shopping process, as the five self checkouts are always available. Before, the number of checkouts available would have been dependent on how many people were working the tills.

Customers are interested in how quickly they can pay for their goods and get out of a shop, and retailers are constantly focused on improving that speed.

However, critics of Tesco's plan argued that the plan is indicative of Tesco's overall business strategy. One said, 'Once you have driven down prices, the next step to find savings and efficiencies is to get rid of people' – with the implication being that cost savings and profits are more important to Tesco than its staff.

Distribution, logistics and supply chain

Another way in which Tesco looks to achieve efficiencies is through its supply chain.

The company has recognised that an efficient distribution system starts with an understanding of the products its stores need. It achieves this in two ways:

- Forecasting what customers will purchase by using sophisticated, detailed models which consider variables such as seasonality, weather forecasts and likely response to promotions
- Real time updates to its ordering systems based on what customers are actually buying, so that stores can be supplied with the products they need at the right time

Another element in improving product availability is vendor managed inventory (VMI). For example, in 2005, Nestlé switched to a VMI relationship with Tesco in a bid to improve availability. Under VMI, Nestlé suppliers have access to Tesco's sales and inventory data and know when replenishment is needed without the supermarket having to issue purchase orders. Access to forecasting tools also allows replenishment quantities to be adjusted according to demand predictions.

Done properly, VMI can make a significant difference to availability, because suppliers are typically dealing with a handful of inventory lines, rather than the hundreds or thousands that a supermarket is responsible for. As Tesco's director of food supply said at the time, 'Half of our top suppliers deliver what we want, every week. Others continually fail. They must be more agile, adaptable and aligned to customers.'

Pricing and marketing

Tesco's price promise in the UK states that when customers shop at Tesco, Tesco will check their basket of groceries against the prices at Asda, Sainsbury's and Morrisons. If a customer's comparable grocery shopping would have been cheaper at one of those other stores, Tesco promises to give the customer a voucher for the difference (up to £10).

However, there is also an implicit information requirement behind this price promise: In order for Tesco to be able to measure its prices against the competitors' prices, it needs to have details of all the competitors' prices. This suggests therefore that Tesco's information systems need to include external information (about competitors' prices) as well as internal information about its own prices in order to make the relevant comparisons.

2 Information for strategic planning and control

2.1 Management information and strategy

Section overview

- Managers need information (including management accounting information) for three main reasons:
  – To make effective **decisions** (for example, how much of a product to make, what price to charge for it, and what distribution channels to use)
  – To **control** the activities of an organisation. There are four steps to this control process: establish measurable goals, measure actual performance, compare actual performance against the goals, and then take corrective action if necessary
  – **Co-ordinating** the activities of different departments and divisions (for example, by co-ordinating the flow of materials, semi-finished goods, and finished goods throughout the supply chain)

Managers need information for three main reasons:

- To make effective **decisions**
- To **control** the activities of the organisation
- To **co-ordinate** the activities of the organisation

2.1.1 Information and decisions

Decision-making is a key element of management. For example, a marketing manager must decide what price to charge for a product, what distribution channels to use, and how to promote the product. Equally, a production manager must decide how much of a product to make, while a purchasing manager must decide how much inventory to hold and whom to buy inputs from.

At a more strategic level, senior managers must decide how to allocate scarce financial resources among competing projects, how the organisation should be structured, or what business-level strategy an organisation should be pursuing.

In order to make effective decisions, managers need information from both inside and outside the organisation. For example, when deciding how to price a product, marketing managers need information about the way consumer demand will vary in relation to different prices, the cost of producing the product and the organisation's overall competitive strategy (since its pricing strategy will need to be consistent with this overall strategy).

2.1.2 Information and control

The management control process can be summarised in four key steps:

- Establish measurable standards of performance or goals
- Measure actual performance
- Compare actual performance against established goals
- Evaluate the results and take corrective action where necessary

In their text, *Contemporary Management*, Jones and George refer to the example of the package delivery company DHL. They note that DHL has a goal to deliver 95% of the packages it picks up by noon the next day. DHL has thousands of branch offices across the US which are responsible for the physical pick-up and delivery of packages, and DHL managers monitor the delivery performance of these offices on a regular basis. If the 95% target is not being achieved, the managers analyse why this is and then take corrective action if necessary.

In order to control operational activity in this way, the managers have to have information about deliveries and performance. In particular, the managers need to know what percentage of packages each branch office delivers by noon, and this information is provided through DHL's IT systems.

All packages to be shipped are scanned with handheld scanners by the DHL drivers, and details of the packages are sent wirelessly to a central computer at DHL's headquarters. The packages are scanned again when they are delivered, with the related delivery time being sent wirelessly back to the central computer. Therefore, managers can identify the percentage of packages which are delivered by noon the day after they were picked up, and can also break down this information to analyse delivery performance on a branch-by-branch basis.

2.1.3 Information and co-ordination

Another key element of management is co-ordinating the activities of individuals, departments or divisions in order to achieve organisational goals.

One area where this is particularly important is in relation to managing global supply chains. Organisations are using increasingly sophisticated IT systems to co-ordinate the flow of materials, work in progress, and finished products throughout the world.

Jones and George consider the example of Bose, the manufacturers of high quality music systems and speakers. Almost all of the components which Bose uses in its speakers are purchased from external suppliers, and about 50% of its purchases are from foreign suppliers, many in the Middle East.

The challenge for Bose is to co-ordinate its globally dispersed supply chain in a way that minimises inventory and transportation costs. Bose employs a just in time production system, so it needs to ensure that component parts arrive at the relevant assembly plants just in time to enter the production process and not before.

Equally, however, Bose has to be responsive to customer demands. This means that Bose and its supplier need to be able to respond quickly to changes in demand for different kinds of speakers, increasing or decreasing production as necessary.

In order to co-ordinate its supply chain, Bose uses a logistics IT system which provides it with real-time information about parts as they move through the global supply chain. When a shipment of parts leaves a supplier it is logged onto the system, and from that point Bose can track the supplies as they move across the globe to the assembly plant.

On one occasion, a significant customer unexpectedly doubled its order for Bose speakers, which meant that Bose had to increase its manufacturing output rapidly. Many of its components were stretched out across the supply chain. However, by using its logistics system Bose was able to locate the parts it needed, and accelerate them out of the normal delivery chain by moving them on air freight. In this way, Bose was able to get the parts it needed at the assembly plant in time to fulfil the customer's order.

2.2 Management accounting information

Management accounting information is used by managers for a variety of purposes:

(a) **To measure performance**. Management accounting information can be used to analyse the performance of the business as a whole, and of the individual divisions, departments or products within the business. Performance reports provide **feedback**, most frequently in the form of comparison between actual performance and budget.

(b) **To control the business**. Performance reports are a crucial element in controlling a business. In order to be able to control their business, managers need to know the following:

  (i) What they want the business to achieve (targets or standards; **budgets**)
  (ii) What the business is actually achieving (**actual performance**)

  By comparing the actual achievements with targeted performance, and identifying **variances**, management can decide whether corrective action is needed, and then take the necessary action when required.

  Much control information is of an accounting nature because costs, revenues, profits and asset values are major factors in how well or how badly a business performs.

(c) **To plan for the future**. Managers have to plan, and they need information to do this. Much of the information they use is management accounting information.

(d) **To make decisions**. As we have seen, managers are faced with several types of decision:

  (i) **Strategic decisions** (which relate to the longer term objectives of a business) require information which tends to relate to the organisation as a whole, is in summary form and is derived from both internal and external sources.

  (ii) **Tactical and operational decisions** (which relate to the short or medium term and to a department, product or division rather than the organisation as a whole) require information which is more detailed and more restricted in its sources.

In the remainder of this section, we will look briefly at some of the management accounting information and management accounting tools which managers can use to evaluate aspects of business strategies.

2.3 Costs

One of the most crucial elements of an organisation's performance management and control is to ensure that the value created by its activities is greater than the cost of carrying out those activities. (This is the point highlighted by the 'margin' element in Porter's value chain model.)

2.3.1 Costs and strategy

A key element of performance measurement and control for a company will be ensuring that its costs remain under control. However, cost information is also important from a strategic perspective.

For example:

A company's choice of generic strategy interacts with cost and value. A company which is pursuing a **cost leadership** strategy needs to maintain a strict control of costs (and, wherever possible, also needs to benchmark its costs and the efficiency of its processes against its competitors to ensure its costs remain lower than theirs).

However, a **differentiation** strategy will also have cost implications – for example, associated with product quality and customer service or after-sales service.

Moreover, the structure of costs and value creation is likely to change over time, as illustrated, for example, in the **product life cycle**. As sales and production rise in the growth stage of the life cycle, unit costs could be expected to fall due to **economies of scale**. In the mature stage, prices become increasingly sensitive as firms compete with one another to try to increase their share of the market. Therefore cost reductions may be required to help firms sustain their profits.

Costs and decision-making

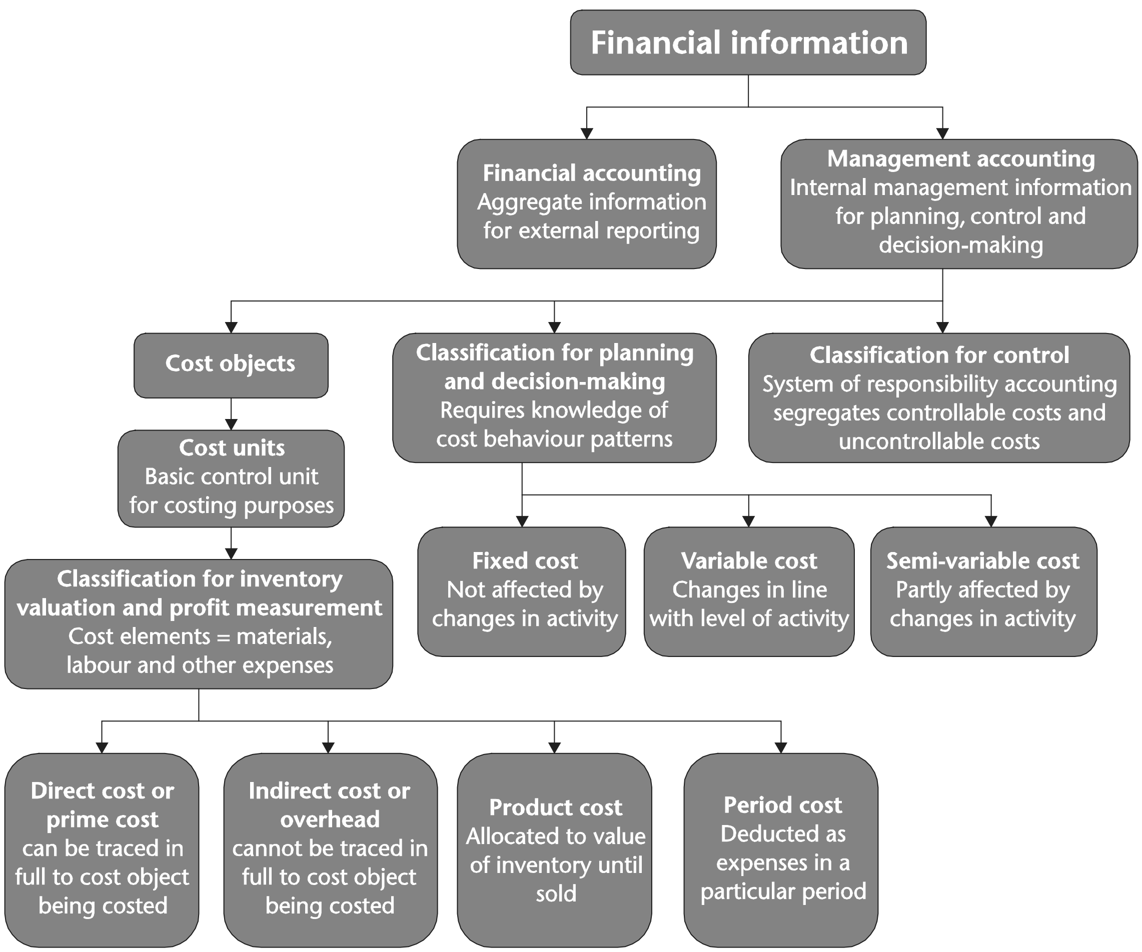
Managers also need to know the cost of producing different products and services because they cannot make informed decisions about pricing or about whether or not to continue producing them without having accurate cost information.

Sub-optimal decision making – Importantly, if managers do not have accurate and reliable cost information, this is likely to lead to sub-optimal decision making. For example, if the costs attributed to producing a product are understated, then a company may continue producing that product when it would actually be better advised to stop producing it.

Short v long-term trade-off – Equally, managers may find themselves under pressure to reduce costs. However, it is important that decisions taken to reduce costs in the short term don't hinder an organisation's ability to achieve its strategic goals. For example, if marketing expenditure is reduced to cut costs in the short term this could be detrimental to an organisation's strategic goal to increase market share.

2.3.2 Cost classification

You should already be familiar with cost classification from your earlier studies, but here is a summary brought forward from the Management Information paper.



Make sure you are familiar with all these classifications.

2.3.3 Costing systems

One of the purposes of the following costing systems is to calculate the cost of a unit of output which can ultimately be used to set the selling price.

Absorption costing

With absorption costing, a unit of output is valued at **full cost** – that is, the prime cost plus an absorbed share of production overhead costs.

Marginal costing

Marginal costing is an alternative to absorption costing where only variable costs are included in the valuation of units. All fixed costs are treated as period costs and written off against sales revenue in the period in which they are incurred.

The difference in unit valuations using the two methods lies in the treatment of the fixed costs. The absorption cost of sales will include some fixed costs from a previous period (included in opening inventory) while all fixed costs are written off as expenses in the year of incurrence with marginal costing.

Interactive question 2: Absorption and marginal costing [Difficulty level: Easy]

Hamilton Ltd manufactures and sells a single product, the Feronda, which has a selling price of CU150 per unit and variable costs of CU70 per unit. During the months of July and August, the following details are available.

	July	*August*
Fixed production costs	CU110,000	CU110,000
Production	2,000 units	2,500 units
Sales	1,500 units	3,000 units

Hamilton Ltd normally expects to produce 2,200 units and fixed production costs were budgeted at CU110,000 per month, which are absorbed on a per unit basis. There were no opening inventories in July.

Requirements

(a) Determine the profit for each of July and August using:

(i) Absorption costing and
(ii) Marginal costing

(b) Demonstrate why the profits under each method are different.

See **Answer** at the end of this chapter.

2.3.4 Activity Based Costing (ABC)

ABC is an alternative approach to absorption costing. Cost drivers – that is, those activities that cause costs in the first place – are identified and overheads are assigned to products or services based on the number of the cost drivers generated by each. More than one cost might have the same cost driver, so costs associated with the same driver are gathered into cost pools and then allocated using the appropriate driver. The product costs resulting from ABC should be more accurate than those under absorption costing as overheads are allocated on a more objective basis. Try the question below to make sure you remember the principles and procedures of ABC.

Interactive question 3: Activity Based Costing [Difficulty level: Easy]

Tammy Ltd currently makes and sells four products, cost and output details of which are below.

Product	*Alpha*	*Bravo*	*Echo*	*Oscar*
Output (units)	500	300	400	200
Cost per unit (CU):				
Material	60	42	80	100
Labour	32	20	35	50
Activities:				
Number of set ups	20	15	30	35
Number of times materials handled	3	4	2	6
Number of orders	11	12	16	25
Number of spare parts required	15	20	10	15

Total overhead costs (CU)	
Set up costs	25,000
Material handling	69,000
Ordering costs	32,000
Engineering costs	45,000
	171,000

Requirements

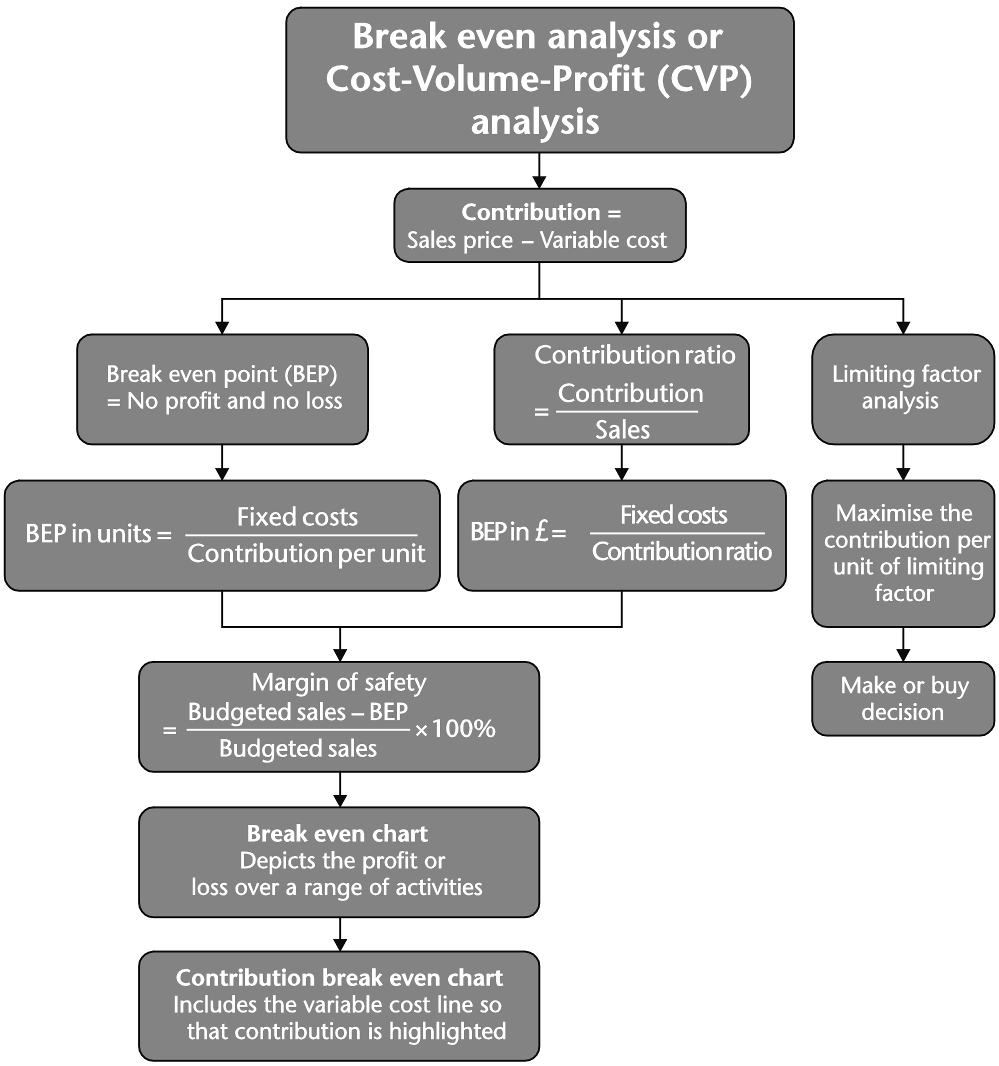
(a) Using the information given, what is the most suitable cost driver for each overhead cost?
(b) Calculate the total product cost for each of the four products, showing all workings.

See **Answer** at the end of this chapter.

2.4 Break even analysis

Break even analysis is the study of the inter-relationships between costs, volume and profit at various levels of activity. The study of break even analysis requires understanding, application and interpretation of various formulae which are summarised below.

You will notice from the chart that break even analysis is also used for decision making purposes where there are limiting factors, such as make or buy decisions. Remember that the most important figure for decision making is **contribution** – if a product is making a contribution towards fixed costs then production should continue, as overall profit will be reduced (or loss increased) if this contribution is lost.



Interactive question 4: Break even analysis **[Difficulty level: Easy]**

Bonzo Ltd manufactures and sells roller skates. Current sales volume is 20,000 pairs of roller skates per annum. Selling price and variable cost details per pair is shown below:

	CU
Selling price	55.00
Variable costs	25.00

Total fixed costs per annum are:

	CU
Marketing	75,000
Salaries	200,000
Other	150,000

Requirements

(a) How many pairs of roller skates have to be sold in one year for Bonzo Ltd to break even?

(b) What is the current margin of safety in terms of number of pairs of skates sold?

(c) Bonzo Ltd has decided to increase its marketing campaign, which means spending an extra CU40,000 on marketing. Selling price of the roller skates will also increase to CU65. If Bonzo Ltd wishes to make a profit of CU25,000, how much sales revenue must be generated from the sale of roller skates?

See **Answer** at the end of this chapter.

2.5 Multi-product break even analysis

The key issue with multi-product break even problems is determining the mix in which the products are sold and reducing it to the lowest common denominator. For example, if 500 units of Product X and 250 units of Product Y are sold, then the mix in which the two products are sold is 2:1. This mix is used to define a standard batch which can be used to determine a break even point in terms of number of batches. Once this has been determined, the number of batches can then be converted into the number of units of each product that must be sold at the break even point.

Worked example: Multi-product break even analysis

Toodiloo Ltd manufactures and sells two types of microwave oven: the Silver Star oven and the Gold Senator combination oven and grill. The following information is available for the two models.

	Silver Star	*Gold Senator*
Sales volume in units	5,000	3,000
Per unit:	CU	CU
Selling price	65.00	90.00
Variable costs	45.00	60.00

Direct fixed costs are CU40,000 for the Silver Star and CU30,000 for the Gold Senator. General fixed costs, which can only be avoided if neither model is sold, are CU63,000.

Requirement

Calculate how many units of each model would have to be sold for Toodiloo Ltd to cover all its fixed costs.

Solution

As with all break even questions, the first thing to do is to establish the contribution per unit:

	Silver Star	*Gold Senator*
	CU	CU
Selling price	65.00	90.00
Variable costs	45.00	60.00
Contribution per unit	20.00	30.00

The key to multi-product break even analysis is to look at the product mix. In this case we are told that Toodiloo sells 5,000 units of the Silver Star and 3,000 units of the Gold Senator, giving a product mix ratio of 5:3. A standard batch can therefore be assumed to comprise five Silver Star and three Gold Senator, which will give a total contribution towards total fixed costs of CU190 (5 × CU20.00 + 3 × CU30.00).

Using the total contribution per standard batch, we can calculate the number of batches that have to be sold in order to break even:

$$\text{Break even point in batches} = \frac{\text{Total fixed costs}}{\text{Contribution per batch}}$$

$$= \frac{133{,}000}{190}$$

= 700 batches

How many units of each model will have to be sold in order to break even? Remember that in every batch, five units of the Silver Star are sold and three units of the Gold Senator. Therefore, in order to break even, Toodiloo will have to sell:

Silver Star: 5 × 700 = 3,500 units

Gold Senator: 3 × 700 = 2,100 units

Check:

	Silver Star	*Gold Senator*	*Total*
	CU	CU	CU
Contribution per unit	20.00	30.00	
Total contribution	70,000	63,000	133,000
Fixed costs:			
Direct	40,000	30,000	70,000
General			63,000
Total profit/(loss)			NIL

Note: You will have probably noticed that this break even number of batches and units will only work if the product mix remains at 5:3. As soon as the product mix changes you will have to calculate a new break even point. As you might expect, an increase in the proportion of sales of products with a higher contribution will normally reduce the break even point, while an increase in the proportion of sales of products with a lower contribution will normally increase the break even point.

Interactive question 5: Multi-product break even analysis [Difficulty level: Easy]

Netcord Ltd produces and sells three different types of tennis racquet: the McEnrova, the Grafassi and the Federdal. The sales and costs forecast for the next period are as follows.

	McEnrova	*Grafassi*	*Federdal*	*Total*
Sales units	8,000	6,000	4,000	
	CU	CU	CU	CU
Sales revenue	320,000	360,000	400,000	
Variable costs	176,000	228,000	280,000	
Contribution	144,000	132,000	120,000	396,000
Total fixed costs				306,900
Net profit				89,100

Total fixed costs can only be avoided if all models are eliminated.

Requirement

How many units of each model must be sold in order for Netcord Ltd to break even and what is the break even sales revenue?

See **Answer** at the end of this chapter.

2.6 Price

Price is a key element of the marketing mix, and you should have covered pricing and pricing issues in the Business Strategy syllabus. However, when evaluating pricing strategies, it is vital to consider how 'price' information fits with the other elements of the marketing mix.

Price directly affects how well an organisation performs competitively, and is also closely linked to the perceptions of value for money held by the customers.

If the price is too high, the exchange may not be perceived as worthwhile, and customers may not buy the product.

If the price is too low, then one of two things could happen:

(1) The product sells well, however the revenue per item is lower than it could be if the price were higher, so less revenue is earned which in turn means less profit than may be possible with a higher price.

(2) The consumer perceives the price to be too low and interprets this as meaning quality has been compromised. The customer does not buy the product at all.

Getting this balance right (and not setting a price either too high or too low) can be difficult and the organisation will have to take many factors into account when setting the price for their products and services.

The following factors should be considered when evaluating a firm's pricing strategy:

(1) What are the **pricing objectives** (for example, budget pricing or premium pricing?)

(2) What are the firm's **target markets**, and what will they be prepared to pay for the firm's products?

(3) How will demand for the firm's products or services vary with price (ie what is their price elasticity?)

(4) What is the relationship between demand, cost and profit (eg how does the break-even point vary for a range of different prices)?

(5) How do the firm's prices compare to **competitors' price**s?

(6) What is the basis for pricing?

- **Cost-based pricing** (marginal cost-plus, full cost-plus pricing, mark-up pricing, target-return pricing)
- **Demand-based pricing** (set prices high when demand is high, and low when demand is low)
- **Competition prices** (set prices in relation to competitors' pricing, depending on the organisation's strategy)
- **Marketing-oriented pricing** (set prices to reflect the marketing strategy: ie target market profile, brand positioning, and sales targets)

(7) What is the pricing strategy?

For example:

- **Differential pricing** (charging different prices to different customers for the same quality and quantity of product)
- **New product pricing** (price skimming, penetration pricing)
- **Psychological pricing** (eg everyday low prices; bundle pricing, where two or more complementary products are sold together for a single price which is lower than the aggregate price if both were purchased separately; prestige pricing, where prices are set artificially high to give a product a 'quality' image)
- **Promotional pricing** (eg selling products below the usual mark up for a short-term period)

Prices have to be revised in response to market conditions and trends (eg recession, new entrants). However, it is important that an organisation does not overlook any potential longer-term implications for the brand, or the relationship between demand, costs and profits.

Case example: McDonald's in China

In February 2009, McDonald's lowered the price of four of its meals in China by up to one-third. The price of the Filet-o-Fish, double cheeseburger, chicken fillet sandwich and pork burger meals was reduced to 16.50 yuan (or $2.40).

McDonald's said that the price reduction follows the Chinese government's direction to stimulate domestic demand and help build a stronger economy, in the light of concerns about the impact which the global economic slowdown was having on China.

McDonald's felt that it could do its part by stimulating domestic demand in the restaurant sector. However, McDonald's was not the only food retailer to have lowered prices in China. Others, like KFC, had also started promotions as consumers in China begin to worry about slowing growth and rising unemployment.

Only a year earlier, the price of staple items like pork, rice and cooking oil were soaring, lifting inflation and threatening to overheat the Chinese economy which had recorded double-digit growth for a number of years. Once growth started to slow, the pressure shifted to retailers to entice shoppers with special deals.

However, China remains an attractive location because of the size of the market and because its growth rates are still ahead of most of the rest of the world. Therefore, McDonald's price cut was also influenced by its plans to expand in the country, which was one of its fastest-growing markets.

McDonald's had 1,050 outlets in China at the start of 2009, but it hopes to have reached 2,000 outlets by the end of 2013.

In this respect, McDonald's has been a rare beneficiary of the global economic downturn, as shoppers around the world switch to lower-priced goods.

2.7 Budgets

Budget should provide an organisation with short-term targets within the framework of longer-term strategic plans. Budgets represent the short term targets which need to be achieved in order to fulfil strategic objectives.

Budgets also provide a mechanism for **controlling performance** as they provide a yardstick against which to assess performance. This means finding out why actual performance did not go according to plan, and then seeking ways to improve performance for the future.

Budgets enable managers to manage by exception, that is focus on areas where things are not going to plan (ie the exceptions). This is done by comparing the actual performance to the budgets to identify the **variances.**

However, the reason a budget is not achieved may sometimes be because the budget itself was unrealistic. If this is the case, the budget may need to be revised. Only realistic budgets can form a credible basis for control.

2.8 Variance analysis

When actual performance is compared to standards and budgeted amounts, there will inevitably be **variances**. They may be favourable or adverse depending on whether they result in an increase to, or a decrease from, the budgeted profit figure.

2.8.1 Sales variances

Sales volume variance is the difference between the original and flexed budget profit figures. This is an important variance because losing sales generally means losing profit as well. If it has the effect of making profit lower than budgeted it is **adverse** and if it makes profit higher than budgeted it is **favourable**.

Sales price variance is the difference between actual sales revenue and actual volume at the standard sales price. Higher sales prices (if all else remains constant) mean an increase in profit.

2.8.2 Materials variances

Total direct materials variance is the difference between the actual and direct materials cost and the direct materials cost according to the flexed budget. If the actual material cost is higher than budget, it has an adverse effect on profit.

Direct materials usage variance is the difference between actual usage and budgeted usage for the actual volume of output, multiplied by the standard materials cost. If actual usage is higher than budgeted usage there will be an adverse effect on profit.

Direct materials price variance is the difference between actual materials cost and the actual usage multiplied by the standard materials cost. Again, if actual costs are higher than those budgeted, there will be an adverse effect on profit.

2.8.3 Labour variances

Total direct labour variance is the difference between the actual direct labour cost and the direct labour cost according to the flexed budget. If more is spent on labour than was budgeted, there will be an adverse effect on profit.

Direct labour efficiency variance is the difference between the actual labour time and budgeted time, for the actual volume of output, multiplied by the standard labour rate. It looks at the actual versus the budgeted number of hours used to produce the output. If actual time is greater than budgeted time the effect on the profit will be adverse. The faster people work, the more profit can be made.

Direct labour rate variance is the difference between the actual labour cost and the actual labour time multiplied by the standard labour rate. This means it compares the actual cost of the hours worked against the anticipated cost based on a standard hour. Where actual costs exceed the standard, profit will be adversely affected.

2.8.4 Fixed overhead variances

Fixed overhead spending variance is the difference between the actual and budgeted spending on fixed overheads. Higher than budgeted overheads lead to less profit and have an adverse effect.

Worked example: Flexible budgets and budgetary control

Penny manufactures a single product, the Darcy. Budgeted results and actual results for May are as follows.

	Budget	*Actual*	*Variance*
Production and sales of the Darcy (units)	7,500	8,200	
	CU	CU	CU
Sales revenue	75,000	81,000	6,000 (F)
Direct materials	22,500	23,500	1,000 (A)
Direct labour	15,000	15,500	500 (A)
Production overhead	22,500	22,800	300 (A)
Administration overhead	10,000	11,000	1,000 (A)
	70,000	72,800	2,800 (A)
Profit	5,000	8,200	3,200 (F)

Note. (F) denotes a favourable variance and (A) an unfavourable or adverse variance.

In this example, the variances are meaningless for the purposes of control. All costs were higher than budgeted but the volume of output was also higher; it is to be expected that actual variable costs would be greater than those included in the fixed budget. However, it is not possible to tell how much of the increase is due to **poor cost control** and how much is due to the **increase in activity**.

Similarly it is not possible to tell how much of the increase in sales revenue is due to the increase in activity. Some of the difference may be due to a difference between budgeted and actual selling price but we are unable to tell from the analysis above.

For control purposes we need to know the answers to questions such as the following:

- Were actual costs higher than they should have been to produce and sell 8,200 Darcys?
- Was actual revenue satisfactory from the sale of 8,200 Darcys?

Instead of comparing actual results with a fixed budget which is based on a different level of activity to that actually achieved, the correct approach to budgetary control is to compare actual results with a budget which has been **flexed** to the actual activity level achieved.

Suppose that we have the following estimates of the behaviour of Penny's costs:

(a) Direct materials and direct labour are variable costs.

(b) Production overhead is a semi-variable cost, the budgeted cost for an activity level of 10,000 units being CU25,000.

(c) Administration overhead is a fixed cost.

(d) Selling prices are constant at all levels of sales.

Solution

The **budgetary control analysis** should therefore be as follows.

	Fixed budget	*Flexible budget*	*Actual results*	*Variance*
Production and sales (units)	7,500	8,200	8,200	
	CU	CU	CU	CU
Sales revenue	75,000	82,000 (W1)	81,000	1,000 (A)
Direct materials	22,500	24,600 (W2)	23,500	1,100 (F)
Direct labour	15,000	16,400 (W3)	15,500	900 (F)
Production overhead	22,500	23,200 (W4)	22,800	400 (F)
Administration overhead	10,000	10,000 (W5)	11,000	1,000 (A)
	70,000	74,200	72,800	1,400 (F)
Profit	5,000	7,800	8,200	400 (F)

Workings

1 Selling price per unit = CU75,000 / 7,500 = CU10 per unit

Flexible budget sales revenue = CU10 × 8,200 = CU82,000

2 Direct materials cost per unit = CU22,500/7,500 = CU3

Budget cost allowance = CU3 × 8,200 = CU24,600

3 Direct labour cost per unit = CU15,000 / 7,500 = CU2

Budget cost allowance = CU2 × 8,200 = CU16,400

4 Variable production overhead cost per unit = CU(25,000 – 22,500)/(10,000 – 7,500)

= CU2,500/2,500 = CU1 per unit

∴ Fixed production overhead cost = CU22,500 – (7,500 × CU1) = CU15,000

∴ Budget cost allowance = CU15,000 + (8,200 × CU1) = CU23,200

5 Administration overhead is a fixed cost and hence budget cost allowance = CU10,000

Comment

(a) In selling 8,200 units, the expected profit should have been not the fixed budget profit of CU5,000, but the flexible budget profit of CU7,800. Instead, actual profit was CU8,200 ie CU400 more than we should have expected.

One of the reasons for this improvement is that, given output and sales of 8,200 units, the cost of resources (material, labour etc) was CU1,400 lower than expected.

These total cost variances can be analysed to reveal how much of the variance is due to lower resource prices and how much is due to efficient resource usage.

(b) The sales revenue was, however, CU1,000 less than expected because the price charged was lower than budgeted.

We know this because flexing the budget has eliminated the effect of changes in the volume sold, which is the only other factor that can affect sales revenue. You have probably already realised that this variance of CU1,000 (A) is a **selling price variance**.

The lower selling price could have been caused by the increase in the volume sold (to sell the additional 700 units the selling price had to fall below CU10 per unit). We do not know if this is the case but without flexing the budget we could not know that a different selling price to that budgeted had been charged. Our initial analysis above had appeared to indicate that sales revenue was ahead of budget.

The difference of CU400 between the flexible budget profit of CU7,800 at a production level of 8,200 units and the actual profit of CU8,200 is due to the net effect of cost savings of CU1,400 and lower than expected sales revenue (by CU1,000).

The difference between the original budgeted profit of CU5,000 and the actual profit of CU8,200 is the total of the following:

(a) The savings in resource costs/lower than expected sales revenue (a net total of CU400 as indicated by the difference between the flexible budget and the actual results).

(b) The effect of producing and selling 8,200 units instead of 7,500 units (a gain of CU2,800 as indicated by the difference between the fixed budget and the flexible budget). This is the **sales volume contribution variance**.

A **full variance analysis statement** would be as follows:

	CU	CU
Fixed budget profit		5,000
Variances		
Sales volume	2,800 (F)	
Selling price	1,000 (A)	
Direct materials cost	1,100 (F)	
Direct labour cost	900 (F)	
Production overhead cost	400 (F)	
Administration overhead cost	1,000 (A)	
		3,200 (F)
Actual profit		8,200

If management believes that any of the variances are large enough to justify it, they will investigate the reasons for their occurrence to see whether any corrective action is necessary.

2.8.5 Reasons for variances

Variances may occur for a number of reasons. One possible reason is that the budget itself was not realistic. Unless they are achievable, budgets are not a useful method of control. However, there are many other reasons why variances may arise, as shown by the table below.

Variance	Possible reason for variance
Sales volume	Poor performance by sales staff Deterioration in market conditions between the time the budget was set and the actual event Lack of goods or services to sell as a result of a production problem
Sales price	Poor performance by sales staff Deterioration in market conditions between the time the budget was set and the actual event

Variance	Possible reason for variance
Direct materials usage	Poor performance by production department staff, leading to high rates of scrap Substandard materials, leading to high rates of scrap Faulty machinery, causing high rates of scrap
Direct materials price	Poor performance by the buying department staff Using higher quality material than was planned Change in market conditions between the time the budget was set and the actual event
Direct labour efficiency	Poor supervision A worker with a low skill grade taking longer to do the work than was envisaged for the correct skill grade Low-grade materials, leading to high levels of scrap and wasted labour time Problems with a customer for whom a service is being rendered Problems with machinery, leading to labour time wasted Dislocation of materials supply, leading to workers being unable to proceed with production
Direct labour rate	Poor performance by the human resources department Using a higher grade of worker than was planned Change in labour market conditions between the time of setting the budget and the actual event
Fixed overhead spending	Poor supervision of overheads General increase in costs of overheads not taken into account in the budget

2.9 Limiting factors

Every organisation operates under resource **constraints**.

Usually, an organisation's output is restricted by the level of demand rather than the organisation's ability to produce. However, sometimes there is a limit to the amount which can be produced due to a limiting factor within the organisation.

Examples of limiting factors are:

- A shortage of production capacity
- A limited number of key personnel, such as salespeople with technical knowledge
- A restricted distribution network
- Limited shelf space or display space (for a retailer)
- Too few managers with knowledge about finance or overseas markets
- Inadequate research design resources to develop new products or services
- A poor system of strategic intelligence
- Lack of money
- A lack of adequately trained staff

Once the limiting factor has been identified, the planners should:

- In the short term, make best use of the resources available
- Try to reduce the limitation in the long term

The most profitable combination of products will occur where the **contribution per unit of the scarce factor** is maximised.

When evaluating strategic plans, managers need to assess what the limiting factors (if any) are, and then assess whether the company is producing the combination of products which allows it to maximise its profits. For example, if labour is scarce then the company's priority should be on producing the products which generate the highest profit per unit of labour.

Worked example: Scarce resources

A business makes three different products (A, B and C), as follows:

Product	A	B	C
Selling price per unit (CU)	25	20	23
Variable cost per unit (CU)	10	8	12
Weekly demand (units)	25	20	30
Machine time per unit (hours)	4	3	4

Fixed costs are not affected by the choice of product because all three products use the same machine. Machine time is limited to 148 hours a week.

Which combination of products should be manufactured if the business is to produce the highest profit?

Solution

	A	B	C
Selling price per unit (CU)	25	20	23
Variable cost per unit (CU)	(10)	(8)	(12)
Contribution per unit (CU)	**15**	**12**	**11**
Machine time per unit	4 hours	3 hours	4 hours
Contribution per machine hour	CU3.75	CU4.00	CU2.75
Order of priority	2nd	1st	3rd

Therefore produce:

20 units of product B using	60 hours
22 units of product A using	88 hours
	148 hours

This leaves unsatisfied the market demand for a further three units of product A and 30 units of product C.

Limiting factors could also be important in determining the feasibility of an organisation's strategy. If an organisation has a limited amount of labour available, the total amount of sales it can generate will be restricted by this labour. If the organisation is looking to grow, but isn't also looking to increase its staff levels, its strategy will not be feasible (unless it is able to prevent staff levels being a limiting factor in some other way – for example, by automating some processes which are currently carried out manually).

Limiting factors and make-or-buy decisions

The issue of limiting factors could also have implications on a decision about whether to make or buy. If a factor is scarce and is preventing growth, then buying additional units of that resource might be justified, even if a traditional make-or-buy decision would not otherwise justify it.

Limiting factors and capacity

The reference to limiting factors and capacity also highlights that organisations may need to adjust their capacity by some means. For example, if labour (or staff hours available) is the limiting factor, an organisation should consider how it can increase its labour capacity.

Overtime – the quickest and most convenient way of increasing capacity is to increase the number of hours worked by the existing staff, by offering them overtime payments to work additional hours.

However, this method is only useful if the timing of the extra capacity matches that of the demand. For example, there will be no benefit from asking retail staff to work longer hours in the evenings if the excess demand is occurring during normal daytime working hours.

Conversely, at a micro level an organisation might be able to solve capacity issues by building **flexibility** into **job design and job roles** so that staff could be transferred from less busy areas into the busiest areas for short periods of time. For example, because they found that peak times for registering new customers coincided with the least busy times in the kitchen and restaurant areas, the hotel chain Novotel trained some of its kitchen staff to also escort customers from the reception area up to their rooms.

Adjusting the size of the workforce – If capacity is largely governed by the size of the workforce, then one way to increase capacity is to take on extra staff in periods of high demand. These might often be temporary or part-time staff.

A variation on this approach could be to use **subcontractors**.

Demand management

Instead of looking to resolve capacity issues through supply side solutions, it might also be possible to address them through demand management activities.

Such an approach is popular among travel operators who offer cheaper holidays and flights at less busy times in order to try to stimulate off-peak demand and curtail peak demand.

2.10 Expected values

An **expected value** (or **EV**) is a weighted average value based on probabilities. The expected value for a single event can offer a helpful guide for management decisions.

Although the outcome of a decision may not be certain, there is some likelihood that probabilities could be assigned to the various possible outcomes from an analysis of previous experience.

If the probability of an outcome of an event is p, then the expected number of times that this outcome will occur in n events (the expected value) is equal to n × p.

The concepts of probability and expected value are vital in **business decision-making**. The expected values for single events can offer a helpful guide for management decisions.

- A project with a positive EV should be accepted.
- A project with a negative EV should be rejected.
- When choosing between options the alternative which has the **highest EV of profit** (or the **lowest EV of cost**) should be selected.

Where probabilities are assigned to different outcomes we can evaluate the worth of a decision as the **expected value**, or weighted average, of these outcomes. The principle is that when there are a number of alternative decisions, each with a range of possible outcomes, the optimum decision will be the one which gives the highest expected value.

Expected values can be built into **decision trees** in order to aid decision making. The amount of expected profit is likely to be conditional on the result of various decisions.

However, remember the limitations of using expected values as a basis for decisions.

2.10.1 Limitations of expected values

Evaluating decisions by using expected values has a number of limitations.

(a) The **probabilities** used when calculating expected values are likely to be estimates. They may therefore be **unreliable** or **inaccurate**.

(b) Expected values are **long-term averages** and may not be suitable for use in situations involving one-off decisions. They may therefore be useful as a **guide** to decision making.

(c) Expected values do not consider the **attitudes to risk** of the people involved in the decision-making process. They do not, therefore, take into account all of the factors involved in the decision.

(d) The time value of money may not be taken into account: $100 now is worth more than $100 in ten years' time.

2.11 Transfer pricing

You should have looked at issues around transfer pricing in Business Strategy, but it is important to remember transfer pricing can have important strategic implications.

Sales and prices

Transfer prices can determine the overall price and sales of a product.

Suppose Division A supplies an intermediary product to Division B for CU12,000. Division B does additional work to the product (at a cost of CU5,000) and the product's market price is set at a 15% mark-up on cost.

If Division A transfers the intermediary product at cost, the final price will be CU19,550: (CU12,000 + CU5,000) x 1.15.

However, if Division A sets a transfer price of CU15,000 for the intermediary product, the final price would be CU23,000: (15,000 + 5,000) x1.15.

The difference in price is likely to have a significant effect on the volume of products sold, and therefore company profits.

Tax liabilities

If a multinational company has divisions in countries with different tax rates, the level at which transfer prices are set will influence the overall level of tax the company has to pay.

Dysfunctional decision-making

Transfer pricing could lead to dysfunctional decision-making.

In the illustration above, if Division A believes it can achieve a higher price by selling on the open market (rather than selling to Division B) it should take the open market price. However, this might mean that Division B does not have a product to sell if it cannot obtain the component elsewhere.

Equally, however, if Division B can obtain supplies of an equivalent product more cheaply from an external supplier than from Division A it should buy the product from the external supplier. However, this might leave Division A with unsold stock.

Transfer pricing and control

As a means of control, the main concern is reconciling the need for transfer prices to be set at an **appropriate level to assess performance** with the need for **goal congruence** within the organisation. Ideally, pricing levels should be set at a level to avoid the complications and loss of resources of departments dealing unnecessarily with external sources rather than with internal 'suppliers'.

Transfer pricing may also be a significant issue if one division of a company makes an **investment** that benefits all the other divisions.

A **transactions cost approach**, taking into account costs associated with setting and administering the transfer price and also time commitments and obligations is an appropriate way to determine which transactions should take place within an organisation and which transactions should occur in the outside world.

Transfer pricing and MNCs

More generally, transfer pricing could be an important issue for multinational companies, and we will look at international transfer pricing in more detail in Chapter 16 of this Study Manual.

2.12 Balanced scorecard

We have already discussed the balanced scorecard in Chapter 4 of this Study Manual.

The **scorecard** was devised as a way of integrating the traditional **financial indicators** with **non-financial measures** such as operational performance quality, customer satisfaction and staff potential. It is balanced in the sense that managers are required to think in terms of all four perspectives in order to prevent improvements being made in one area at the expense of another.

The aspects of the balanced scorecard can be as effective as **financial measures (as indicators of long-term profitability)**, control mechanisms, business trends or benchmarks against other organisations. They can act as **targets** for employees, and will be more effective if linked to the organisation's reward schemes. The range of perspectives they provide can be a **better link** with strategy than a few financial measures.

Perspective	Addresses	Examples
Customer	Measures relating to what actually matters to customers (time, quality, performance of product)	• Customer complaints • On-time deliveries
Internal business	Measures relating to the business processes that have the greatest impact on customer satisfaction (quality, employee skills)	• Average set-up time • Quality control rejects

Perspective	Addresses	Examples
Innovation and learning	Measures to assess the organisation's capacity to maintain its competitive position through the acquisition of new skills/development of new products	• Labour turnover rate • % of revenue generated by new products
Financial	Measures that consider the organisation from the shareholders' viewpoint	• Return on capital employed • Earnings per share

3 Management information systems

Section overview

- There are many different types of management information systems available according to the level of information required. These range from operational systems (such as transaction-processing systems, which process large volumes of data from routine transactions) to strategic-level systems (such as executive information systems, whose focus is on identifying high-level issues and long-term trends).
- Organisations need a range of strategic, tactical and operational information, however, and it is important that operational information is aligned to and supports strategic information.
- An organisation's critical success factors should help determine its information requirements, because an organisation needs to know how well it is performing in relation to its key operational goals.

3.1 Strategic planning, management control and operational control

In Chapter 4 of this Study Manual, we noted the idea of a hierarchy of decision-making within organisations, meaning that information is required for planning and control at strategic, tactical (management) and operational levels.

The existence of this hierarchy means that different types of management information systems are required to provide the different types of information required at the different levels:

Types of information systems

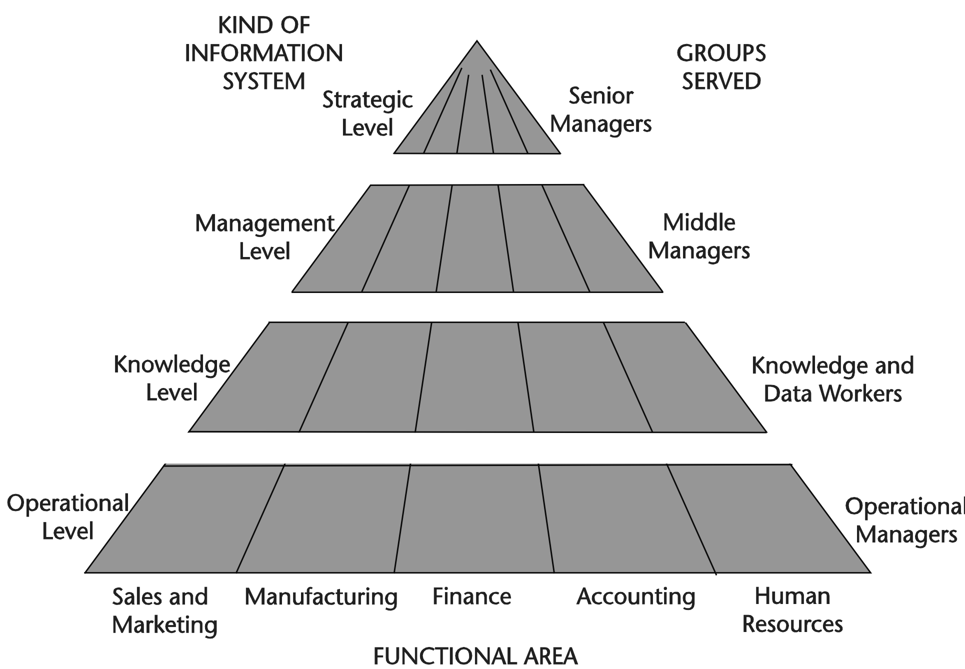


Figure 9.2: Hierarchies of information and information systems in organisations

A point to note from Figure 9.2 (above) is that the higher level applications, such as managerial information, depend to a great extent on skimming data for their own purposes from the operational systems maintained by the different functional departments.

Types of information

Strategic information

Strategic information is used to **plan** the **objectives** of the **organisation** and to **assess** whether the objectives are being met in practice. Such information includes overall profitability, the profitability of different segments of the business, future market prospects, the availability and cost of raising new funds, total cash needs, total manning levels and capital equipment needs.

Tactical information

Tactical information is used when strategic decisions are implemented. It is used when decisions are made on **how the resources of the business should be employed**, to **monitor** how they are being and have been employed. Such information includes productivity measurements (output per hour), budgetary control reports, variance analysis reports, cash flow forecasts, staffing levels within a particular department of the organisation and short-term purchasing requirements.

Operational information

Operational information is used to ensure that **specific operational tasks** are planned and carried out as intended. It assists in controlling the day-to-day activities of an organisation and should be pushed upwards to assist in tactical decision-making if necessary.

So, for example, continuing on from our earlier example of Tesco, store managers working for a supermarket group are likely to need information about daily or weekly sales against budget, inventory levels and stock-outs, and information about staffing levels and staff costs. Such information will be **tactical information.** In turn, the operational information which informs inventory management, for example, will be the details of individual product sales which have been scanned through the EPoS tills.

3.2 Strategic management accounting and external information

We discussed strategic management accounting briefly in Chapter 4 of this Study Manual.

Two of the key features of strategic management accounting are the importance it places on **external information** and on **non-financial information** in addition to internally-generated financial information.

This external orientation highlights the extent to which customers, competitors and the external environment, as well as the actions of the organisation itself, affect an organisation's performance. So, for example, whereas a traditional management accountant would report on an organisation's own revenues, the strategic management would report on **market share** or trends in market size and growth.

(a) **Competitive advantage is relative**. Understanding competitors is therefore of prime importance.

For example, knowledge of competitors' costs as well as a firm's own costs could help inform strategic choices; a firm would be unwise to pursue a cost leadership strategy without first analysing its costs in relation to the cost structures of other firms in the industry.

This also highlights the importance of **benchmarking** – comparing performance to competitors.

(b) **Customers** determine if a firm has competitive advantage.

Some **examples** of strategic management accounting issues are provided below.

Item	Comment
Competitors' costs	What are they? How do they compare with ours? Can we beat them? Are competitors vulnerable because of their cost structure?
Financial effect of competitor response	Have sales fallen?

Item	Comment
Product profitability	A firm should want to know not just what profits or losses are being made by each of its products, but why one product should be making good profits while another equally good product might be making a loss
Customer profitability	Some customers or groups of customers are worth more than others
Pricing decisions	Accounting information can help to analyse how profits and cash flows will vary according to price and prospective demand
Value of market share	A firm ought to be aware of what it is worth to increase the market share of one of its products
Capacity expansion	Should the firm expand its capacity, and if so by how much? Should the firm diversify into a new area of operations, or a new market?
Brand values	How much is it worth investing in a 'brand' which customers will choose over competitors' brands?
Shareholder wealth	Future profitability determines the value of a business
Cash flow	A loss-making company can survive if it has adequate cash resources, but a profitable company cannot survive unless it has sufficient liquidity

3.3 Linking strategic and operational information

One of the key challenges that organisations face is linking their (long term) strategy to their day-to-day operations. For example, a strategic plan might set revenue growth targets for an organisation over the next five years, but the operational plan will need to consider what practical steps will be taken to generate these revenue increases, in effect creating a road map that defines the detail of how the overall strategies are going to be put into action.

Case example: BMW Group

At the end of 2007, BMW Group took on a new strategic direction. BMW Group announced that, up to the year 2020, it intended to strengthen its position within the global motor vehicle market by increasing sales to more than two million automobiles per year.

In addition to striving to grow its existing business, the Group also intends to develop new and profitable areas of activity, and it will look to invest in future technologies, new vehicle concepts and pioneering driving systems.

This new strategy has been given the name 'Number ONE', which stands for 'New Opportunities' and 'New Efficiency'. This means making the best use of new opportunities and becoming more efficient in order to ensure BMW's competitive success against its competitors.

The period referred to by BMW's strategic plan (2007 – 2020) highlights the long-term nature of strategic planning, and it also highlights the way strategic plans relate to the whole organisation. However, this long-term, group-wide goal is unlikely to have much relevance for the operational staff at each of BMW's 25 manufacturing sites. Their focus is more likely to be on the short-term operational issues which affect the number and quality of cars they can produce, and therefore their ability to meet more short-term customer demands and market requirements.

Information and performance

Management accounting models such as the performance pyramid (Lynch and Cross) and the balanced scorecard seek to align operational objectives and initiatives with an overall strategy and mission.

Practical steps in developing a balanced scorecard

As with any other project or change, if an organisation is going to implement a scorecard successfully, it will need to think carefully about the steps involved in developing a scorecard:

Identify key outcomes – Identify the key outcomes critical to the success of the organisation (this is similar to identifying the organisation's critical success factors)

Key processes – Identify the processes that lead to those outcomes

KPIs – Develop key performance indicators for those processes

Data capture – Develop systems for capturing the data necessary to measure those key performance indicators

Reporting – Develop a mechanism for communicating or reporting the indicators to staff (such as through charts, graphs or on a dashboard)

Performance improvement – Develop improvement programmes to ensure that performance improves as necessary

Capturing performance information

Importantly, these 'steps' highlight that an organisation needs to have systems in place to be able to capture the information it needs to assess how well it is performing.

As the context of strategic management accounting highlights, this performance information is likely to include non-financial performance, and could also include external elements (such as competitor performance or market growth) as well as information about the organisation's own financial performance.

3.3.1 CSFs and information requirements

The use of **critical success factors (CSFs)** can help to determine the information requirements of an organisation.

Critical success factors are a small number of key **operational goals** vital to the success of an organisation. If these operational goals are achieved, the organisation should be successful. CSFs are **measured** by key performance indicators (KPI).

The CSF approach is sometimes referred to as the **strategic analysis** approach. The philosophy behind this approach is that managers should focus on a small number of objectives, and information systems should be focused on providing information to enable managers to monitor these objectives.

Two separate types of critical success factors can be identified:

(a) **Monitoring** CSFs are important for **maintaining** business. A **monitoring** CSF is used to keep abreast of existing activities and operations.

(b) **Building** CSFs are important for **expanding** business. A **building** CSF helps to measure the progress of new initiatives and is more likely to be relevant at senior executive level.

One approach to **determining the factors** which are critical to success in performing a function or making a decision is as follows:

- List the organisation's corporate objectives and goals
- Determine which factors are critical for accomplishing the objectives
- Determine a small number of **key performance indicators** for each factor

Note that most KPIs will be quantitative. It is quite possible that CSFs will be quantitative as well.

One of the **objectives** of an organisation might be to maintain a high level of service direct from inventory without holding uneconomic inventory levels. This is first quantified in the form of a **goal**, which might be to ensure that 95 per cent of orders for goods can be satisfied directly from inventory, while minimising total inventory holding costs and inventory levels.

CSFs might then be identified as the following.

- **Supplier performance** in terms of quality and lead times
- Reliability of **inventory records**
- **Forecasting** of demand variations

The determination of **key performance indicators** for each of these CSFs is not necessarily straightforward. Some measures might use **factual**, objectively verifiable data, while others might make use of **'softer' concepts** such as opinions, perceptions and hunches.

For example, the reliability of inventory records can be measured by means of physical inventory counts, either at discrete intervals or on a rolling basis. Forecasting of demand variations will be much harder to measure.

Where measures use quantitative data, performance can be measured in a number of ways:

- In **physical quantities**, for example units produced or units sold
- In **money terms**, for example profit, revenues, costs or variances
- In **ratios** and **percentages**

Sequence	Explanation	Example (1) National Health Service	Example (2) Mobile phone operator
Organisational goal	Overall strategy	Improve health care	Increase sales by entering new markets
Critical success factors (CSFs)	Operational goal: must be achieved for the overall strategy to be on track	Measurable reduction in time between booking an operation and receiving it	Establish network coverage in two countries in a year's time
Key performance indicators (KPIs)	Data sharing performance on CSF	For example % patients seen after waiting: less than one month less than three months less than six months more than six months	% of country covered and date, reported monthly
Critical information requirements	Information requirements to generate KPI	Booking and operations data to enable accurate KPI to be compiled	Information about masts installed

Data sources for CSFs

In broad terms, Rockart identifies four **general sources** of CSFs:

(a) The **industry** that the business is in

(b) The **company** itself and its situation within the industry

(c) The **environment**, for example consumer trends, the economy, and political factors of the country in which the company operates

(d) Temporal organisational factors, which are **areas of corporate activity** that are currently **unacceptable** and represent a cause of concern, such as high inventory levels

More specifically, possible internal and external data sources for CSFs include the following:

(a) **The existing system**. The existing system can be used to generate reports showing **failures to meet CSFs.**

(b) **Customer service department**. This department will maintain details of **complaints** received, **refunds** handled, **customer enquiries** etc. These should be reviewed to ensure all failure types have been identified.

(c) **Customers**. A survey of customers, provided that it is properly designed and introduced, would reveal (or confirm) those areas where **satisfaction** is high or low.

(d) **Competitors**. Competitors' operations, pricing structures and publicity should be closely monitored.

(e) **Accounting system**. The **profitability** of various aspects of the operation is probably a key factor in any review of CSFs.

(f) **Consultants**. A specialist consultancy might be able to perform a detailed review of the system in order to identify ways of satisfying CSFs.

3.4 Information systems

In Chapter 4 of this Study Manual, we discussed some of the types of information system is which firms can use to provide them with information about its performance and its processes:

- Executive information systems (EIS)
- Management information systems (MIS)

- Decision support systems (DSS)
- Value added networks (VAN)

Importantly, a firm needs systems to support different groups or levels of management, and to provide different levels of information: strategic, tactical, and operational.

3.4.1 Operational level

Definition

Transaction processing systems: a transaction processing system (TPS) performs and records the daily, routine transactions necessary to conduct business – for example, sales order entry or hotel reservations.

TPS provide operational level data. Operational managers need systems which keep track of the everyday activities and transactions in an organisation such as sales, receipts, payroll, or the flow of materials in and out of inventory. The principal purpose of TPS is to provide answers to routine questions (for example, how many units of a product are in stock?) and to track the flow of transactions through an organisation (for example, what has happened to a supplier's payment?)

However, TPS are often vital for the successful running of a business. For example, how would airline companies operate without their computerised reservation systems, and how would supermarkets operate without their computerised EPoS tills?

3.4.2 Tactical level

Management Information Systems (MIS) provide middle managers with reports on an organisation's current performance. MIS summarise data from TPS and enable it to be presented in reports which can be used to monitor and control the business.

Typically, MIS provide answers to routine questions which have been specified in advance and which have a predefined procedure for answering them. For example, MIS reports could be used to compare monthly sales figures for different products to planned targets.

By contrast, **decision-support systems** (DSS) can be used for less routine decision-making. They focus on problems which are unique or rapidly change, and which may not have a pre-defined procedure for finding their solution. For example, DSS might be used to assess the impact on production schedules if sales were double for a month.

Although DSS use internal information from TPS and MIS, they often also incorporate information from external sources, such as, competitors' product prices.

3.4.3 Strategic level

Senior managers need information systems which address strategic issues and long-term trends, both within an organisation and also in the external environment. They are concerned with questions such as where does our organisation fit in the industry? What new products should we be offering? What new acquisitions would help protect us from cyclical business swings?

Executive information systems (EIS) or executive support systems (ESS) help senior managers make these decisions. ESS incorporate external data (about industry trends, forecasts, or external events such as tax changes) as well as summarised internal information from MIS and DSS.

The outputs from ESS are often presented as graphs or charts, and are increasingly presented in the form of **digital dashboards**.

Interactive question 6: Health club **[Difficulty level: Intermediate]**

KLL is a large health and fitness complex located in a capital city. Started seven years ago, the business has been profitable. The introduction of a much wider range of activities over the past few years has led to increased complexity of administration and difficulty in interpreting the rapidly growing basic data generated daily. This data remains largely unstructured and this in turn leads to uncertainty in decision making.

The present management information system (MIS) is able to produce monthly reports on the performance overall but can only break down the key indicators of revenue and gross profit into six broad categories: water sports, sports hall activities, fitness training, beauty treatments, squash courts and outdoor sports. Thus there is no detail on specific activities such as table tennis, sauna room, badminton or soccer.

The managing director and the board cannot distinguish the profitable activities from the unprofitable ones. The managing director tells the board, 'We must have a management information system that can cope with our complex business; there are so many variables it is becoming impossible to make decisions with confidence. Sometimes we have detail we cannot interpret and sometimes we simply do not have enough good information'. The finance director points out that 'the staff are doing their best but they have limited technical knowledge and the software support company is often slow to help'.

The board have recognised that it is important to build an MIS to serve the company well into the future, and are currently reviewing various proposals for new systems.

Requirement

Prepare a memorandum to the board explaining the main purposes of a new MIS and the benefits the company could expect such a system to bring.

See **Answer** at the end of the chapter.

3.5 Enterprise applications

One of the key issues facing an organisation and its managers is the question of how to manage all the information in the different systems within the organisation. In particular, if the organisation has a number of different operating systems, how can these systems share information and how can work or activities be co-ordinated?

One solution is to implement enterprise applications – systems which span different functional areas and focus on executing business processes across the organisation.

There are four main enterprise applications:

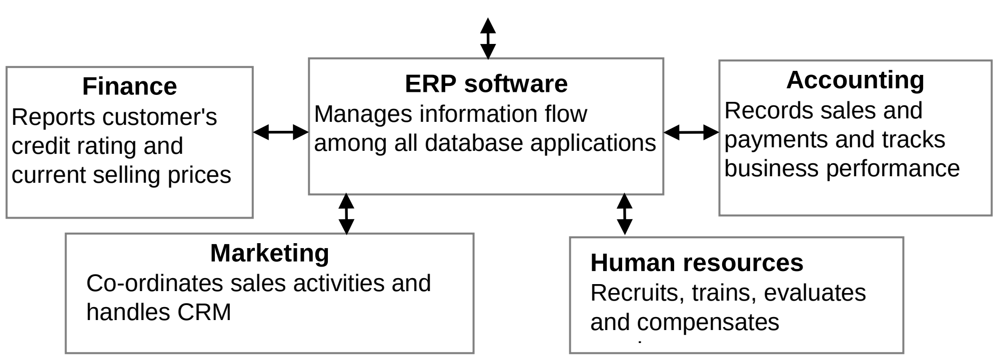
- Enterprise resource planning systems
- Supply chain management systems
- Customer relationship management systems
- Knowledge management systems

The presence of these integrated systems also serves as a reminder that management accounting information does not exist in isolation, but is part of the wider information system in an organisation.

3.5.1 Enterprise Resource Planning Systems

Enterprise Resource Planning Systems are software systems designed to support and automate the business processes of medium and large enterprises. ERPS are accounting-oriented information systems which aid in identifying and planning the enterprise wide resources needed to schedule, make, account for and deliver customer orders. They aid the flow of information between all business functions within an organisation, and they manage connections to outside stakeholders (such as suppliers).

ERPS handle many aspects of operations including **manufacturing, distribution, inventory, invoicing** and **accounting**. They also cover support functions such as **human resource management** and **marketing**. **Supply chain management** software can provide links with **suppliers** and customer relationship management with **customers**.



ERPS thus operate **over the whole organisation** and **across functions**. All departments that are involved in operations or production are **integrated** into one system. In this way, adopting ERPS makes firms more agile in the way they use information, meaning they can process that information better and integrate it into business procedures and decision-making more effectively.

Some ERPS software is custom-built, and ERPS software is now often written for organisations in particular industries. ERPS can be configured for organisations' needs and software adapted for circumstances. The data is made available in data warehouses, which can be used to produce customised reports containing data that is consistent across applications. Data warehouses can also **support performance measures,** such as balanced scorecard, and strategic planning.

ERPS should result in **lower costs** (for example, through workforce analytics and workforce redeployment) and lower **investment required** in assets. ERPS should increase **flexibility** and **efficiency of production,** for example by co-ordinating procurement and logistics functions. They should also increase **customer-to-cash processes**, and thereby improve control of cash flow.

Their disadvantages include cost, implementation time, and lack of scope for adaptation to the demands of specific businesses. Also a **problem** with one function can affect all the other functions. ERPS linked in with supply chains can similarly be vulnerable to problems with any links in the chain, and switching costs may be high. The blurring of boundaries can also cause accountability problems.

As well as ERPS (which focus primarily on operational management), firms can also use **Strategic Enterprise Management Systems** (SEMS) for making high-level strategic decisions.

SEMS focus primarily on strategic management – with a view to allowing organisations to improve their processes, procedures and decision-making – in order to achieve a competitive advantage in their business environment.

SEMS can be seen as an extension of the Balanced Scorecard approach because they encourage senior managers to combine financial and strategic measures when formulating business decisions. Additionally, SEMS provide organisations with the capability to support financial consolidation and to manage strategy and performance through a single piece of software (such as SAP Strategic Enterprise Management: SAP SEM.)

For example, SAP's SEMS supports:

- **Financial reporting** – it can generate financial and management accounting information to allow managers to monitor the financial performance of business units and divisions.
- **Planning, budgeting, and forecasting**
- **Corporate performance management and scorecards** – the software allows managers to develop KPIs that support balanced scorecards and economic value-added scorecard methodologies. The software allows managers to link both operational and strategic plans and to develop scorecards and performance measures based on both financial and non-financial data.
- **Risk management** – the software helps managers identify, quantify, and analyse business risks within their business units and thereby to identify risk-reducing activities.

Case example: Enterprise Systems

(i) ERPS

Case Study

In their text, *Management information systems*, Laudon and Laudon offer the following illustration to show how organisations can benefit from enterprise systems.

Imagine a company has 10 different major product lines, each produced in separate factories and each with separate, and incompatible, sets of systems controlling production, warehousing, and distribution.

As a result, it will be difficult for managers to understand what is happening in the business as a whole, and it is likely that their decision-making could be based on manual hard-copy reports, many of which will be out of date.

At the time they place an order, sales personnel might not know whether the items being ordered are in stock, and manufacturing staff will not easily be able to use sales data to plan for new production.

The company could benefit from an enterprise resource planning system which collects data from the different product lines and factories, as well as from a number of key business processes – not just in manufacturing and production (including inventory management) but also in sales and marketing, finance and accounting, and human resources.

The benefit of such an integrated system is that when new information is entered by one process, such information is immediately made available to other business processes.

For example, imagine if the company makes automobile components. If a sales representative places an order for tyre rims on behalf of a customer, the system verifies the customer's credit limit, schedules shipment of the parts to the customer, and reserves the necessary items from inventory. If inventory stock is not sufficient to fulfil the order, the system schedules the manufacture of more rims, and orders any material or components needed from suppliers. Sales and production forecasts are immediately updated to reflect the customer order. General ledger and cash levels are automatically updated with the revenue and cost information from the order.

Users across the company could log into the system and find out the status of the order at any time. Additionally, management could obtain information at any point in time about how the business was operating. The system could also generate company-wide data for management analyses for product cost and profitability.

(ii) Supply chain management

Supply chain management systems can have similar benefits for organisations.

Laudon and Laudon highlight the example of the high-end bicycle manufacturer Cannondale.

Cannondale has supply and distribution chains which span the globe, and Cannondale offers its customers the option of 'made-to-order' models of bicycle. As a result, Cannondale has to manage over 200,000 individual parts, some of which have to be ordered from speciality vendors.

Managing the availability of parts in a constantly changing product line affected by volatile customer demand requires a great deal of manufacturing flexibility.

However, historically, Cannondale's material requirements planning system did not give it the flexibility it needed. The company's legacy material requirements planning system for planning production and controlling inventory could only produce reports on a weekly basis, meaning that the company was forced to substitute parts to meet demand, and sometimes lost sales as a result of these substitutions.

To overcome this issue, Cannondale purchased a new supply chain software system which collates data from operations at multiple sites and provides detailed, accurate, up-to-date information via an easy-to-use interface.

In addition, supply chain participants from different locations are able to model manufacturing and inventory data in 'what if' scenarios to see the impact of changes in demand across the entire supply chain.

The improved information from the new system enabled Cannondale to respond to customer orders much more rapidly with lower levels of inventory and without the need to hold extra 'safety stock' just in case it was needed.

Moreover, the lead times for producing bicycles have been reduced, and Cannondale's dates for promising deliveries have become more reliable and accurate.

3.6 Financial statement information

So far in this chapter, we have concentrated on the hierarchy of data and information in the context of management information systems – for example, in the way that management information systems summarise data from transactions processing systems so that it can be presented in reports which can be used to monitor and control an organisation.

However, the data from transactions processing systems not only feeds into management information and management accounts, it also forms the basis for the organisation's financial statements. For example, the sales figures from a retailer's shop tills will ultimately feed into the revenue figures in its financial statements.

Therefore, while an organisation needs to be able to capture and summarise transactions data accurately in order that managers can make informed decisions and can control the business effectively, it equally needs accurate data to populate its financial statements.

This not only highlights the inherent links between management accounting information and financial accounting information, it also reinforces the importance of the internal controls in organisations over their transactions processing systems to ensure that the data collected in them is accurate and reliable.

In this respect, note that in the example of the SAP's SEMS which we mentioned above, the single piece of software generates both financial and management accounting information.

3.7 Sources of information

On several occasions in this chapter we have noted that different levels of decision may require data or information from either internal or external sources.

If an organisation is not able to capture reliable and accurate raw data then, even if it has sophisticated information systems, its managers will not have the quality of information they need to make informed decisions.

3.7.1 Internal information

Capturing data and information from **inside** the organisation involves designing a system for collecting or measuring data and information which sets out procedures for:

- What data and information is collected
- By whom
- How frequently
- By what methods
- How data and information is processed, filed and communicated

The accounting ledgers provide an excellent source of information regarding what has happened in the past. This information may be used as a basis for predicting future events.

Transactions processing systems and enterprise systems can also be sources of internal information, such as, EPoS tills in retail stores.

Equally, sales teams deal with customers and so are in a good position to obtain information about customers and competitors.

Many companies also conduct market research. Although this generally deals with specific issues, it can indicate general environmental concerns (eg consumers' worries).

Case example: EPoS Systems

Virtually all major retail stores now use electronic point of sales (EPoS) systems, which give them a fast and convenient way of transacting sales, while also recording vital business information.

At the most basic level, EPoS systems total up a customer's bill, calculate any change due and issue receipts in the same way that cash tills have historically done.

However, EPoS systems can keep track of inventory levels and can also record customer information. This ability to manage inventory and to promote customer relationship management (CRM) helps EPoS systems improve a retailer's performance.

For example, by keeping track of the products sold, an EPoS system can assist inventory management by ensuring that the retailer has adequate supplies of a product to meet demand, and re-orders top performing products as necessary. However, the system could also highlight which product lines are not selling very well, such that the retailer may question whether it wants to continue selling them, or whether it discounts their price to try and encourage demand.

Equally, if management wants to change the price of an item or run a special offer on it, this can be done very easily with an EPoS system. Importantly, from a performance measurement perspective, the system can also record data on how price changes have affected sales.

The data from EPoS systems can be used for marketing purposes, particularly when used in conjunction with store loyalty cards (such as Tesco's Clubcard). The systems can record trends and patterns in individual customers' behaviour, and in doing so they can provide valuable data for personalised marketing campaigns.

3.7.2 External information

Sources of information from outside sources include the following:

- **Media**. Newspapers, periodicals and television offer environmental information.
- Sometimes more detailed country information is needed than that supplied by the press. **Export consultants** might specialise in dealing with particular countries, and so can be a valuable source of information. The **Economist Intelligence Unit** offers reports into particular countries.
- Academic or **trade journals** might give information about a wide variety of relevant issues to a particular industry.
- **Trade associations** also offer industry information.
- Consultancy firms or analysts (eg MINTEL) can also provide industry reports, or reports about different market sectors.
- The government can be a source of statistical data relating to money supply, the trade balance and so forth, which is often summarised in newspapers. In Bangladesh, the Bureau of Statistics publishes different **Trade data**, which concentrates on export opportunities for Bangladesh firms. Official statistical sources also include government censuses, and demographic and expenditure surveys and Export Development Bureau Publications.
- Sources of technological environmental information can include the national patents office (because patents for new products are registered with the patent office).
- Stockbrokers produce investment reports for their clients which involve analysis into particular industries.
- The **internet** (for example, 'current awareness services' where subscribers can register particular key words related to their industry with media vendors and then receive automatic emails of articles and announcements that include those key words as tags). The websites of rival firms may also give an insight into their mission, objectives, strategy and financial performance.
- **Annual reports** of competitors, suppliers or firms in a potential target market can also provide useful information.

4 The value of information

Section overview

- In this section we look at the factors which make information valuable. We also briefly examine potential trade-off between the cost of obtaining information and the benefit gained from having that information.

4.1 Factors that make information a valuable commodity

Information is now recognised as a valuable resource and a **key tool in the quest for a competitive advantage.**

Easy **access** to information, the **quality** of that information, and **speedy methods of exchanging** the information have become essential elements of business success.

Organisations that make **good use of information** in decision making and which use new technologies to access, process and exchange information are likely to be **best placed to survive** in increasingly competitive world markets.

4.2 The value of obtaining information

In spite of its value in a general sense, information which is **obtained but not used** has no actual value to the person who obtains it. It is only the **action taken** as a result of a decision which realises actual value for a company. An item of information that leads to an actual increase in profit of CU90 is not worth having if it costs CU100 to collect.

Businesses may also try to assess the costs of not having the information and also whether alternative (cheaper, more convenient) sources may be used instead.

4.3 Costs of information

Costs of information include the costs of system development and set-up, day-to-day running and storage costs.

Effective budgeting may be required to keep costs under control, particularly in the purchase of new equipment. An activity-based approach may be appropriate.

4.4 The value of information

There are a number of theoretical models which can be used to value information. However, most of them highlight the same factors in determining the value of information:

- The extent of uncertainty faced by decision makers
- The benefit of making the optimal decision compared to making a decision which is not optimal in the light of better information
- The cost of making use of the information and incorporating it into decisions

Importantly, information only has a value if alternative courses of action are available, and if these alternative courses of action will result in different results for an organisation. Information is most valuable for an organisation when many alternative courses of action are available but the costs associated with a 'wrong' action are high.

By contrast, if there are no alternative courses of action available or if a 'wrong' decision will not result in any net costs to an organisation, information relating to that decision has no value.

Case example: Department for Business, Innovation and Skills

In July 2012, the National Audit Office (NAO) published a report reviewing financial management at the Department for Business, Innovation and Skills.

One of the report's key conclusions is that the Department needs to improve the quality of information it has available to support decision-making.

The Department approaches the review and approval of major financial decisions on a case-by-case basis, with no single board overseeing assessment and approval. NAO's review indicated that this has resulted in a range of processes for examining business cases in different parts of the Department, but there is no single framework to ensure that all cases are prepared in a consistent way and receive appropriate scrutiny.

For example, the Department does not use a standard framework or template for business cases, nor does it have a common cost model to analyse costs and financial benefits consistently. Similarly, there are no consistent quality assurances processes for scrutinising the financial elements of business cases.

As the report notes: 'While these findings do not necessarily mean that appraisals in general are of lesser quality, it makes it harder for the Department to know whether business cases across the organisation are sufficiently robust and include all that they should.'

In one particular case, the NAO's work identified that

> *'the Department made various decisions about the launch of the Green Investment Bank and how it would be established, including the location of the Bank, before developing and approving a full business case. This means that, in our view the Department is now so committed to the Green Investment Bank programme that it could not stop activity if the evidence in the full business case suggested it should do so.'*

Source: National Audit Office, (2012), *Department for Business, Innovation and Skills: Financial Management Report*.

[Note, also, from the case example above, the role played by the National Audit Office in providing assurance over processes and practices within government departments.]

4.5 Cost-benefit analysis

In effect, we can evaluate the value of having better information in the context of a cost-benefit analysis.

Having relevant data and information available should improve the quality of decisions which are made, which in turn should improve an organisation's performance. However, there will also be a cost involved in capturing and analysing the data and information.

The critical question for an organisation is whether the benefits from having the information are greater than costs involved in obtaining that information.

4.5.1 The benefits of a proposed information system

In order to evaluate how the benefits of a proposed information system compare to the costs of the systems, an organisation needs to try to quantify the benefits in some way. Several factors need to be considered when trying to quantify the benefits:

Improved data collection, storage and analysis tools may indicate previously unknown opportunities for sales. Such tools may include software that allows relationships to be discovered between previously unrelated data.

New technology can be used to automate work which was previously manual. This saves staff time and may result in a smaller workforce being required.

Systems such as inventory control can benefit as losses from obsolescence and deterioration are reduced.

Computerised systems that create a more prompt and reliable service will increase customer satisfaction. In some cases it may be that providing decision makers with the most accurate and up-to-date information possible can have substantial benefits. The main areas of benefit are:

- Models can be created to forecast sales trends and the likely effect on costs. Organisations that can make accurate forecasts are in a better position to plan their structure and finances to ensure long-term success.
- Organisations facing uncertain times, or those which operate in dynamic, evolving environments, need to make complex decisions (often quickly) to take advantage of opportunities or to avoid threats. Scenario planning models enable a wide range of variables to be changed (such as inflation rates or sales numbers), the overall effect on the business to be identified and a business plan to be constructed.
- Modelling can be extended into the market that the organisation operates in. Trends such as sales volumes, prices and demand can be analysed. Relationships between price and sales volume can be identified. These can be used by an organisation when deciding on a pricing strategy. Setting the best price for a product can help drive up sales and profitability.
- Organisations will benefit from improved decision making where systems can accurately evaluate a wide range of projects. Investment decisions often involve large capital outlays, and if the system prevents bad decisions it can prevent the organisation wasting large sums of money.
- Systems can also prevent an organisation agreeing 'bad' deals. Tenders for suppliers or other long-term contracts can prove costly if the wrong choice is made.

4.6 Strategic implications of information systems

When formulating an overall information technology strategy the following aspects should be taken into consideration:

- What are the key business areas which could benefit most from an investment in information technology, what form should the investment take, and how could strategically important units be encouraged to use such technology effectively?

- How much would the system cost in terms of software; hardware; management commitment and time; education and training; conversion; documentation; operational manning; and maintenance?
- The importance of lifetime application costs must be stressed – the costs and benefits after implementation may be more significant than the more obvious initial costs of installing an information technology function.
- What criteria for performance should be set for information technology systems? Two areas can be considered: the technical standard the information system achieves and the degree to which it meets the perceived and often changing needs of the user.
- What are the implications for the existing work force – have they the requisite skills; can they be trained to use the systems; will there be any redundancies?

5 Evaluating management information and performance data

5.1 The objectives of management information

Section overview

- Information is only useful to managers or staff if it adds to their understanding of a situation.
- The characteristics of 'good' information can be summarised in the mnemonic 'ACCURATE': accurate, complete, cost-beneficial, user-targeted, relevant, authoritative, timely, and easy to use.

The objective of management accounting and management accounting systems is to provide information for managers to use for planning, control and performance measurement.

In order to evaluate how well the systems are providing this, managers need to assess whether the information available to them gives them what they need to know for planning, control and making decisions.

The management accountant's role is to provide managers with feedback information in the form of periodic reports – suitably analysed and at an appropriate level of detail – to determine whether the business is performing according to plan.

It may be the case that there is too much information available, or the information available is in a format unsuitable for managers to use. For instance, a production manager needs to know about outputs and costs in his or her department but not primarily about marketing data nor even necessarily summarised data that would go into a board report. Information overload can sometimes be as much of a problem as having too little information.

Accounting information needs to be distilled in a manner that makes it clear and concise and does not overwhelm the user. In this context it is important to highlight that, while management accounting involves the process of transforming data about an organisation's performance into information that managers can use for many reasons, management accounting only produces good information if it is useful and relevant to its users.

5.1.1 Presenting performance information

A number of developments in output reporting from information systems have been driven by the need to provide timely and tailored information, and also to avoid swamping the user with too much information.

Dashboards

Increasingly, companies are looking at ways to reduce the number (and size) of paper reports, and to provide the necessary information to decision makers in an easy-to-read manner.

One of the ways to do this is by using 'Executive Dashboards' which show current data, pictures, graphs and tables to illustrate how a business is performing and to help managers make better decisions. For example, a coffee and baked goods chain has been looking to expand and is preparing to open a number of new stores. The chain managers use dashboards to see the status of the new stores. The dashboards display geographic areas and the new stores which are being developed. By clicking on an individual store, executives can see details of how the new stores are being constructed and if any are being delayed.

Historically, much of the criticism of information systems and reports has focused on the difficulties users have faced when trying to produce the reports they wanted from the systems available. Reporting tools tended to be rigid and imposed many requirements about the way reports were produced. However, current reports offer more flexibility, and thereby allow managers to get the reports they actually need, or want.

Drill down reports

Dashboards are often also combined with drill-down reports. Drill-down reports enable users to look at increasingly detailed data about a situation. For example, the sales managers could first look at data for a high level (such as sales for the entire company) and then drill down to a more detailed level (such as sales for individual departments of the company) if he or she is concerned about sales performance. The manager should then also be able to drill down to a very detailed level, possibly to look at sales for an individual sales representative. In this way, the manager can dictate the level of detail and information presented and can avoid being overloaded with too much initial detail.

Exception reports

Another way of managing the amount of information being presented, and thereby **preventing information overload**, is through the use of exception reports. Exception reports are reports that are only triggered when a situation is unusual or requires management action. For example, the parameters could be set so that exception reports are generated for all capital projects which exceed budget by greater than $100,000.

However, the key to using exception reports successfully is setting the parameters carefully. The aim of an exception report is only to highlight the situations which require management action. If the parameters are set too low (for example, all capital projects which exceed budget by over $100) then the manager will end up looking at too many items. Conversely, if the parameters are set too high (for example, capital projects which exceed budget by over $10 million) then situations which should receive management attention will not do so.

Because the aim of exception reports is to highlight situations which require management attention or action, they are best used to monitor aspects of performance which are important to an organisation's success. In this respect, exception reports could be used to report against KPIs, or other aspects of an organisation's performance relating to its critical success factors.

Finally, in relation to the outputs of information systems as a whole, **users need to get involved when scoping what they require from their information systems.** If a MIS has immense capacity but does not give users the data they need individually, then the system is making life harder for the user.

5.2 Qualities of good information

The qualities of good information are outlined in the following table. You can use the mnemonic 'ACCURATE' to help you remember the qualities of good information. 'ACCURATE' can also be used as a framework when describing how poor information can be improved.

5.2.1 Qualities of good information

Quality	Example
Accurate	Figures should add up, the degree of rounding should be appropriate, there should be no typing errors, items should be allocated to the correct category, and assumptions should be stated for uncertain information.
Complete	Information should include everything that it needs to include, such as external data if relevant, comparative information or qualitative information as well as quantitative. Sometimes managers or strategic planners will need to build on available information to produce a forecast using assumptions or extrapolations.
Cost-beneficial	It should not cost more to obtain the information than the benefit derived from having it. Providers of information should be given efficient means of collecting and analysing it. Presentation should be such that users do not waste time working out what it means.
User-targeted	The needs of the user should be borne in mind; for instance, senior managers need strategic summaries periodically, and operational managers need more detailed performance information.

Quality	Example
Relevant	Information that is not needed for a decision should be omitted, no matter how 'interesting' it may be.
Authoritative	The source of the information should be a reliable one (not, for instance, 'Joe Bloggs Predictions Page' on the internet unless Joe Bloggs is known to be a reliable source for that type of information). However, subjective information (eg expert opinions) may be required in addition to objective facts.
Timely	The information should be available when it is needed. It should also cover relevant time periods, the future as well as the past.
Easy to use	Information should be clearly presented, not excessively long, and sent using the right medium and communication channel (email, telephone, hard-copy report etc).

5.2.2 Improvements to information

As well as being able to identify the qualities of good information, you may also need to identify the problems that an organisation has with the information it currently produces, and to suggest potential ways that information can be improved.

The table below contains some suggestions as to how poor information can be **improved**.

Feature	Examples of possible improvements
Accurate	Use computerised systems with automatic input checks rather than manual systems. Allow sufficient time for collation and analysis of data if pinpoint accuracy is crucial. Incorporate elements of probability within projections so that the required response to different future scenarios can be assessed.
Complete	Include past data as a reference point for future projections. Include any planned developments, such as new products. Information about future demand would be more useful than information about past demand. Include external data.
Cost-beneficial	Always bear in mind whether the benefit of having the information is greater than the cost of obtaining it.
User-targeted	Information should be summarised and presented together with relevant ratios or percentages. Consider use of graphics or dashboards to summarise data for senior management.
Relevant	The purpose of the report should be defined. Avoid trying to fulfil too many purposes at once. Consider whether several shorter reports would be more effective. Information should include exception reporting, where only those items that are worthy of note – and the control actions taken by more junior managers to deal with them – are reported.
Authoritative	Use reliable sources and experienced personnel. If some figures are derived from other figures the method of derivation should be explained.
Timely	Information collection and analysis by production managers needs to be speeded up considerably, probably by the introduction of better information systems (possibly even systems that can provide real-time information).

Feature	Examples of possible improvements
Easy-to-use	Graphical presentation, allowing trends to be quickly assimilated and relevant action decided upon. Alternative methods of presentation should be considered, such as graphs or charts, to make it easier to review the information at a glance. Numerical information is sometimes best summarised in narrative form or vice versa. A 'house style' for reports should be devised and adhered to by all. This would cover such matters as number of decimal places to use, table headings and labels, paragraph numbering and so on.

5.3 Completeness, accuracy and credibility of data and information

Another key feature which affects the quality and usefulness of information is the extent to which it accurately reflects real-world objects or events. For example, if an organisation's sales in a period are known to have decreased (such as due to a new competitor launching) but management information shows sales increasing, the management information's accuracy and usefulness for decision-making must be called into question.

There are a number of factors which could potentially lead to poor quality data and information:

Business dynamics change: A company expands into new markets but figures for the new markets are not incorporated into standard reports; a company purchases another company and has to consolidate figures from different software applications.

System design changes: Over time the design of databases may change, such as when new fields are added. This will not prevent transactions being recorded accurately, but can affect management information. For example, it may mean that current information is no longer being compared to historical information on a like-for-like basis.

Weak control over application changes: Cost (or time) pressure may lead business units to create or modify local applications despite not fully understanding the IT systems or software involved. As a result, these locally modified applications may no longer follow the same standards as applications in the rest of an organisation. This could lead to problems in consolidating or comparing data from the different systems.

Lack of common data standards or meta-data: If an organisation doesn't have a standardised way of recording data, inconsistencies could arise if different operators record similar transactions or data differently.

Legacy systems: As companies grow, they start building new systems with new system architectures. However, the way data is structured in these may be different to the way data is held in existing legacy systems. If the 'legacy' systems are not enhanced to bring them in line with the new systems, it will be difficult to manage data between the two systems.

Time decay: Over time, the quality of data will decrease unless that data is updated. For example, customers on a customer database may change address or marital status. If a company is not aware of these changes, then the value of its data for marketing purposes declines.

Data entry issues: In many systems, there will always be a risk of human error, but this can be reduced by well-designed entry forms. For example, the risk of data entry error can be reduced if there are controls that prevent a telephone number entry being posted with insufficient digits.

Case example: Retail IT systems

The 2013 report '*Audit Insights: Retail*' by ICAEW's Audit & Assurance Faculty highlights that IT systems in retail have historically been developed in-house, resulting in a diverse and often inefficient architecture.

Often, retailers have only invested in IT after their investments in stores had been completed, with the result that few retailers have integrated IT systems and control.

However, the move towards online retail has now provided greater impetus to develop IT systems, and has prompted many retailers to review their overall IT strategies.

The ICAEW report notes that in the current difficult economic climate many retailers may find it difficult to make significant capital investment in IT, despite the risks of making do with less developed systems. Some retailers are now replacing their customer-facing systems to allow for the 'full multi-channel experience.' Others are making do with existing systems, delaying the need for costly investment in IT with the associated risks of migrating to a new system. However, the report warns that 'This is likely to prove a false economy, as retailers which do not adapt and embrace the opportunities of the changing environment may struggle to stay competitive. Furthermore, a lack of access to robust data increases risk across the business.' For example, failure to invest in IT improvement may lead to security and reputation risk if commercially-sensitive data is not kept secure and up to date. Equally, the retailers' ability to monitor customers' shopping habits and to understand their needs will be impeded by a lack of data monitoring and analytics capacity.

Crucially, without relevant and reliable data, retailers will not be able to fully understand what gives rise to profits across different channels. A better understanding of the factors which give rise to profits could help retailers make more efficient use of their resources and identify their most profitable products. In turn, this will help improve pricing strategies and target promotional activity to drive profitable growth.

Finally, strong internal data systems will help retailers track and value their inventory more accurately, enabling them to have more detailed control over how much of their working capital is tied up as inventory at any given time.

In this respect, the report notes: 'As customers increasingly look to the internet and other non-traditional sales channels, strong internal data systems will allow different aspects of the business to work together more effectively. This includes inventory management, supplier relationship management, and efficient processing of orders and payments.'

Issues of accountability and quality control might also be relevant when considering the quality of information and data:

Accountability – Are managers held accountable for making certain that procedures (controls) are in place to ensure the completeness and reliability of data, and for making certain that those procedures are followed?

Quality control – Are there any systems tests to check the consistency and accuracy of the outputs from automated systems and databases? Are unexpected results investigated?

A company's internal audit department could play an important role in providing assurance over these areas.

5.3.1 Business performance management software

Although business performance management should not be primarily about software, organisations need to consider whether their performance management software is suitable for managing performance effectively and efficiently.

Many organisations still rely on office tools (such as Microsoft Excel and PowerPoint) as their main technology to analyse and report performance data. However, particularly for large and complex organisations, spreadsheets may not be appropriate for performance management.

For example, many spreadsheets contain significant **errors**. A lack of version control, and a lack of logging changes over time, lead to errors which could compromise the reliability of data in the spreadsheets and impede management's ability to make decisions based on data from the spreadsheets.

Scalability: Large organisations are likely to find that the amount of data to analyse means that spreadsheets grow into big documents with colour coding, macros, calculations etc. In turn, this causes spreadsheet-based applications to become slow and prone to crashing. Often, there is just too much data and complexity in the spreadsheet.

Equally, spreadsheet-based solutions are often **manually fed and updated**. As well as increasing the risk of human error, this makes them very time-consuming, as business analysts have to spend time updating the spreadsheets on a regular basis.

Therefore, organisations should consider whether it may be more appropriate for them to use specialist performance management software rather than relying on standard office tools (such as Excel). For example, performance management software could provide managers with interactive drill-down capabilities to analyse performance data, and it could also provide business intelligence features such as trend analysis, root-cause and impact analysis, and simulation and scenario features.

5.4 Information risks

The UK Government has published a paper 'Managing Information Risk' which includes a summary of the key areas of information risk an organisation needs to consider. Information risks are risks which affect an organisation's guardianship and management of information. In this respect, it is important to note that information risks are not necessarily the same as IT risks, although managing IT security is likely to be a key component of any strategy to manage information risks.

Risk category	Example of risk
Governance and culture	Lack of comprehensive oversight and control (so anything can go wrong) When something goes wrong, handling it badly and not learning from it (so the problem can happen again) Third parties (eg suppliers) let you down (eg because they are not made aware of the standards/timetables required of them) New business processes don't take information risk into account
Information management and information integrity	Critical information is lost (with legal, reputational or financial consequences) Critical information is wrongly destroyed, not kept, or can't be found when needed Lack of basic disciplines in record-keeping (eg records are incomplete) Inaccurate information (which causes the wrong decisions to be made or the wrong action to be taken) Electronic information becomes unreadable due to technical obsolescence (with legal, reputational or financial consequences)
The human dimension	Despite having procedures and rules, staff, acting in error, do the wrong thing or make mistakes (meaning things go badly wrong) Despite having procedures and rules, 'insiders', acting deliberately, do the wrong thing (and things go badly wrong) External parties get your information illegally (and expose it/act maliciously/defraud you or your customers)
Information availability and use	Inappropriate disclosure of sensitive personal information (causing reputational damage or worse) Failure to disclose critical information when required Failure to utilise the value of the information asset Failure to allow information to get to the right people at the right times (leading to a failure to service customers)

Sources of internal assurance

As well as identifying these risks, the Government paper also suggests potential sources of internal assurance over them. These include:

- Identifying a Board-level senior information risk owner, supported by a team, to manage the organisation's information and information risks
- Identifying key information assets across the organisation (in terms of both information content and information systems)
- Producing and regularly updating a risk register for the organisation's information risks with key risks prioritised and action plans in place to address them
- Compliance with legislation and key standards (eg Data Protection Act); spot checks to ensure data quality is being maintained
- Clear guidance and rules about what information needs to be kept, how long it needs to be kept, and where it can (or cannot) be stored
- Mandatory training in place for asset owners and users of information systems

- Controls in place to restrict access to (or ability to change) key files; audit checks on inappropriate use of key systems, personnel security
- Factoring information management into business and system design processes
- Strong links between the information management team and IT teams
- Back-ups of key information; back-up systems held in a secure, separate location
- Strong, regular engagement of the Audit Committee with information risks
- 'Whistleblowing' procedures in place and understood by all staff
- Mapping of key suppliers, their associated information assets linkages, and their risks
- Clear standards and contractual obligations for suppliers to meet

5.5 Information systems and assurance

In this chapter we have highlighted a number of ways in which organisations use information systems and information technology.

Equally, however, we must recognise that the increasing use of computer systems brings certain risks to an organisation, which in turn could have an impact on the organisation's financial statements.

Two key risks of using computerised systems are:

- The system is put at risk by a virus or some other fault or breakdown which spreads across the system.
- The system is invaded by an unauthorised user who could then disrupt the smooth operation of the system, or obtain commercially sensitive information from it.

Consequently, it is important for an organisation to ensure that its systems are as reliable as possible, and that they are the best systems at the given cost.

If the organisation has purchased its information systems from an external service provider it might seek these assurances from its service provider. However, the service provider has a vested interest in believing that its system is reliable and the best available, because they are paid to supply it.

Therefore, the organisation might seek an assurance service from its auditors to undertake work to ascertain whether the assertions made by the service provider are correct. In other words, the auditors might be asked to undertake an assurance assignment to report on the reliability and adequacy of an organisation's IT systems.

If a firm of accountants is considering taking on such an assurance engagement, it must ensure that it has staff with sufficient skills and experience to undertake the procedures required. To this end, there must be an IT specialist on the engagement team.

Information subject to assurance

More generally, there is a wide range of information which could be subject to some form of external assurance. The following are examples of areas where an external assurance service might be requested:

- Quantitative information, including non-financial information and performance measures such as KPIs – the range of information which organisations now disclose (or have to disclose) about themselves has gone far beyond traditional financial reporting. However, if organisations are disclosing this information externally (for example, as part of their Annual Report) it follows that they also need external assurance on the quality of that information
- Environmental information – for example, if an entity has stated a performance target to reduce greenhouse gas emissions, it will need someone to measure its level of emissions and verify the degree to which they have been reduced
- Aspects of information technology such as information flows and security over those information flows
- Management information flows
- Compliance with contractual obligations
- Risk management systems and processes
- Internal controls and the internal control environment

Few organisations can function effectively without IT systems supporting their key business processes, and many cannot function at all if their systems fail. However, organisations' systems may be vulnerable to attack or failure, either as a result of flaws in the design of the systems, failure to apply security patches, or poor security management.

Unauthorised access to an organisation's systems and data could have serious financial or legal implications, as well as potentially damaging the reputation of the company. In this respect, the directors of the organisation might seek an assurance service from their auditors, or another firm of accountants, that the organisation's technology systems and the processes they support are functioning as intended. For example, are security systems designed to reduce the risk of unauthorised access to systems and data reliable?

Systems audit

An example of an assurance assignment might be a request to report on the adequacy of the internal controls in place. Internal control effectiveness is generally assessed by means of a systems audit.

As part of any audit, auditors are required to assess the quality and effectiveness of an entity's accounting system, which necessarily includes a consideration of any computer systems in place within the entity which are linked to its accounting system.

However, auditors could also accept an assurance engagement outside of the audit to report specifically on how reliable an entity's information systems are.

Key areas which an assurance engagement is likely to concentrate on are:

- **Management policy**
  - Does management have a written statement of policy in relation to computer systems and other information systems?
  - Is that policy compatible with management policy in other areas?
  - Is that policy sufficient and effective? Is it adhered to?
  - Is the policy updated when any systems are updated? Does it relate to the current systems?
- **Segregation of duties**
  - Is there adequate segregation of duties in relation to data input?
  - Are there adequate systems controls (eg passwords) to enforce segregation of duties?
- **Security**
  - Is there a security policy in place covering physical security (locked doors/windows), access security (passwords), and data security (virus shields)?
  - Is the security policy sufficient and effective? Is it adhered to?

General controls and application controls

When testing the control environment in an entity, an auditor should assess general controls as well as application controls.

The areas covered by **general IT controls** include:

- Development of computer applications
- Prevention of and detection of unauthorised changes to programs
- Testing and documentation of program changes
- Controls to prevent unauthorised amendments to data files
- Controls to ensure continuity of operations (eg back-up and emergency procedures)

The purpose of **application controls** is to establish specific control procedures over accounting applications to provide reasonable assurance that all transactions are authorised and recorded, and are processed completely, accurately and on a timely basis.

Application controls include data capture controls, data validation controls, processing controls, output controls and error controls.

Controls and assurance over e-commerce

Earlier in this Study Manual, we noted how e-commerce has provided new growth opportunities for entities. However, it is equally important to note that an entity using e-commerce also needs to have internal controls in place to mitigate against the risks associated with e-commerce.

In particular these risks include security issues (eg ensuring customers transactions are secure) and process alignment (eg if a website is not automatically integrated with the internal systems of the entity, such as its accounting system and its inventory management system, the entity will need to ensure that it processes transactions completely and accurately).

A key issue with e-commerce is trust. In many cultures, consumers grant their trust to business parties that have a close physical presence. On the internet this physical presence is simply not there. The seller's reputation, the size of the business, and the level of customisation in products and services also engender trust.

Internet merchants need to elicit consumer trust when the level of perceived risk in a transaction is high.

However, research has found that once consumers have built up trust in an internet merchant, such concerns are reduced.

Internet merchants need to address issues such as fear of invasion of privacy and abuse of customer information (about their credit cards, for example) because these issues can stop people even considering the internet as a shopping channel.

The parties involved in e-commerce need to have confidence that any communication sent gets to its target destination unchanged and without being read by anyone else.

WebTrust and SysTrust are examples of assurance services developed in the last few years in relation to e-commerce. The underlying principles of these two services have been combined into one common set of principles known as Trust Services, which allow auditors to evaluate business systems and controls.

Trust Services are based on five principles:

- Security – the system is protected against unauthorised access
- Availability – the system is available for operation and use as agreed
- Processing integrity – system processing is complete, accurate, timely and authorised
- Online privacy – personal information obtained as a result of e-commerce is collected, used, disclosed and retained as agreed
- Confidentiality – information designated as confidential is protected as agreed

WebTrust and SysTrust can be used to provide assurance on an organisation's website and on its systems respectively. Such assurance engagements are performed as reasonable assurance engagements in accordance with ISAE 3000.

6 Using information to develop competitive advantage

Section overview

- The notions of organisational learning and knowledge management indicate that knowledge should be seen as an important resource for an organisation and, accordingly, knowledge management as an important competence or capability.
- Increasing the amount and quality of data available to an organisation should help support strategic decision-making within that organisation.
- In particular, improving the level of data an organisation holds about its customers should help the organisation understand their purchasing behaviour better, such that it can tailor its products and services to their wants (or needs) more closely.

You should already be familiar with the concept of knowledge management from the *Business Strategy* syllabus. However, it remains relevant here because knowledge management is becoming increasingly important in helping organisations sustain competitive advantage.

6.1 Knowledge management

Knowledge management refers to the set of business processes developed in an organisation to create, store, transfer and apply knowledge. Knowledge management increases the ability of the organisation to learn from its environment and to incorporate knowledge into its business processes.

(Laudon & Laudon, *Management Information Systems)*

Knowledge management is a relatively new, but increasingly important, concept in business theory. It is connected with the theory of the **learning organisation** and founded on the idea that knowledge is a major source of competitive advantage in business.

Studies have indicated that 20-30% of company resources are wasted because organisations are not aware of what knowledge they already possess. Lew Platt, former Chief Executive of Hewlett Packard, highlighted this when he said, 'If only HP knew what HP knows, we would be three times as profitable'.

In effect, knowledge management has three phases: capturing knowledge, recording knowledge, and disseminating knowledge (across the organisation).

The importance of knowledge

As organisations become more complex, there is more knowledge to manage. Moreover the importance of capturing and sharing it increases as job mobility increases. If staff leave, there is a danger that knowledge could leave with them if it has not been properly managed within the organisation.

Also, organisations' external environments – technology, competitors, markets – are changing rapidly so organisations need to ensure they have up-to-date knowledge about these to take account of the opportunities and threats they represent.

Knowledge is thus seen as an important **resource**, and knowledge management may in itself constitute a **competence;** it can certainly **underpin** many competences, and knowledge management should be seen as a strategy to achieve competitive advantage, for example through the sharing of cost reduction ideas across divisions, or through the diffusion of innovation.

Companies are now starting to use Web technologies such as blogs and wikis for internal use to foster collaboration and information exchange between individuals and teams. Collaboration tools from commercial software vendors (such as Microsoft SharePoint) can also be used to share information between individuals and teams in an organisation.

In a knowledge management system, an organisation will appoint **knowledge managers** who are responsible for collecting and categorising knowledge and encouraging other people in the organisation to use the available knowledge. The knowledge managers also monitor the use of knowledge in their organisation.

Some companies are now taking the idea of knowledge sharing one stage further and are adopting the practice of **knowledge brokering**. In knowledge brokering, companies look externally to find ways of improving internal business processes. In effect, knowledge brokering resembles benchmarking by allowing companies to find world-class solutions to problems rather than having to invent their own solutions.

For example, a bank faced frequent complaints from customers about the length of the queues in its local branches. The bank staff responsible for reducing queuing times identified three potential sources of brokers: amusement parks, supermarkets and department stores. In each of these environments, it is important to keep queuing times under control. In time, the bank worked with an amusement park and a supermarket to redesign layout of the windows in its branches and change the way it deployed staff between back office and customer-facing windows at busy times.

6.2 Organisational learning

Organisational learning is particularly important in the increasing number of task environments that are both complex and dynamic. It becomes necessary for strategic managers to promote and foster a **culture that values intuition**, **argument from conflicting views, and experimentation**. A willingness to back ideas that are not guaranteed to succeed is another aspect of this culture; there must be freedom to make mistakes.

The aim of **knowledge management** is to exploit existing knowledge and to create new knowledge so that it may be exploited in turn. This is not easy. All organisations possess a great deal of data, but it tends to be unorganised and inaccessible. It is often locked up inside the memories of people who do not realise the value of what they know. This is what Nonaka calls **tacit knowledge**. Even when it is made **explicit** (available to the organisation) by being recorded in some way, it may be difficult and time consuming to get at, as is the case with most paper archives. This is where knowledge management technology can be useful. Another important consideration is that tacit knowledge is inherently more robust than explicit knowledge.

From 'tacit' to 'explicit' knowledge

Nonaka and Takeuchi describe four ways in which knowledge moves within and between the tacit and explicit categories.

(a) **Socialisation** is the informal process by which individuals share and transmit their tacit knowledge.

(b) **Externalisation** converts tacit knowledge into explicit knowledge; this is a very difficult process to organise and control.

(c) **Internalisation** is the learning process by which individuals acquire explicit knowledge and turn it into their own tacit knowledge.

(d) **Combination** brings together separate elements of explicit knowledge into larger, more coherent systems; this is the arena for meetings, reports and computerised knowledge management systems.

6.3 Knowledge management (KM) systems

Laudon and Laudon highlight that one apt slogan of knowledge management is 'Effective knowledge management is 80% managerial and organisational, and 20% technology.'

In other words, the culture and patterns of behaviour in an organisation need to support knowledge management. IT cannot support knowledge management by itself. For example, in order for knowledge to be shared between teams, members from different teams have to be prepared to share it.

In terms of actually developing and implementing a knowledge management strategy, there are five main steps to consider:

(a) **Support from senior management.** Senior management support will be needed not only to provide the necessary **resources** and to lead the development of a knowledge-based culture, but also because if senior managers are not seen to be supporting the strategy then other staff will not do so either.

(b) **Installing the IT infrastructure**. IT hardware and software will need to be acquired to ensure that the organisation has the capabilities to **capture, store and communicate knowledge**.

(c) **Developing the databases**. Advanced databases and database management systems may need to be developed, with the details of their design and structure being tailored to the type of knowledge the organisation is looking to capture.

(d) **Develop a sharing culture**. Knowledge is widely known to represent **power**, and staff are likely to want to hoard the knowledge they have already accumulated rather than to share it. A **culture** of **knowledge sharing** must be developed.

(e) **Capturing and using the knowledge**. Existing knowledge needs to be captured and recorded in the databases. Staff then need to be trained how to use the databases and encouraged to do so.

6.3.1 Potential issues in implementing a knowledge management system

Structure and culture – The current structure and culture of an organisation may not be conducive to sharing knowledge; for example, if there is little communication between departments in an organisation, or if staff are reluctant to share knowledge for fear that it will reduce their power within the organisation. These inherent barriers will have to be overcome in order for the system to be successful.

Technological infrastructure – If an organisation does not have a suitable network which allows information to be stored and accessed, one will have to be installed before knowledge can be shared across the organisation. There may be significant costs associated with installing such a network.

Incompatible systems and sources of information – Problems could arise if some divisions or departments record data or information in systems which are incompatible with those used by other divisions or departments. Such a situation will mean that data or information must be transferred into a new common format before they can be shared, and there is a risk that errors or omissions could result from the resulting conversion process.

Equally, it is possible that some information is not stored in a digital form at all, and so the organisation will have to decide how this material can be indexed and archived such that it can be accessed when needed.

Resistance to change – Staff in different areas of an organisation may already have their own preferred ways of organising data. However, this may not be compatible with the common format in which data is held on the network. Staff may be reluctant to change their current practices, particularly if they are not given adequate training in any new systems or sufficient time to adapt to them.

6.3.2 IT and knowledge management systems

Importantly, although there is an IT element to knowledge management systems and their infrastructure, a knowledge management strategy need not be IT-driven**. IT should support rather than dominate the strategy**. The **cultural aspects** of a knowledge management strategy (particularly encouraging staff to share knowledge) are likely to be just as critical to its success as the IT elements.

Nonetheless, the IT elements (knowledge management systems) do play an important role in facilitating knowledge management. In this context, expert systems, databases and data warehouses all help to acquire and store information which can, in turn, be converted into knowledge.

6.3.3 Expert systems

An **expert system** is a computer program that captures **human expertise** in a limited domain of knowledge. Such software uses a knowledge base that consists of facts, concepts and the relationships between them and uses pattern-matching techniques to solve problems. For example, many financial institutions now use expert systems to process straightforward loan applications. The user enters certain key facts into the system such as the loan applicant's name and most recent addresses, their income and monthly outgoings, and details of other loans. The system will then:

(a) Check the facts against its **database** to see whether the applicant has a good previous credit record.

(b) Perform **calculations** to see whether the applicant can afford to repay the loan.

(c) Make a **judgement** as to what extent the loan applicant fits the lender's profile of a good risk (based on the lender's previous experience).

(d) **A decision is then suggested** based on the results of this processing.

IT systems can be used to store vast amounts of data in an accessible form. A **data warehouse** receives data from operational systems, such as a sales order processing system, and stores it in its most fundamental form, without any summarisation of transactions. Analytical and query software is provided so that reports can be produced at any level of summarisation and incorporating any comparisons or relationships desired.

The value of a data warehouse is enhanced when **data mining** software is used. True data mining software **discovers previously unknown relationships** and provides insights that cannot be obtained through ordinary summary reports. These hidden patterns and relationships constitute **knowledge**, as described above, and can be used to guide decision making and to predict future behaviour. Data mining is thus a contribution to organisational learning. For example, the relationship between the weather and changes in peoples' purchasing habits in supermarkets can be viewed as knowledge discovery through data mining.

6.3.4 Databases and models

The way in which data is held on a system affects the ease with which that data can be accessed and then analysed. Many modern software packages are built around a database. A database provides a comprehensive set of data for a number of different users.

A database is a collection of data organised to service many applications. The database provides convenient access to data for a wide variety of users and user needs.

A database management system is the software that centralises data and manages access to the database. It is a system which allows numerous applications to extract the data they need without the need for separate files.

Databases can be used in conjunction with a variety of tools and techniques, eg Decision Support Systems, Executive Information Systems, data warehousing, and data mining.

Case example: Continental Airlines

Forecasting is critical to the airline industry. Managers at major airlines track many indicators and statistics — fluctuations in travel demand, oil prices, and changing currency rates — to make educated business decisions. All these data have significant impact on the costs of doing business and the profitability of a company.

The airline environment is very dynamic, so senior management need up-to-date information and forecasts to reflect the rapid changes in the business and economic environments.

The US airline Continental Airlines traditionally recorded key performance indicators such as load factors, fuel efficiency, and on-time rates in Excel spreadsheets. This necessitated the time-consuming manual creation of thousands of monthly reports to get business decision-makers the information they needed.

There was a huge price for such inefficiency. Because they spent so much time preparing reports and information, the financial planning and analysis team at Continental spent less than 20 percent of its time on actual analysis. This was much less than desired.

Moreover, the dependence on spreadsheets meant that much of the business logic used to prepare the numbers remained in individual employees' heads and on their desktop computers.

The head of Financial Planning and Analysis at Continental pointed out: 'Excel is a great tool—I don't think anyone can do without it. But Excel is just a spreadsheet. It shouldn't be a database tool, it shouldn't be a reporting tool, and it shouldn't be a communication tool.'

In 2008, although travel demand fell and oil prices skyrocketed, Continental executives saw an opportunity to change systems and processes to navigate the challenging times and emerge more efficient than ever.

They moved away from relying exclusively on Excel and implemented a suite of Hyperion EPM applications.

Within weeks of going live, Continental saw significant new efficiencies in analysing industry trends and performing strategic analysis. Additionally, Continental achieved the goal of generating an 18-month rolling forecast every month, updating executive insight and enabling better decision-making. The financial planning and analysis team increased time spent on analysis by 80 percent. Uploading data for reports on actuals was slashed from four hours to a matter of minutes. Additionally, moving critical data off both personal laptops and network storage represented a huge improvement in data security.

However, potentially the most important benefit was the information and insights which became available for senior management. The goal for the financial planning team at Continental is simple: to give senior management the quickest, most complete picture of business conditions possible.

The head of Financial Planning and Analysis sums this up as follows: 'Our CFO needs to be able to come in every day, sign on to his dashboard, click on the button and see, “What's my outlook as of yesterday? What's changed since the prior day?”'

In the fast-changing airline industry, having such insight could be crucial for the success of the business.

6.3.5 Data warehouses

Definition

Data warehouse: A data warehouse consists of a database containing data from various operational systems and reporting and query tools.

A data warehouse is a large-scale data collection and storage area containing data from various operational systems, plus **reporting** and **query tools** which allow the data to be analysed. The key feature of a data warehouse is that it provides a single point for **storing a coherent set of information** which can then be used across an organisation for **management analysis** and decision making.

Importantly, a data warehouse is **not an operational system**, so the data in it remains static until it is next updated. For example, if a supermarket introduces a customer credit card, the history of customers' transactions on their cards could be stored in a data warehouse so that management could analyse spending patterns.

However, although the reporting and query tools within the warehouse should facilitate management reporting and analysis, data warehouses are primarily used for **storing** data rather than analysing data.

A data warehouse contains data from a range of **internal** (eg sales order processing system, nominal ledger) and **external sources**. One reason for including individual transaction data in a data warehouse is that, if necessary, the user can drill-down to access transaction level detail. Increasingly, data is obtained from newer channels such as customer care systems, outside agencies or websites.

Maintenance of a data warehouse is an iterative process that continually refines its content. Data is copied to the data warehouse as often as required – usually daily, weekly or monthly. The process of making any required changes to the format of data and copying it to the warehouse tends to be automated.

The result should be a coherent set of information available for use across the organisation for management analysis and decision making. The reporting and query tools available within the warehouse should facilitate management reporting and analysis.

The reporting and query tools should be flexible enough to allow multidimensional data analysis also known as **on-line analytical processing** (OLAP). Each aspect of information (eg product, region, price, budgeted sales, actual sales, time period etc) represents a different dimension. OLAP enables data to be viewed from each dimension, allowing each aspect to be viewed and in relation to the other aspects.

Features of data warehouses

A data warehouse is subject-oriented, integrated, time-variant, and non-volatile.

(a) **Subject-oriented**

A data warehouse is focused on data groups, not application boundaries. Whereas the operational world is designed around applications and functions such as sales and purchases, a data warehouse world is organised around major **subjects** such as customers, suppliers, products and activity.

(b) **Integrated**

Data within the data warehouse must be consistent in format and codes used – this is referred to as **integrated** in the context of data warehouses.

For example, one operational application feeding the warehouse may represent sex as 'M' and 'F' while another represents sex as '1' and '0'.

While it does not matter how sex is represented in the data warehouse (let us say that 'M' and 'F' is chosen), it **must** arrive in the data warehouse in a **consistent, integrated** state. The data import routine should cleanse any inconsistencies.

(c) **Time-variant**

Data is organised by time and stored in time-slices.

Data warehouse data may cover **a long time horizon**, perhaps from five to ten years. Data warehouse data tends to deal with **trends** rather than single points in time. As a result, each data element in the data warehouse environment must carry with it the time for which it applies.

(d) **Non-volatile**

Data **cannot be changed** within the warehouse. Only load and retrieval operations are made.

Advantages of data warehouses

Advantages of setting up a data warehouse system include the following.

(a) **Supports strategic decision making.** The warehouse provides a single source of authoritative data which can be analysed using data mining techniques to support strategic decision making.

(b) Decision makers can access data without affecting the use of operational systems.

(c) **Data quality**. Having a single source of data available will reduce the risk of inconsistent data being used by different people during the decision making process.

(d) Having a wide range of data available to be queried encourages the taking of a wide perspective on organisational activities.

(e) **Speed**. Data warehousing can enable faster responses to business queries, not only by storing data in an easily accessible central repository but also by using OLAP technologies.

(f) Data warehouses have proved successful in some businesses for:

  (i) Quantifying the effect of marketing initiatives
  (ii) Improving knowledge of customers
  (iii) Identifying and understanding an enterprise's most profitable revenue streams

In this way, data warehouses (and data mining) allow organisations to use the data they hold to help improve their competitiveness.

Limitations of data warehouses

Some organisations find they have invested considerable resources implementing a data warehouse for little return. To benefit from the information a data warehouse can provide, organisations need to be flexible and prepared to act on what they find. If a warehouse system is implemented simply to follow current practice, it will be of little value.

Other limitations exist, particularly if a data warehouse is intended to be used as an operational system rather than as an analytical tool. For example:

(a) The data held may be outdated.

(b) An efficient regular routine must be established to transfer data into the warehouse.

(c) A warehouse may be implemented and then, as it is not required on a day-to-day basis, be ignored.

There is also an issue of **security**. The management aim of making data available widely and in an easily understood form can be at variance with the need to maintain confidentiality of, for example, payroll data.

This conflict can be managed by **encrypting** data at the point of capture and **restricting access** by a system of authorisations entitling different users to different levels of access. For this to work, the data held must be classified according to the degree of protection it requires; users can then be given access limited to a given class or classes of data. Encryption at the point of capture also exerts control over the **unauthorised uploading** of data to the data warehouse.

6.3.6 Data mining

While a data warehouse is effectively a large database which collates information from a wide variety of sources, data mining is concerned with the discovery of meaningful relationships in the underlying data.

Data mining software looks for hidden patterns and relationships in large pools of data. Data mining is primarily concerned with **analysing data**. It uses statistical analysis tools to look for **hidden patterns and relationships** (such as trends and correlations) in large pools of data. The value of data mining lies in its ability to highlight previously unknown relationships.

In this respect, data mining can give organisations a **better insight into customer behaviours**, and can lead to **increased sales through predicting future behaviour**.

When a supermarket customer pays for their shopping using a loyalty card (see example about Tesco's Clubcard in the next section), the supermarket can create a record of the items the customer has bought. The purchasing behaviour of customers can be used to create a profile of what kinds of people the cardholders are.

Data mining techniques could be applied to customers' purchasing information to identify patterns in the items which were purchased together, or what types of item were omitted from shopping baskets, and how the make-up of customers' baskets varied by different types of customer. The supermarket could then target its promotions to take advantage of these purchasing patterns.

In this way, by identifying patterns and relationships, data mining can **guide decision-making**.

True data mining software discovers **previously unknown relationships**. The hidden patterns and relationships the software identifies can be used to guide decision making and to **predict future behaviour**.

Data mining uses statistical analysis tools as well as neural networks, fuzzy logic and other **intelligent techniques**.

The types of relationships or patterns that data mining may uncover are classified as follows.

Relationship/ Discovery	Comment
Classification or cluster	These terms refer to the identification of patterns within the database between a range of data items. For example, data mining may find that unmarried males aged between 20 and 30 who have an income above $75,000 are more likely to purchase a high performance sports car than people from other demographic groups. This group could then be targeted when marketing material is produced/distributed.
Association	One event can be linked or correlated to another event.

In Chapter 5 we considered how obtaining detailed customer information is an important element of **customer relationship management**.

Obtaining detailed customer information allows a firm to identify customer needs and develop improved ways of meeting those needs, as well as targeting marketing campaigns to specific customers, bringing relevant new products or services to their attention.

Customer loyalty/reward cards can provide valuable information about the buying habits and patterns of customers, but more generally the process of gathering and storing data about customers and then analysing patterns is an application of data warehousing and data mining.

Interactive question 7: Data and knowledge [Difficulty level: Intermediate]

PBB is a Bangladeshi university. PBB's management board has identified student performance as a Critical Success Factor (CSF). PBB's management board has identified this CSF as it targets an area where it is currently underperforming compared to other Bangladeshi universities.

PBB is aware of a nearby comparable university, KLN, which had considerable success when several of its departments worked together to improve student performance. KLN has a culture of sharing knowledge and a knowledge management strategy. PBB does not have a culture of knowledge sharing. Within PBB, knowledge is regarded as the personal property of the individual and very few of its staff are prepared to share their knowledge with any of their colleagues. PBB has an abnormally high level of staff turnover compared to other universities, nearly twice as high as that of KLN.

Student performance

Student performance is measured by PBB as the number of students who successfully complete their courses. Those students who do not are described as 'drop-outs'. The number of drop-outs is measured by the drop-out rate. PBB has access to data for all Bangladeshi universities for student drop-out rates analysed by age and gender.

Drop-out rates vary greatly across PBB's academic departments. In some academic departments the drop-out rate is extremely high; in others it is very low, much better than the national average. Where the drop-out rate is much better than the national average, the departments have operated extensive schemes for student support. For example, students with personal problems can seek help from trained counsellors, students with financial problems have been helped to find part-time work and students with academic problems are given extra individual tuition from the academic staff.

In the departments where the drop-out rates are extremely high, none of these student support schemes is operating. The departments with the extremely high drop-out rates are not aware of how the departments with the very low drop-out rates support their students. The departments with very low drop-out rates are unwilling to share their knowledge about how to reduce the drop-out rates as they have spent considerable time and effort developing their schemes and regard these as their own property.

PBB has not conducted any systematic analysis into its overall drop-out rate. Within its information systems, PBB has the following information about each of its students:

- Name
- Age
- Gender
- Address
- Educational record prior to joining PBB
- Educational record within PBB
- Academic department

PBB is aware that many universities have successfully used data mining to assist them in managing student performance.

Requirements

(a) Many organisations integrate their CSFs into their performance management systems by converting them to Key Performance Indicators (KPIs).

Briefly explain, using examples, the advantages that PBB would gain by doing the same.

(b) Advise PBB's management board of three benefits the university and its staff could expect to receive from the implementation of a knowledge management strategy.

(c) Explain data mining and how the outputs of the analysis could be used by PBB to improve the student drop-out rates.

See **Answer** at the end of the chapter.

6.4 Analytics and business intelligence

In May 2013, the ICAEW's Finance & Management faculty published an article '10 key business analytics and how they are used to drive value.'

The article highlights that the amount of data available to companies, generated either internally or externally, is greater than at any time in the past. Companies can use analytics to turn this data into insight and thereby improve decision-making.

Web analytics – analytics tools (like Google Analytics) allow companies to track the traffic on their website – for example: what search phrases people used, how they got to the page, what they were looking at and in which sequence, how long they stayed, whether they were converted into customers.

Such information is very useful to enable companies to track their website effectiveness and customer engagement. In turn, if companies can improve the effectiveness of their website and their engagement with their customers, this should help them achieve their strategic goals.

Customer analytics – Customer analytics enable companies to understand which customers are their most loyal, their most profitable or their most expensive to keep. Data rich companies such as telecom companies and retailers are now also looking at understanding customer life time value, and even identify trigger points when customers are likely to cancel their contracts or to shop at a rival company.

Predictive business analytics – In the simplest form predictive analytics allow companies to use their data to forecast and predict future liquidity and cash flows as well as revenue and profit predictions. More sophisticated approaches use the cause and effect logic to understand, for example, the impact of increased customer satisfaction on future loyalty as well as financial performance. In one case, a bank found that even though most of its customers were happy, few actually generated a profit for the bank.

HR analytics – Given that people are important assets for companies, companies need to identify who is performing well, who is performing less well and who needs more support or training.

HR analytics can also be used to identify the best ways to recruit new talent, to monitor development activities, to identify skills gaps in an organisation, for succession planning, and to identify the drivers of staff satisfaction. Google used analytics to identify ten factors which make a good manager, and they now use this insight when recruiting and training managers.

Project analytics – Companies use project analytics to track whether projects are running on time and on budget, and also whether they are generating the desired outcomes. In many cases, simple project management software applications can generate most of the analytics which are required, although for more sophisticated project-specific analytics software may be required.

Process analytics – By contrast to project analytics which look at 'one-off' projects, process analytics are concerned with the day-to-day operations in a company. Process analytics are used to understand which processes are optimised and to identify processes that can be improved or changed to increase efficiency and effectiveness.

Traditional process analytics start with process mapping (often end-to-end) and an analysis of the effectiveness and efficiency of each of the process steps. Other approaches are TQM, Lean or Six Sigma, which allow companies to measure, analyse and optimise process performance.

Supply chain analytics – Supply chain analytics enable companies to optimise their supply chains; for example, by finding the most efficient delivery routes, the best locations for their warehouses or production plants, and the most intelligent storage approaches.

Supply chain analytics can also be used to analyse data from delivery routes to better understand fuel consumption, and to identify potential risks to the supply chain (for example, from disruption to road or air freight links).

Procurement analytics – The main benefits from procurement analytics will be generating significant cost savings in the purchase of goods and services, and reducing the business risks associated with those purchases. Procurement analytics allow companies to optimise, consolidate or standardise purchasing and contracts, and enable companies to strategically source products and services at the right time, for the right price, and in the right quantities.

Marketing and brand analytics – Applying analytics to marketing and brand building activities enables companies to understand the effectiveness of their marketing campaigns.

Digitalisation and e-commerce means that companies can track how many customers and how much business each marketing campaign has generated. Analytics allow companies to identify the most effective marketing channels and marketing strategies, for example. Companies can also use analytics to track brand awareness and brand engagement.

Big data analytics – Big data analytics refer to the ability to analyse larger quantities or more unstructured data (ie data not in a database) such as keywords from conversations people have on Facebook or Twitter, and content they share through media files (photographs and videos).

The aim of 'Big data analytics' is to extract insights from unstructured or large volumes of data. This can come from a wide range of different sources: for example, from RFID tags, tracking devices and traffic flow, from social networks, from internet search indexes (such as Google Trends), or from the timing and location of cash withdrawals from ATM machines.

Some commentators believe that big data analytics has the potential to transform the way companies make decisions.

Case example: Human swarm

Morrisons

The supermarket chain, Morrisons, uses weather forecasts to predict customers' purchasing patterns.

They have analysed five years of sales data and have identified how sales patterns change in line with increases or decreases in temperature. Although people make purchasing decisions as individuals, overall trends in their purchases show that we act as a 'human swarm.'

When temperatures fall during the winter, purchases of 'warming' food such as soup, porridge and ready meals increase. Therefore, when the weather forecast shows a fall in temperature, Morrisons increase the amount of these 'warming' foods it ships from its central distribution centre to its stores.

Similarly, Morrisons has identified that when weather forecasts in summer predict three or more consecutive days of hot, dry weather, demand for barbecue-related foods increases significantly. By reacting to the weather forecast, Morrisons can control not only the quantities of different products it ships from its warehouses to its stores, but it can also ask its suppliers to change the volume of different products they supply. For example, if hot weather is forecast, Morrisons asks its supplier of minced beef to switch from producing ready meals (such as Cottage Pie) to producing beef burgers (which will be used for barbecues).

Bravissimo

The lingerie and clothing retailer also uses local weather reports to change its online adverts in different parts of Bangladesh as the weather changes. Bravissimo uses a software solution (called weatherFIT) to enable it to tailor online adverts in real time to respond to local weather data.

In the three months of March – May 2013, Bravissimo reported a 600% growth in revenue from its online adverts compared to the same period the previous year.

Bravissimo's senior marketing manager commented: 'Using [weatherFIT] to fine-tune our … advertising and promotions by taking into account local weather conditions really boosted sales in the crucial run-up to the holiday season.'

Case example: Tesco and customer insights

The ability to collect and analyse data has transformed Tesco from an organisation that *thinks* it knows what customers want to one that has the knowledge and insights into what customers prefer, and how these preferences keep shifting over time. Former Chief Executive Officer (CEO) Sir Terry Leahy stated, 'We don't spend a pound or dollar on a store without talking to our customers – they are the best management consultants.'

An essential component of Tesco's performance data is its extensive customer knowledge gathered through its Clubcard loyalty programme, established in 1994 and now with over 14 million users. Although 'Clubcard' was ostensibly introduced as a loyalty programme, its main purpose for Tesco was to provide insights which would help managers improve the way they run the company.

Ultimately, loyalty programmes which are solely used to target customers with discounts and offers are self-defeating, because they reduce the margins which a company earns on its sales. But loyalty programmes can be beneficial to companies when: (a) the potential to generate competitive advantage from the data is recognised, and (b) the capability to mine data, and to make sense of and apply the insights gleaned from that data, is embedded into the organisation as a capability and focus.

It was the decision-support 'potential' of the data that convinced the senior leaders in Tesco to endorse the idea of a loyalty programme.

When Tesco began its Clubcard programme, it outsourced the data analysis to Dunnhumby, an organisation that specialises in data analysis. Tesco realised it didn't have the skills to systematically analyse the mass of data gleaned from its customers, and therefore left it to Dunnhumby to develop the strategy for the data analysis.

However, as it increasingly began to realise that analytics are an important driver of success, Tesco wanted to improve its in-house competencies to analyse customer and performance data. Therefore, it created an internal team responsible for analysing data and extracting insights. Tim Mason, Tesco's marketing director and chairman of Tesco.com, explained:

> *These people are geographers, statisticians who had spent a lot of time applying those skills to understanding how customers would behave. They could crunch through the stuff that came from the Clubcard, see the patterns in it and they could start to help the management of the organisation understand what was going on, but also point towards what should be done about it. They had to find the data, and present it in a way that makes the decisions stark, and clear.*

Tesco ensures it maintains the ability to develop common-sense responses. It aims to create processes that enable relevant insights to be used to improve the customers' experience.

Presentation of data

Data is presented in different ways in Tesco, such as through insightful performance reports as well as organisational intelligence applications that provide dashboards and performance reports to the management team. Most reporting is scheduled weekly or monthly. These dashboards and reports allow executives to drill down into the data and perform high-level analysis of their own.

Decisions based on customer insights

Tesco's objective is to never make any changes without first talking to its customers. It also ensures it runs experiments to test ideas before implementing them on a wider scale. The performance data plays a vital role in this process and has enabled Tesco to take new ideas and offers to smaller groups of customers, while using the remaining customers as control groups. This takes a lot of risk out of innovative ideas.

In many ways, the performance and customer data has become a powerful laboratory to test whether new ideas work or not. Tesco's performance information, especially its Clubcard data, is not just about passively observing trends; it is a massive laboratory of customer behaviour. If it launched a new initiative, but it was doing something wrong, it knew about it in days. Equally, if it was doing something right, the new initiative could be implemented nationwide in weeks.

Tesco's marketing director highlighted that, as a company, Tesco has moved from being intuitive to being analytical. 'This is a much more complicated business than it used to be. We don't forget our intuition, but better data led to better thinking, and our data give us the confidence to ask the right questions. You can have all the data you want, but the key is to use them to ask the right questions.'

For example, Tesco is now able to conduct experiments to understand whether new product lines, innovative offers, and price reductions have the desired effects. Using its customer data allows Tesco to track the response immediately, which takes a lot of guesswork out of organisational decision-making.

Abridged from a case study in ICAEW Business performance management community: 'Driving customer insights from data at Tesco'

6.4.1 Business intelligence

Business intelligence (BI) refers to technologies, applications, and practices for collecting, integrating, analysing, and presenting business information.

Analytics relates to the use of (a) data and evidence, (b) statistical, quantitative and qualitative analysis, (c) explanatory and predictive models, and (d) fact-based management to drive decision making.

Together, they include approaches for gathering, storing, analysing and providing access to data that helps users to gain insights and make better fact-based business decisions, to improve performance, to help cut costs or to help identify new business opportunities.

Examples of business intelligence and analytics applications include:

- Measuring, tracking and predicting sales and financial performance
- Budgeting, financial planning and forecasting
- Analysing customer behaviours, buying patterns and sales trends
- Tracking the performance of marketing campaigns
- Improving delivery and supply chain effectiveness
- Customer relationship management
- Risk analysis
- Strategic value driver analysis

Overall, a company also needs intelligence about its business environment to enable it to anticipate change and design appropriate strategies that will create business value for customers and be profitable in new markets and new industries in the future. Not only does a company have to anticipate the future, but it also needs the capability to react to that future successfully.

6.5 Information, knowledge and competitive advantage

The resource based view of strategy, discussed in Chapter 1, highlights that a successful organisation acquires and develops resources and competences over time, and exploits them to create competitive advantage.

The ability to capture and harness corporate knowledge has become critical for organisations as they seek to adapt to changes in the business environment, particularly those businesses providing financial and professional services.

Therefore, as we have already mentioned, knowledge becomes a strategic asset, and organisation-specific knowledge, which has been built up over time; it is a core competence that cannot easily be imitated.

Therefore, knowledge management can help promote competitive advantage through:

- The fast and efficient exchange of information
- Effective channelling of the information to:
  - Improve processes, productivity and performance
  - Identify opportunities to meet customer needs better than competitors
  - Promote creativity and innovation

Importantly, however, the importance of meeting customer needs better than competitors means that organisations need to capture and analyse information about customers and potential customers rather than simply looking at internal processes.

Case example: EuroDisney

The following example illustrates that market understanding is as important as pure market research.

When Disney opened its EuroDisney resort near Paris, the company lost $921 million in its first year. However, the decision to enter the European market had been well-supported by the research Disney had undertaken.

Figures showed a growing number of European visitors to US theme parks (suggesting European people like going to theme parks).

The more detailed choice of location had been based on modelling population figures, which showed 17 million people lived within a two hour drive of the Paris site, and 109 million within a 6 hour drive. These potential customer numbers were much greater than for theme parks in the US.

However, while the figures were encouraging, the launch of EuroDisney proved an expensive lesson in market understanding, rather than just market research.

Disney ignored the failure of amusement parks in France; it dismissed anti-Disney demonstrations as insignificant; and it ignored the fact that European holiday patterns are significantly different to those in the US. People in Europe have longer holidays, but spend less on each.

Perhaps crucially, marketing short-sightedness also led Disney to ban alcohol from EuroDisney. Clearly Disney's market research had overlooked the key aspect of French culture that the French like to drink wine at lunchtime. Because Disney prevented them from doing so, customers voted with their feet and stayed away from the park.

In the same way that a company needs to know its customers and serve them well, a company also needs to engage with its suppliers. The more a company engages with its suppliers, the better the suppliers can provide vital inputs.

How a company can really get to know its customers, or its suppliers, is a key challenge facing businesses with millions of offline and online customers.

Case example: Customer and supplier engagement

Hotels and customer services

Like other high-end hotels, the Mandarin Oriental in Manhattan uses information systems and technologies to develop detailed knowledge of its customers. The hotel uses computers which keep track of guests' preferences, such as room temperature, check-in time, and television programmes, and store these in a large data repository.

Individual rooms in the hotels are networked to a central network server computer so that they can be remotely monitored or controlled. When a customer arrives at one of the hotels, the system automatically changes the room conditions, such as dimming the lights, setting the room temperature or selecting appropriate music based on the customer's digital profile. The hotels also analyse their customer data to identify their best customers, and to develop individualised marketing campaigns based on customers' preferences.

Suppliers and inventory management

JCPenney exemplifies the benefits of information systems-enabled supplier intimacy. Every time a dress shirt is bought at a JCPenney store in the United States, the record of the sale appears immediately on computers in Hong Kong at TAL Apparel Ltd, a contract manufacturer that produces one in eight dress shirts sold in the United States. TAL runs the numbers through a computer model it has developed and then decides how many replacement shirts to make, and in what size and style. TAL then sends the shirts to each JCPenney store, completely bypassing the retailer's warehouses. In this way JCPenney's shirt inventory is almost zero, as are any associated storage costs.

6.5.1 Supply chain information

Another context in which information can help generate competitive advantage is the supply chain, and supply chain management, which we discussed in Chapter 3 of this Study Manual.

In relation to supply chain management, Edward Davis and Robert Spekman refer to the notion of the **'extended enterprise'**. This is a concept in which a dominant enterprise 'extends' its boundaries to all or some of its suppliers, developing collaboration within the supply chain. Davis and Spekman argue that organisations can gain competitive advantage through developing collaborative supply chains.

The transition from conventional supplier/buyer relations to an extended enterprise based on collaboration can be seen in the following steps:

Open market negotiations: price-based discussions and adversarial relationships

Co-operation: fewer suppliers, information sharing, longer-term contracts

Co-ordination: information linkages, work-flow linkages, EDI exchange

Collaboration: supply chain integration, joint planning, technology sharing

In this way, Davis and Spekman argue, firms can achieve sustainable competitive advantage through:

- Achieving and maintaining lowest costs
- Dealing with changing customer requirements that demand an increasing number of new and innovative products and services

Supply chain management is not only about cost reduction, but also about looking for revenue-enhancing opportunities as well.

Davis and Spekman's model highights the importance of information flows within the extended enterprise. The model relies on connectivity between the supply chain partners, with seamless and transparent information flows between them.

6.5.2 Bullwhip effect

We have just suggested that supply chain management and networks should involve companies working together to meet customers' needs more effectively. In theory, collaboration and connectivity should enable this: customers order products, the vendor keeps track of what is being sold and orders enough materials or inputs from supplier to meet customers' demand and replenish inventory levels in line with expected future demand.

However, in practice, the supply chains are not always this co-ordinated. Suppliers, manufacturers, sales people, and even customers often have an incomplete understanding of what the real demand is. These dynamics create inaccuracy and volatility in production levels, and these (inaccuracies and volatility) increase for operations further upstream in the supply chain.

This increase is known as the bullwhip effect, because the increasingly large disturbances in the chain as they work their way to the end resemble the oscillations in a whip when it is cracked.

Each group in the supply chain (suppliers, manufacturers, sales staff) only has control over part of the chain, but the decisions they take (for example, ordering too much or too little) affect production or inventories levels throughout the whole chain. Furthermore, each group in the chain is influenced by decisions that others are making.

We can illustrate the effect using a very simple model of a supply chain, in which all the producers in the chain work on the principle that they keep one month's inventory in stock at any time. In the model, market (customer) demand has historically been running at 100 units per period (prior to period 1). However, demand starts to fluctuate from period 2. The bullwhip effect can be seen by the fact that the producer and intermediate supplier's monthly production levels fluctuate increasingly more than market demand, in response to changes in market demand.

Period	Customer	Final producer		Intermediate supplier	
	Demand	Production	Inventory	Production	Inventory
1	100	100	100	100	100
2	95	90 (*)	95	80	90
3	95	95	95	100	95
4	100	105	100	115	105
5	100	100	100	95	100

* Production (90) = Closing inventory (95) + Demand (95) – Opening inventory (100)

Although the bullwhip effect in our model is simply caused by movements in and out of stock working their way up the supply chain, the effects can be magnified by problems of communication or co-ordination in the supply chain. This can be illustrated by the story of a car manufacturer which found itself with surplus inventories of green cars. To help get these sold, the car manufacturer's sales department offered special deals on green cars, so demand for them increased. However, the production departments were unaware of the promotion, and so when they saw the increase in sales they increased the production of green cars.

This simple 'car' example highlights one of the key problems behind the bullwhip effect: each operation in the supply chain only reacts to the orders placed by its **immediate customer**, but they have little overview of what is happening throughout the chain as a whole.

Therefore, in order to improve supply chain performance (and reduce the bullwhip effect) organisations need to improve the co-ordination of all the activities in the chain and the **knowledge sharing throughout the supply chain.** For example, if retailers make information on sales available to their suppliers, suppliers are more aware of movements in final customer demand and manage production accordingly.

In this context, one way to reduce the bullwhip effect is through better forecasts. However, a more important solution is to make sure that the strategies of all the firms in the supply chain are harmonised, and one way of doing this is through vendor-managed inventory.

6.5.3 Vendor-managed inventory

One way of reducing fluctuations in demand and production throughout the supply chain is to allow an upstream supplier to manage the inventories of its downstream customer. This is known as vendor managed inventory (VMI).

Under a VMI model, the (downstream) buyer of a product provides information about customer demand to the (upstream) supplier of that product, and the supplier manages production levels in order to maintain an agreed inventory of the product to meet demand.

VMI encourages a closer relationship and understanding between buyer and supplier, and it helps reduce both the levels of inventory in the supply chain and the risk of stock-out situations. Because the vendor is responsible for supplying the buyer when items are needed, this removes the need for the buyer to hold significant levels of safety stock.

However, a crucial element in VMI working effectively is the use of Electronic Data Interchange (EDI) between the buyer and supplier; for example, so that the supplier knows the quantity of a product the buyer has sold to end-user customers. Effective VMI also uses statistical methodologies and demand-planning tools to help forecast and maintain the correct levels of inventory in the supply chain (taking account of variables such as promotions or seasonality for example).

Integrated supply chain management packages provide web-enabled visibility to suppliers so that they can review the on-hand inventory at their buyers' warehouses. The packages also allow buyers and suppliers to calculate buffer quantities, and when the buffer level is reached this triggers a new order from the supplier.

A crucial difference between a VMI system and traditional supply chain arrangements is that the vendor receives data from the buyer rather than purchase orders. Instead of the downstream buyer making purchase orders and 'pulling' supply through the system, the upstream supplier now initiates the order (based on the purchase information they receive) and they 'push' supplies through the system.

Summary and Self-test

Summary

Information systems are necessary for an organisation to have the information it needs for strategic planning, and then to assess whether its objectives and targets are actually being met.

Although IS/IT are often used to support business strategy, they may help determine business strategy (eg e-commerce) and provide a source of competitive advantage in their own right (eg data mining and CRM; analytics and inventory management; knowledge management and organisational learning).

Managers need information for three main reasons: to make effective decisions, to control the activities of their organisation, and to co-ordinate the activities of the organisation.

Management accounts are an important source of information for managers. For example, management accounts can provide information on costs and costing, prices and pricing, budgets, and variances.

Management accounting tools can also be valuable in evaluating business strategies or elements of business strategies. Useful tools include: break even analysis, limiting factors, expected values, activity-based costing, transfer pricing, and the balanced scorecard.

A key feature of an organisation's management information systems is that they enable the organisation to measure its performance in relation to its critical success factors (CSFs). An organisation should set its KPIs to measure performance in relation to its CSFs.

Different types of information system must meet the information requirements of different levels of management within an organisation. Transaction processing systems (TPS) provide operational level data. Management information systems (MIS) summarise TPS data at a tactical level.

Executive information systems (EIS), management information systems (MIS) and decision support systems (DSS) could be used to provide summarised information at strategic level.

An important consideration for managers is how to integrate information from different systems. Enterprise applications (eg enterprise resource planning systems, supply chain management systems, or customer relationship management systems) span different functional areas and focus on executing business processes across the organisation.

Although information in general is seen as a valuable resource for organisations, when evaluating a new information system an organisation should consider the value of the information compared to the costs associated with using it (ie cost-benefit analysis).

Information is ultimately only useful to managers or staff if it adds to their understanding of a situation. The qualities of good information can be summarised by the mnemonic 'ACCURATE': accurate, complete, cost-beneficial, user-targeted, relevant, authoritative, timely and easy to use.

The use of computerised information systems in organisations can create risks for an organisation (eg viruses, hacking). Organisations may therefore seek external assurance over the security of their systems, and also over the integrity of the information produced by their systems.

Self-test

Self-test question 1

MMM is an advertising agency specialising in work for the hotel industry. MMM has no formal mission statement or strategy. However, the management board agrees that MMM should grow, while remaining profitable as it always has been.

MMM's market niche is small, and competition with the sector is intense. MMM is unaware of the total size of its market niche, but MMM believes that the market is growing. Within its market, BBB estimates it is the second or third largest company. MMM thinks it wins most of its work because of the high quality of its output, but thinks sometimes price is the determinant for securing a new client.

MMM employs 15 staff, but it has always found it difficult to attract sufficient staff. MMM sometimes has to turn down work due to a lack of staff. It passes such work on to other advertising agencies. When this happens, MMM earns commission on the work it has referred. However, due to the seasonal nature of the hotel industry, there are times when MMM has surplus capacity. The management board believes MMM could increase its profit if it increased the number of its staff in order to accept some of the work that it currently turns down.

MMM's accountant provides management accounting information to the management board to support planning and decision-making. This consists of budgetary control and standard costing information. The accountant produces budgetary control monthly reports which are very detailed and show every expenditure over CU25. The annual budget is flexed each month to reflect that month's level of activity. The accountant produces very detailed monthly variance reports relating to labour, variable overheads and fixed overheads. The accountant produces a monthly profit figure.

Work undertaken for clients is priced by adding a standard uplift to total cost. A blanket overhead recovery rate is used in arriving at total cost. On occasion, some of MMM's clients have complained that they have been charged too much. However, on other occasions MMM believes that it may have undercharged its client.

The management board has stated that it 'urgently needs additional information to support its planning and decision-making'. A member of the management board attended a recent seminar which discussed benchmarking and is investigating whether this technique could assist MMM.

Requirement

Advise MMM's management board what additional information it needs to support its planning and decision-making.

Self-test question 2

FDS Co installs irrigation systems. Its customers include farmers, local government bodies, sports centres and building contractors. Its annual sales turnover is currently CU25 million, and annual pre-tax profit is CU1.2 million. The company is currently working at close to capacity, and its activities are restricted by a shortage of skilled engineers to install and maintain the pumping equipment for the irrigation systems.

Prices for the installation of irrigation systems are negotiated between customers and sales representatives of FDS. The sales representatives have authority to offer discounts on price in order to win large contracts or in return for more favourable payment arrangements.

The installation of irrigation systems typically takes several months for large contracts, and FDS usually sets up a site office on the customer's premises with a compound for holding system parts and other inventory. Delivering inventory to a site can be difficult, especially when the customer is a farmer in a remote location.

Sports centres often insist on minimum disruption to sporting activities during the installation of a new irrigation system. This can limit the size of the site office and inventory compound, which sometimes delays progress on a contract when the installation team has to wait for more inventory to be delivered. The installation teams fill in time sheets on a daily basis.

The management accountant of FDS is not satisfied with current reporting arrangements and thinks that some types of contract are much more profitable than others. It seems likely, for example, that farmers negotiate much better prices than local government bodies (such as local councils). Some contracts are more complex and difficult to negotiate than others, and winning a contract from a local government body can take much longer than contract negotiations with other customers.

The management accountant thinks that the company would benefit from the introduction of a customer profitability reporting system, where the profitability of each type of customer is measured and assessed separately. A benefit of this type of reporting system is that FDS should be able to put more resources into selling to more profitable types of customers, thereby helping to increase the company's profitability.

The management accountant is particularly concerned that as FDS is working close to its capacity there is a danger it could turn down contracts (due to lack of capacity) which would have been more profitable than contracts it has accepted.

This issue has been highlighted recently as FDS has been asked to undertake three new installations, but only has sufficient resources to carry out two of them.

	Sports centre	*Farm*	*Building contractor*
Basic price (CU)	200,000	200,000	200,000
Discount negotiated	4%	5%	3%
Installation team time budgeted (@ CU1,500 per day)	56 days	50 days	45 days

The inventory delivery costs for the sports centre and the building contractor's installations were expected to be the same, but the costs for the farm installation were expected to be CU25,000 higher. All other costs were expected to be the same for the three contracts. FDS has not yet decided which two contracts to accept.

Despite the management accountant's concerns about the current reporting arrangements, the CEO is not convinced that a customer profitability reporting system would be useful for FDS. The CEO wants to know where the information will come from and how it will be collected, as well as what the costs and benefits of the reporting system would be.

Requirements

(a) Discuss the information requirements for a customer profitability reporting system within FDS and where the data for this system might be obtained.

(b) Discuss how the information in a customer profitability reporting system might improve management control and decision-making within FDS.

(c) Explain what the direct and indirect costs of obtaining data and producing information for this system might be, and how the value of such a system should be assessed.

Self-test question 3

The board of CMA Supermarkets is considering an upgrade of its company-wide IT system. The company has been opening new supermarket stores at a rapid rate in recent years, and has ambitions to rival the established supermarket chains in its country. The board believes that CMA could gain a significant competitive advantage from having a unified corporate database and from replacing its bar code technology with RFID, the radio frequency technology for labelling and identifying inventory.

The management accountant at CMA has been asked to explain to the board how a new network system and RFID technology may help to improve the management accounting system within the company, and also the company's performance.

At the moment, management accounts are prepared for each individual store, and monthly sales and profitability reports are presented to the store manager. Regional reports and a national report on company performance are also prepared each month, and presented to senior management and the board.

Because the company is trying to increase market share rapidly, it keeps its prices as low as possible, and whereas rival companies achieve a gross profit margin of about 55% on its sales, CMA's average gross margin is slightly below 50%.

In addition, a number of CMA's stores have reported an increase in out-of-stock products in recent weeks. The store managers are concerned that if customers keeping finding items out-of-stock they will stop shopping at CMA and will revert to one of the established supermarket chains.

The management accountant thinks that new technology will help to improve profitability and will influence the nature of performance reporting system. However, the benefits of improved IT will only be obtained if there is a radical re-thinking of how information is used within CMA.

Requirements

(a) Explain how RFID technology for tracking inventory and inventory movements may help to improve the quality of management information in CMA Supermarkets, and may also help to improve CMA's operational performance.

(b) Assess the changes which may be required to performance reporting in CMA Supermarkets in order to obtain the greatest value from a new IT system and RFID technology.

(c) Suggest how the IT system for a supermarket might exploit information about individual customers to improve sales and profits.

Answers to Interactive questions

Answer to Interactive question 1

Strengths

Operations: The owners have developed a considerable income stream by charging for their respected consultancy advice about antiques.

Service: The owners have developed a national reputation in the antiques trade and their experience has allowed them to build up a loyal following of repeat customers.

Firm infrastructure: The business operates from a large modern shop in a fashionable area, which makes its premises very valuable. If the owners sold the shop they could realise a substantial capital gain.

Human resource management: The business is run by the owners, and their experience in the antiques trade, and their reputation as experts, is a valuable asset for GLS.

Weaknesses

Inbound logistics: The inconvenience of the shop's location may mean that people with antiques to sell may take them to another antiques dealer rather than bringing them to GLS.

Operations: The location of the shop is not convenient for potential customers (antique traders and collectors) to visit, and the people who live nearby are not interested in buying antiques.

The owners are unable to attend antiques fairs because they need to be physically at the shop to keep it open.

Outbound logistics: The inconvenience of the location may also be a weakness in relation to customers buying antiques; for example, a collector may choose not to buy an item due to the difficulty of transporting home, or GLS may have to bear the cost of transporting customers' purchases to their homes.

Security costs have also increased significantly in recent years, and these costs are presumably related to the cost of storing antiques at the shop. If these security costs continue to rise, storing antiques in the shop may become a weakness.

Marketing and sales: The owners themselves believe that the location of the shop restricts the success of the business.

However, at the moment GLS's website is very basic, and although a number of people have visited it there is no scope for them to buy anything through the website.

Firm infrastructure:

The fixed costs relating to the shop premises have increased sharply over the last five years. This is likely to be a contributing factor to the fact that the business made a loss for the first time in the last year.

Human resource management:

There appear to be no succession plans in place for when the owners retire. Given that they have been running the business for over 30 years it is likely they will be approaching retirement age soon.

Technology development

The business has only recently set up a very basic website. As we have already noted, it does not have any e-commerce capabilities.

(b)

Note: A useful way of approaching this question would be to consider how the introduction of e-commerce will help address some of the weaknesses of GLS's operations which were identified in part (a), or to build on some of its existing strengths.

However note that, as in part (a), the question requires you to link your answer to the value chain, so it would be sensible to use value chain functions as headings for your answer.

Operations – The main impact of introducing e-commerce is that GLS is no longer reliant on its current shop as a physical site for their business. GLS will still need a site where it can store antiques, and it is likely to keep retain some kind of shop or showroom where the owners can make face-to-face sales. However, this can be moved to new, cheaper premises, for example an out-of-town location which should also be easier for antique traders to get to.

Outbound logistics – The new location should provide a more convenient base from which to distribute the antiques, and it should also help to reduce the insurance and security costs relating to storing the antiques.

Marketing and sales – e-commerce should increase the geographical reach of the business, and so should increase sales. Potential customers who previously couldn't visit GLS's shop (perhaps even international customers) can now search the website to look for items they may want to buy (and then also buy them online if they want to).

Firm infrastructure – The reduction in overheads and potential for increased sales should allow GLS to return to profit. The owners will also receive an injection of cash from the proceeds of the sale of the shop, which should cover the costs of the website upgrade.

Human resource management – Once the website is running, the owners will be able to reduce the opening hours of their 'bricks and mortar' shop, which will give them more opportunity to attend the antiques fairs which they have previously been unable to attend.

Technology – Once the website starts becoming a source of income for the business, then technology becomes a much more important aspect of its value chain. In effect, the website could become GLS's main 'shop'.

Procurement – As the website increases the geographical reach of GLS's customers, it may also mean that the supply of antiques into the business also increases as more and more people become aware of it.

Answer to Interactive question 2

WORKINGS

(1) Fixed production costs absorbed per unit $= \dfrac{\text{Budgeted fixed production costs}}{\text{Budgeted production}}$

$$= \frac{110{,}000}{2{,}200}$$

= CU50 per unit

Therefore full cost (absorption cost) per unit = CU50 + 70 = CU120

(2) **Under-/over-absorption of overheads**

	July	*August*
Actual production	2,000	2,500
Expected production	2,200	2,200
(Under-)/over-production	(200)	300
Fixed costs per unit	CU50	CU50
(Under-)/over-absorption	(CU10,000)	CU15,000

C H A P T E R 9

Income statements – absorption costing

	CU	July CU	CU	August CU
Sales (CU150 per unit)		225,000		450,000
Cost of sales:				
Opening inventory	Nil		60,000	
Production	240,000		300,000	
Less: closing inventory	(60,000)		Nil	
		(180,000)		(360,000)
Gross profit		45,000		90,000
(Under-)/over-absorption		(10,000)		15,000
		35,000		105,000

Income statements – marginal costing

	CU	July CU	CU	August CU
Sales		225,000		450,000
Cost of sales				
Opening inventory	Nil		35,000	
Production	140,000		175,000	
Less closing inventory	(35,000)		Nil	
		(105,000)		(210,000)
Contribution		120,000		240,000
Less fixed costs		(110,000)		(110,000)
Net profit		10,000		130,000

Difference in profits

	July CU	August CU	
Absorption cost profit	35,000	105,000	
(Increase)/decrease in inventory and fixed costs charged against sales	(25,000)	25,000	(500 × CU50)
Marginal cost profit	10,000	130,000	

Profits are different under each method due to the fixed costs that are included in closing inventory with absorption costing.

Answer to Interactive question 3

(a)

Overhead cost	*Cost driver*
Set up costs	Number of set ups
Materials handling costs	Number of times materials handled
Ordering costs	Number of orders
Engineering costs	Number of spare parts required

(b) Set-up costs per unit=

$$\frac{[(\text{Number of setups per product / Total number of setups}) \times \text{Total set up costs}]}{\text{Number of units produced}}$$

Alpha $= \dfrac{[(20/100) \times 25{,}000]}{500}$ = CU10.00/unit

Bravo $= \dfrac{[(15/100) \times 25{,}000]}{300}$ = CU12.50/unit

Echo $= \dfrac{[(30/100) \times 25{,}000]}{400}$ = CU18.75/unit

Oscar $= \dfrac{[(35/100) \times 25{,}000]}{200}$ = CU43.75/unit

Material handling costs per unit =

$$\frac{[(\text{Number of times mats handled per product / Total times mats handled}) \times \text{Total handling costs}]}{\text{Number of units produced}}$$

Alpha $= \dfrac{[(3/15) \times 69{,}000]}{500}$ = CU27.60/unit

Bravo = CU61.33/unit

Echo = CU23.00/unit

Oscar = CU138.00/unit

Ordering costs per unit = $\dfrac{[\text{No of orders per product / Total no of orders}) \times \text{Total ordering costs}]}{\text{Number of units produced}}$

Alpha $= \dfrac{[(11/64) \times 32{,}000]}{500}$ = CU11.00/unit

Bravo = CU20.00/unit

Echo = CU20.00/unit

Oscar = CU62.50/unit

Engineering costs/unit = $\dfrac{[(\text{No of spare parts per product / Total spare parts}) \times \text{Total engineering costs}]}{\text{Number of units produced}}$

Alpha $= \dfrac{[(15/60) \times 45{,}000]}{500}$ = CU22.50/unit

Bravo = CU50.00/unit

Echo = CU18.75/unit

Oscar = CU56.25/unit

Total cost per unit

	Alpha	*Bravo*	*Echo*	*Oscar*
	CU	CU	CU	CU
Direct costs:				
Material	60.00	42.00	80.00	100.00
Labour	32.00	20.00	35.00	50.00
Other costs:				
Set-up costs	10.00	12.50	18.75	43.75
Material handling costs	27.60	61.33	23.00	138.00
Ordering costs	11.00	20.00	20.00	62.50
Engineering costs	22.50	50.00	18.75	56.25
	163.10	205.83	195.50	450.50

Note: Remember to include the direct costs that were given in the question when calculating the total cost per unit. This is a common mistake in exam situations.

Answer to Interactive question 4

(a) Break even point = $\dfrac{\text{Total fixed costs}}{\text{Contribution / unit}} = \dfrac{425{,}000}{(55-25)}$ =14,167 pairs of roller skates

(b) Margin of safety = Current sales units – Break even sales units

= 20,000 – 14,167

= 5,833 pairs of roller skates (29%)

(c) Required sales revenue to ensure a profit of CU25,000: = $\dfrac{\text{Total fixed costs} + \text{Required profit}}{\text{Contribution ratio}}$

where:

Contribution ratio = $\dfrac{\text{Contribution per unit}}{\text{Selling price per unit}}$

$= \dfrac{(65-25)}{65}$

$= \dfrac{40}{65}$

Required sales revenue = $\dfrac{465{,}000 + 25{,}000}{(40\,/\,65)}$

= CU796,250

Answer to Interactive question 5

The first step is to calculate contribution per unit:

	McEnrova	*Grafassi*	*Federdal*
Total sales units	8,000	6,000	4,000
Total contribution (CU)	144,000	132,000	120,000
Contribution per unit	CU18	CU22	CU30

The lowest common denominator for the sales mix is 4:3:2.

Total contribution for the standard batch is CU198 (4 × CU18 + 3 × CU22 + 2 × CU30).

Break even point in batches = $\dfrac{306{,}900}{198}$ = 1,550 batches

The number of units of each model that must be sold in order to break even is:

McEnrova:	1,550 × 4	= 6,20
Grafassi:	1,550 × 3	= 4,65
Federdal:	1,550 × 2	= 3,10

The break even point in terms of sales revenue is:

	CU	
McEnrova	248,000	(CU40 × 6,200)
Grafassi	279,000	(CU60 × 4,650)
Federdal	310,000	(CU100 × 3,100)
	837,000	

Check:

	McEnrova	*Grafassi*	*Federdal*	*Total*
Sales units	6,200	4,650	3,100	
Contribution per unit	CU18	CU22	CU30	
Total contribution (CU)	111,600	102,300	93,000	306,900
Total fixed costs (CU)				306,900
Profit/(loss)				NIL

Answer to Interactive question 6

MEMORANDUM

To: Board members

From: Accountant

Subject: Purposes and benefits of an Management Information System

Date: [today's date]

KLL requires a new Management Information System to provide more detailed information on the various activities of the company. The existing MIS is limited in the information that it can provide, and the directors have identified additional information that would help them control and develop the business. This memo summarises the purposes and benefits that can be obtained from a modern Management Information System.

(a) **Purposes of a Management Information System**

A MIS is a system to convert data from internal and external sources into information and to communicate that information, in an appropriate form, to managers at all levels in all functions to enable them to make timely and effective decisions for planning, directing and controlling the activities for which they are responsible. The MIS is therefore established in a company to satisfy the information needs of management.

Within KLL, the directors will already be aware of this objective of a MIS because the company already has a MIS. The limitations of that MIS are now apparent, however, because activities cannot be split between those that are profit making and those that are loss making.

(b) **Benefits of a MIS**

The benefits of a MIS are summarised below, focusing particularly on the requirements of KLL.

(i) **Provision of financial information**

The existing MIS can provide some financial information, although the limitations of this information have been recognised by the directors. This limitation may well be a function of an older MIS being designed to produce specific reports rather than holding the data in some form of database and then different reports being generated from that data as required.

A new MIS should store data in a less rigorous format, enabling different reports to be produced as required. Details of profit and loss making sports can therefore be obtained.

(ii) **Provision of more timely information**

The current MIS produces reports on a monthly basis. It is not clear whether this is a system limitation or whether reports have not been requested on a more frequent basis. However, monitoring the profitability of individual sports activities may benefit from more frequent provision of information. For example if a competitor starts pricing activities below the price charged by KLL, then an immediate response will be required rather than waiting up to a month to amend prices.

A modern MIS should be able to provide information on a daily if not real time basis to enable the directors to make quicker and more effective decisions.

(iii) **Provision of summary information**

The managing director is concerned about the inappropriate level of detail being provided by the MIS. If the detail cannot be interpreted (per the question), then it is likely that the MIS is producing information at an operational level rather than a strategic or tactical level. The detail is available, but this has not been summarised appropriately. It is possible, for example, that income from individual games of squash can be seen, but not the total income for each court or for the sport squash itself for each week or month.

The new MIS will provide a summary of income initially, with the ability to provide more operational information as necessary using the 'drill down' ability of many information systems. Focusing the information at the strategic level first, rather than the operational, should provide the managing director with the appropriate level of detail.

(iv) **'Better' information**

The managing director is also concerned about the lack of 'good' information. This appears to be linked to the comment concerning the limited technical knowledge of staff and poor support from the software company. It is therefore possible that staff either have a lack of training in the use of the MIS or they are producing bespoke reports, and are not receiving the support from the supplier to help them do this. The board are not receiving good information because reports are not sufficiently focused on the activities of KLL.

Whether the situation actually needs a new MIS to resolve it remains unclear. It is possible that appropriate training or support would enable staff to provide the appropriate reports for the board. Alternatively, more recent MIS programs normally provide an easy-to-use report generator so staff should find it easier to produce the necessary reports.

Alternatively, data can be exported into a spreadsheet package for additional analysis and production of visual aids such as charts and graphs as necessary.

(v) **Staff morale**

Providing a new MIS will have other benefits for the company such as increased staff morale and a better working environment. Staff are likely to be more motivated because the company is providing the software that is needed to carry out their job.

Answer to Interactive question 7

(a) **CSFs and performance management** – PBB's CSFs should identify the areas which are central to its future success and therefore where it needs to perform well if it is to be successful overall.

CSFs and KPIs – Once PBB has identified which aspects of performance are crucial to future success, it needs to be able to **measure** how well it is performing in relation to them. It can use KPIs to measure whether or not its CSFs are being achieved.

Examples – So, for example, measuring the number of students who do not complete each year of a course, or measuring the percentage of students who drop out each year, will allow HHH to monitor student performance.

(b) **Improved student performance** – One of the aims of PBB's knowledge management strategy should be to gather, organise and share knowledge and experience about areas of its business which will contribute to its future success.

In this respect, if the staff in the departments that currently have high student drop-out rates can learn more about how to improve student performance, this should enable them to reduce the drop-out rates. In turn, this should allow the university to improve its performance in this area.

Reduce staff turnover – Currently PBB has an abnormally high level of staff turnover. Its staff turnover levels are double those of KLN, which has a culture of knowledge sharing.

Although there is no guarantee that introducing a knowledge management system will reduce staff turnover, if sharing knowledge helps improve performance this, in turn, should help improve the motivation and job satisfaction of PBB's staff. If staff value working for PBB because it is a successful organisation, this should help reduce staff turnover levels.

Increased collaboration between colleagues and departments – Currently very few of PBB's staff share knowledge with any of their colleagues. However, this lack of collaboration is likely to be stifling **innovation and creativity** within the university.

By contrast, if PBB implemented a knowledge management system, this should encourage staff to share ideas and experience with their colleagues, which in turn could lead to new opportunities for collaboration and innovation across the university. These should not only be focused on new opportunities for how to improve student performance, but could also extend into areas of academic research as well.

(c) **Data mining** – Data mining is concerned with analysing large pools of data to highlight previously unknown patterns and relationships in that data.

Predicting future behaviour – One of the key benefits which accrue from data mining is the ability to use the identified patterns and relationships to predict future behaviour. In PBB's case, the aspect of behaviour it wants to be able to predict is students dropping out of their courses.

Identify factors affecting drop-out rates – PBB could use data mining software to analyse data to try to identify which factors appear to be influencing student drop-out rates.

Because data mining software is designed to analyse large pools of data, PBB shouldn't be restricted to analysing only the performance of its own departments. It could also look at data for students in other Bangladeshi universities to see what factors appear to be affecting their drop-out rates.

Importantly, if PBB can get a better understanding of the issues which are causing students to drop out of their courses, it can then develop plans to address those issues and thereby hopefully improve student retention rates.

Preventing drop-outs – If PBB can identify, in advance, the groups of students which are most at risk of dropping out, it can then offer them additional support or guidance to try to prevent them dropping out of their courses.

For example, data mining might identify that foreign students who perform poorly in mock exams also fail their end of year exams and therefore cannot continue with their courses. In this case, action could be taken to offer extra tuition to students who fail their mock exams to help them improve their chances of passing their end of year exams.

Answers to Self-test

Answer to Self-test question 1

The current management accounting information provides a very detailed analysis of MMM's internal financial performance, but MMM does not appear to have any information about non-financial aspects of its performance, or any external information.

External information – It would be useful if the Board had additional information about MMM's market niche and its competitors, for example, about the size of the market, and MMM's share of that market.

Market size – MMM is currently unaware of the size of its market niche and whether or not that niche is growing. Information about the size of the market and the rate at which it is growing (or declining) will be very useful for MMM because it can help identify how much scope there is for it to grow as well.

Market share – The fact that MMM has to 'estimate' that it is the second or third largest company in its niche indicates that it doesn't accurately know the size of its competitors or its market share. However, this information would be useful not only for monitoring MMM's current performance, but also for evaluating possible future growth plans or strategies.

Basis of competition – MMM is not sure whether it is the high **quality** of its output or its **prices** which are most important in securing new clients. This lack of information about what its customer value makes it harder for MMM to determine what its most effective competitive strategy should be. If customers value the high quality of its output, a differentiation strategy would be appropriate; if customers are attracted by low prices, this suggests a cost leadership strategy could be more appropriate.

Competitor pricing – It seems that MMM does not compare its prices against the prices which its competitors are charging for similar jobs. Consequently, MMM's clients sometimes complain they have been charged too much, while on other occasions MMM feels it has charged too little. However, both of these examples suggest that MMM would benefit from being aware of its competitors' prices so that it can ensure that it sets its own prices at a competitive level.

Industry forecasts – MMM could also look at industry forecasts for the travel and tourism sectors as a whole. The levels of demand which the sector is expecting, and therefore how well hotels might expect to be performing, could affect how much they are prepared to pay for advertising, or are able to pay.

Costing methods – MMM's approach to pricing work for clients accentuates the internal focus of MMM's planning and decision-making, but it also helps to explain why there are concerns that MMM is charging too high or too low a price for items.

By adopting an inflexible approach to costing and pricing, MMM may be setting uncompetitive prices in relation to competitors' prices, or in relation to what its customers want. This again highlights the importance of MMM obtaining additional information about customers and competitors. For example, before setting a price for a client, MMM should try to find out what price the customer has paid for similar pieces of work previously, or what price competitors have charged for similar pieces of work.

Historical focus – An additional problem the Board faces is that the accountant's monthly figures appear to only show actual performance against budget.

Forecast – However, it would be useful if they also showed a **forecast**. This could allow the Board to highlight any shortfalls between the forecast position and their desired future position. In this way, if the forecast highlights any expected profit gaps, it could alert the Board that they need to plan for ways to reduce the gap.

Forecasting could also help with **human resources planning**. For example, forecasting could alert BBB to potentially busy periods when it would be beneficial for BBB to hire additional, freelance designers to satisfy the levels of demand.

Answer to Self-test question 2

(a) A customer profitability reporting system for FDS will presumably categorise customers into four types: farmers, local government bodies, sports centres and building contractors. It would be possible to have a project costing system whereby costs and revenues are attributed to individual projects, and the profitability of each category of customers would then be calculated as the total profits of all the projects for that customer type.

Sources of information

The revenue for each project can be found from the contract agreed with each the customer or from the invoices raised for the work done.

Direct costs

The information for the costs directly associated with each project should also be obtainable from internal sources.

(i) The cost of **materials** for each project would be recorded from the documents for requisitioning materials to the project, and materials would be priced either from inventory records or from purchase invoices from suppliers.

(ii) The cost of labour working on site for each project should be obtained from **time sheets** and payroll records.

(iii) The cost of plant hire from each project should be obtained from **invoices from plant hire companies**. If FDS owns its own plant, records should be kept of the use of the plant on each project and a charge for depreciation can be made to a project on the basis of the time that the plant is on the project site.

Overhead costs

To establish a customer profitability reporting system, it will probably be necessary for FDS to record some costs that in the past may have been accounted for as general overheads.

(i) The cost of the sales effort to win contracts should be recorded and charged to contracts. For customer profitability reporting, the cost of salesmen's time and expenses should include the cost of unsuccessful sales effort as well as successfully negotiated contracts. A system of recording time spent selling, and related expenses, will be required. Time sheets can be used to record time, and expense claims should indicate which expenses were incurred on particular projects or types of customer.

(ii) Irrigation systems presumably have to be planned, and some contracts are more complex than others. The time spent by planners on the design of the system for each contract should be recorded on time sheets.

(iii) Costs of delivering inventory to the customer's site should be recorded. The costs will include the time of drivers and their assistants, together with fuel costs. It is possible that an average cost per tonne-kilometre carried may be used as a standard delivery cost. This could be estimated from delivery records in the transport department. If external delivery firms are used to deliver inventory, invoices can be attributed directly to individual projects.

(iv) The cost of holding inventory may be considered a significant cost. If so, a cost of holding inventory can be calculated for each project from the cost of the inventory on site, the time from purchase of the inventory to payment by the customer, and an appropriate cost of interest or capital for FDS.

(v) If some maintenance costs are included within the price of a contract (for example if maintenance is provided free for a time after installation), maintenance times for engineers and any direct expenses should be recorded and charged to each contract.

(vi) If there are miscellaneous directly attributable costs to projects, a system may be required to capture this cost data and attribute it to individual projects or customer types.

(b) **Highlight differences in profitability** – The purpose of a customer profitability reporting system should be to provide information that will help management to monitor and control the profitability of contracts for each type of customer. However, this information will only have value if costs differ significantly between different types of customers.

It appears that farmers often negotiate lower prices than some other groups, which might initially suggest that the profitability of farming contracts will be lower than for other contracts.

However, negotiations with local government bodies may be lengthy and the contracts may be complex, suggesting that selling and planning times and costs may be high for this type of customer.

Equally for sports centres, there is often difficulty delivering materials to the customer's site which means that delivery costs of materials to site and costs of completing projects may be higher than for other types of customers.

Therefore, there is a degree of uncertainty about how profitable each type of contract actually is, if all the relevant costs are included. However, as the management accountant has suggested, it is important the FDS understands the profitability of different types of contracts; either so that it can focus its attention on the most profitable contracts, or so that it can increase the profitability of other types of contracts (for example, by reducing the level of discounts it is prepared to give to farmers).

Decision making – The potential differences in the profitability of different types of contracts become even more important as FDS gets closer to full capacity. FDS needs to ensure that it accepts the contracts which will generate the highest contributions to profit.

Of the three installations FDS has recently been asked to undertake, the 'Farm' installation generates a significantly lower contribution to profit than the 'Sports Centre' or the one for the 'Building Contractor.' This would suggest that FDS should not accept the 'Farm' contract.

	Sports centre	*Farm*	*Building contractor*
Discounted price ($)	192,000	190,000	194,000
Installation team costs	(84,000)	(75,000)	(67,500)
Additional delivery costs		(25,000)	
Contribution to profit ($)	108,000	90,000	126,500

Improved pricing – Better information about each type of customer may help FDS to price its contracts differently, or to resist demands for lower prices from farmers if profit margins on their contracts seem too low.

There is a shortage of skilled engineers for installation and maintenance; therefore, another possible use of customer profitability analysis is to make decisions about which type of contract should be preferred.

FDS might even introduce some kind of limiting factor analysis which looks at contract revenues and profitability in relation to engineer hours, so that preference (and more selling effort) can be given to the type of contract or customer which generates the highest profit per engineer hour.

(c) **Establishing costs**

The costs of establishing a system for measuring and reporting customer profitability are difficult to estimate. The costs of establishing the system can be estimated as the costs of the time of managers (including the management accountant) in designing and testing the system. There may be external software development costs that would be directly attributable to the system design.

The costs of operating the system would also be very difficult to measure since the data records would be originated by different individuals. If a cost or management accountant is employed to collect and input data and produce profitability reports, the cost of his or her time would be directly attributable.

Most of the costs of the information system would probably be 'lost' in general overheads, however, and the benefits of monitoring the costs are doubtful. The only significant decision affecting the cost of the system is whether the cost of developing and introducing the system is justified by the expected benefits.

Expected benefits

The benefits of the information system will depend on whether the profitability reports would be likely to affect decision-making by management. Specifically, would it affect decision-making about the pricing of contracts, or would it affect decisions about which projects to undertake when there is insufficient skilled engineers' time to meet all current demand?

If the potential benefits are considered significant, the performance measurement system should be introduced. Unfortunately, it will not be possible to estimate the benefits with certainty until after the system has been introduced.

Answer to Self-test question 3

(a) IT technology in supermarkets commonly uses bar codes to identify the products that are sold, and bar code readers enable a supermarket to monitor the quantities of items that it sells as well as to price them for customers. Bar code reader systems are therefore quite sophisticated.

Inventory tracking – Radio frequency ID systems replace bar codes with a chip, and the chip on each item of inventory can hold information in addition to product identification data. This means that RFID readers are able to detect where an item of inventory is at any time and can track inventory movements.

In the case of a supermarket such as CMA, RFID readers could track the movement of inventory from a central stores depot to a supermarket store room, from the store room to the shelves in the supermarket and from the shelves to the customer checkout.

Inventory management – In an industry where fast throughput of items is a critical aspect of success, the ability to monitor the movement of items in such detail, and the time between receiving stores items and selling them, may be of operational value by helping management to adjust purchasing and deliveries in order to speed up sales.

From an accounting perspective, RFID may also be used for inventory counts. An RFID reader can gather information about all the product items held in store at any time, without the need for detailed manual counting.

The additional benefit of having up-to-date **'real time' data** about inventory will depend on the company's management information systems. In principle, a company-wide IT system should be capable of comparing throughput times for different types of product, and comparing the operational performance of different supermarket outlets. The ability to locate stores items may help management to transfer items from where they are turning over slowly to where customer demand is stronger.

Operational performance – CMA's store managers are rightly concerned that the number of out-of-stock products appears to be rising.

This is a problem for two reasons:

- If an items is out-of-stock customers cannot buy it, and so this will reduce CMA's revenue (unless the customers find a direct replacement they are prepared to buy instead).
- If customers keep finding that the items they want to buy are out-of-stock they will stop shopping at CMA. This is potentially a bigger problem for CMA because not only will its revenue and market share fall as a direct result of the lost customers, but it could find it harder to recruit new customers if it develops a reputation for not having items in stock.

Reducing out-of-stock products – RFID tags should lead to fewer out-of-stock products. In turn, keeping CMA's shelves fully stocked should lead to increased sales and profits, and a more positive shopping experience for customers (leading to higher customer retention).

Inventory ordering – Because RFID technology provides real-time information it will enable CMA to manage its supply chain more efficiently, both between its stores and its warehouses, and from its stores back to suppliers.

Using RFID tagging, whenever a product is scanned through a till, inventory levels for that product are updated. However, perhaps more importantly, CMA could also use RFID tagging to inform product suppliers of sales and inventory levels. For example, CMA's RFID system could send inventory messages to suppliers whenever their products are scanned through its tills. In this way, the suppliers are aware of the up-to-date inventories at the stores and can ship additional products as necessary. (If CMA pursued this approach, it might be able to switch to a vendor management inventory relationship with its suppliers, which could be used to help improve product availability.)

However, for CMA to maximise the benefit it can get from using RFID in the short term, it will need its supplier to implement RFID technology on all the products they supply to it. It is not how many of CMA's suppliers can currently do this, or even whether it will be possible to tag all the products CMA sells (for example, fresh fruit and vegetables).

(b) **Integrated system** – The greatest value may be obtained from a new IT system by integrating it across the company. The same system should record data for and report on the performance of central inventory and distribution depots as well as individual supermarket outlets. The system should also record information about costs (which could be held within the data on RFID chips) and selling prices, so that information can be reported about gross profits of stores and product groups within each store. Unexplained losses (due to theft by customers) could also be monitored as a cost item.

Real time information – The system should also operate in real time, so that users of the system are able to access information they want at any time. Stores managers, for example, should be able to obtain information about sales and gross profits for the store, and then if required drill down for further information about the profitability of product ranges, or manufacturers' brands or even individual product items.

Similarly, rather than having to wait until the end of the month for summary performance reports, senior management could receive summary trading updates at the end of each day or week.

Dashboards and drill downs – At the moment, individual store accounts are prepared for each store and then presented to the store manager, alongside summary reports for the senior management team. It would be more useful for CMA if this information was available electronically, in a way that allowed managers to drill down from summary information to more detailed information for regions and then individual stores.

Having an integrated system in this way should help senior management make comparisons between different central inventory and distribution depots or between different supermarket outlets. Non-financial performance information (for example speed of product throughput) as well as financial information should be provided all within the same system.

The system should also include external data, although much of this may have to be input by the company's own staff. For example, employees who visit rival supermarkets to check competitors' prices should be able to insert their current prices into the system, so that supermarket managers and senior management can monitor competitive pricing and respond to rivals' price changes.

Data mining – The information that is gathered about product sales should also be used to extract sales data and analyse it to produce information that might help the company to improve sales further – such as information about what products sell well in different areas and at different times of the day, week or year. Data analysis can also be used to 'mine' for data about individual customers.

(c) **Identify buying habits** – In order to exploit data about individual customers, CMA needs to obtain data about a customer's buying habits. For online sales (for home delivery), the system identifies individual customers and it can prompt them to buy items (by presenting a list of the items they regularly buy as a pro-forma shopping list) or it can try to encourage them to buy more with discount vouchers.

Loyalty card schemes – For other customers, some supermarket groups use a loyalty card scheme. Customers who present their loyalty card at a store checkout may be awarded bonus points which eventually build up into money-off vouchers. The customer is identified through the loyalty card, and sales details are recorded by the check-out system. Through loyalty cards, supermarkets are able to gather data about what individual customers buy, how much they spend and when they do their buying. Offers to encourage customers to buy more can be related to the known buying preferences of the individual.

If required, a supermarket should be able to calculate the gross profit contributed each period by each 'loyal' customer. This may help the company to target particular types of customers who are more profitable than others.

CHAPTER 10

Human resource management

Introduction

Topic List

Summary and Self-test

Technical reference

Answers to Interactive questions

Answers to Self-test

Introduction

Learning objectives

Tick off

- Assess, explain and advise on the role of human resource management in implementing strategy ☐
- Demonstrate and explain how human resource management can contribute to business strategy ☐
- Identify the impact of remuneration structures on organisational behaviour and other aspects of human resource management, and show the corporate reporting consequences ☐
- Demonstrate and explain the role and impact of human resource management in change management ☐

Examination context and syllabus links

Human resource management (HRM) plays a vital role in underpinning strategy. Successful strategic implementation requires the effective recruitment, training and organisation of people, coupled with effective leadership and performance management. As with any other resources, it is crucial that an organisation's human resources are appropriate for the strategy it is pursuing.

There are a number of links between elements of this chapter and topics we have covered earlier in this Study Manual. In Chapter 3, we looked at organisational structure and noted that the leadership and management styles which are appropriate for an organisation will depend on the context of the organisation. This idea of contingency (obtaining a fit between an organisation's HR strategy and its business strategy) is an important strand of HRM.

Also, it is important that an organisation's remuneration and reward systems are aligned to the organisation's objectives and its critical success factors. For example, if highly-skilled employees are critical to an organisation's competitive success, then its reward system should be designed to try to retain these staff, rather than trying to keep staff costs as low as possible.

In Chapter 4 we looked at the relationship between employees' remuneration/reward and performance. Remuneration structures – and the impact they have on employee behaviour – are key issues within HRM, so there are close links between the performance measurement/management issues we discussed in Chapter 4 and those we will discuss in this chapter.

Aspects of HRM (such as setting performance objectives and measuring performance against objectives through methods like staff appraisal) also play an important role in the performance management and control of the organisation as a whole. In this respect, HRM follows a similar control model as is used for the overall strategic and operational control of an organisation.

More generally, employee performance is vital to the overall performance of most organisations (especially service organisations). Therefore HRM's role in leveraging people's capabilities is critical to achieving sustainable competitive advantage.

Change management, which we also discussed in Chapter 3, is another aspect of strategy implementation which has an important HRM element. For example, in order to manage change successfully an organisation will need to handle staff concerns about such change, and to ensure it has the appropriate number, and quality, of staff to operate effectively once the change has been introduced.

Models of HRM

In the course of this chapter, we refer to a number of models of human resource management. You will not be expected to discuss the theory of these models by name in your exam, but rather to apply the ideas in a practical context.

For example, Fombrun, Tichy and Devanna's model illustrates how HRM activities link together. One of the linkages it highlights is that between staff reward and performance. Therefore, if a question scenario indicates there are concerns around performance levels and the scenario also gives details of the reward system (eg performance targets and bonuses), you should consider whether the reward system is contributing to the problems in performance and, therefore, whether the reward system could be revised.

Similarly, Guest's model highlights the link between HRM and an organisation's performance (including its financial performance). So, again, if a question scenario highlights that an organisation's financial performance is deteriorating, you could use the ideas of the model as a general framework to assess how far staff issues might be contributing to the performance issues, and whether any changes to HRM practices might help improve overall performance.

In a similar vein, consider how the references to Theory X and Theory Y, and hard and soft approaches to HRM, could be relevant to a scenario. For example, if you are told a manager is trying to manage highly-skilled professional staff in an autocratic way without any scope for consultation, this should raise concerns. In effect, the manager is employing a 'hard' (Theory X) approach to deal with staff who are likely to respond much better to a 'soft' (Theory Y) approach.

1 Strategic human resource management (HRM)

1.1 Human resource management

Section overview

- HRM emphasises that employees are crucial to achieving sustainable competitive advantage, and that human resources practices need to be integrated with the corporate strategy.

The concept of human resource management and its goals were covered in the *Business Strategy* syllabus.

Human resources strategy involves two inter-related activities:

- Identifying the number and type of people needed by an organisation to enable it to meet its strategic business objectives
- Putting in place the programmes and initiatives to attract, develop and retain appropriate staff

Human resource management (HRM) includes all the activities management engage in to attract and retain employees, and to ensure that they perform at a high level and contribute to achieving organisational goals.

For some companies, particularly service companies, human resources may be a source of strategic advantage in their own right. After all, how many times are we told that a company's people are key assets?

Components of HRM

Within the overall aims of attracting and retaining employees, and ensuring they perform at a high level, we can identify five major components for an organisation's HRM systems:

- **Recruitment and selection** – Attracting and hiring new employees who have the ability, skills and experience to help an organisation achieve its goals.
- **Training and development –** To ensure that all staff develop the skills and abilities which will enable them to perform their jobs as effectively as possible in the present and in the future. In the context of knowledge management and learning organisations, the idea of learning and development should become increasingly important.
- **Performance appraisal and feedback** – Appraisals serve two different purposes in HRM: judgement (in order to make decisions about pay, promotion, and work responsibilities) and development (assessing employees' training and development needs, and supporting their performance).
- **Pay and benefits** – The level of pay and benefits offered to staff has to be appropriate to retain staff. By rewarding high-performing staff with pay rises, bonuses etc managers can increase the likelihood that an organisation's most valued human resources are motivated to continue their high levels of performance, and are more likely to stay with the organisation. Equally, offering attractive pay and benefits should help an organisation fill vacant positions with talented people.
- **Labour relations** – Labour relations encompass the steps that managers take to develop and maintain good working relations with unions that may represent their employees' interests.

The following short example highlights the importance of human resource management by examining the problems which can occur when staff are not motivated to help an organisation perform successfully.

Case example: British Airways and Heathrow Terminal 5

Terminal 5 at Heathrow airport opened its doors to passengers in March 2008 after more than 20 years in the making. The total cost of the building was CU4.3 billion.

Terminal 5 was used exclusively by British Airways, who had been planning for several years to move their existing operations from other terminals at Heathrow into Terminal 5.

However, the day before the opening of the terminal an article in the *Financial Times* reported British Airways executives' concerns about the high expectations which had been set for the new terminal, and the fact that it was 'beyond imagination to contemplate failure'.

Nonetheless, the first few days of operation in the terminal suffered significant problems. Over 300 flights scheduled to depart from Terminal 5 were cancelled, long queues formed at check-in and transfer desks, and about 28,000 passengers found themselves separated from their luggage. The immediate cost to British Airways (for example, in passenger compensation) was CU16 million, but the longer-term direct costs were estimated to be around CU150 million, and there were additional 'losses' resulting from damage to the airline's brand image.

A major reason, perhaps the main reason, for the problems was poor management of people. A major initial problem arose because the staff were not properly trained to use the equipment at Terminal 5, and were unprepared when it came to solving technical 'glitches' that quickly appeared once the baggage handling machinery started operating.

In addition, long delays were caused on the first day as a result of staff being unable to find the staff car park or to get through security screening on time. Later on, as flights began to arrive, staff simply failed to remove luggage quickly enough at the final unloading stage.

More generally, these issues were not helped by a long period of poor employment relationships at British Airways. Commentators reported that the airline's failure to deal with the fundamental problem of its employment relations was a major underlying cause of the Terminal 5 problems. An executive at Heathrow said the managers had been expecting an outbreak of 'f**k 'em disease' as the new terminal opened and some staff simply decided not to work very hard. British Airways' staff were neither committed to the success of the opening of the new terminal nor to their employer. Goodwill was in short supply, meaning that staff were intransigent and unco-operative when effort, enthusiasm and flexibility were all required.

Definition

Human resource management (HRM): 'A strategic and coherent approach to the management of an organisation's most valued assets: the people working there who individually and collectively contribute to the achievement of its objectives for sustainable competitive advantage.'
(Armstrong)

Human resource management (HRM): 'A strategic approach to managing employment relations which emphasises that leveraging people's capabilities is critical to achieving sustainable competitive advantage, this being achieved through a distinctive set of integrated employment policies, programmes and practices.'
(Bratton and Gold)

Figure 10.1 below, adapted from Fombrun, Tichy and Devanna's model of human resource management, is a useful way of illustrating how human resource management activities link together. Try to keep this diagram – and the linkages between the activities – in your mind as you read through this chapter and when answering a question about human resource management in your exam.

Remember also HRM's role in business strategy overall as illustrated by the definitions above.

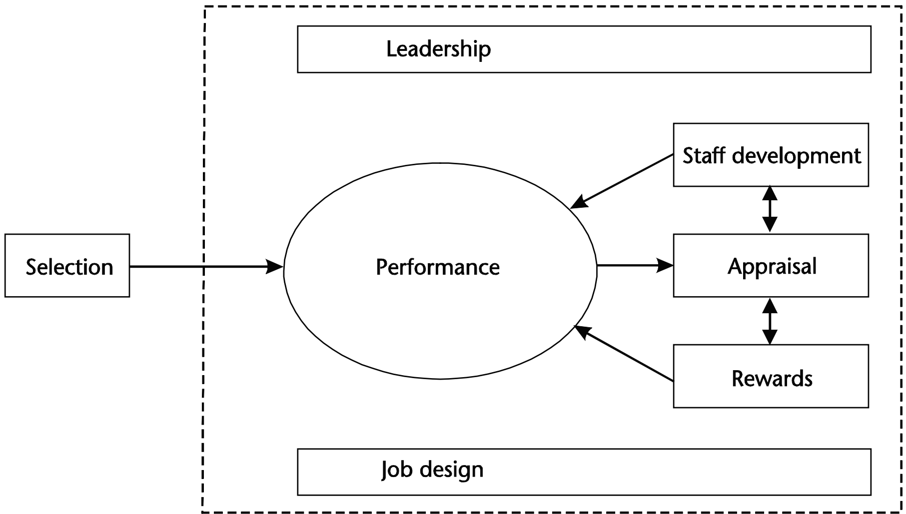


Figure 10.1: Elements of Human Resource Management (after Fombrun, Tichy & Devanna)

CHAPTER 10

1.1.1 Goals of strategic HRM

- Serve the **interests of management**, as opposed to employees
- Suggest a **strategic approach to personnel issues**
- Link **business mission to HR strategies**
- Enable **human resource development to add value** to products and services
- Gain **employees' commitment** to the organisation's values and goals

It is important to recognise that the HR strategy has to be related to the business strategy.

For many businesses, staff are key assets, and this reiterates the importance of HRM. HRM emphasises that employees are crucial to achieving sustainable competitive advantage, but also that human resources practices need to be integrated with the corporate strategy.

In this respect, it is important to understand the links between HRM and an organisation's ability to achieve its objectives and its critical success factors. For example, if an organisation identifies excellent customer service as a CSR, then its recruitment process, training, appraisal and reward systems should all be geared towards promoting customer-service skills in its staff.

Interactive question 1: Scantech [Difficulty level: Easy]

Scantech is a rapidly growing high-technology company which specialises in producing electronic scanners. It currently has 110 employees, but aims to double in size over the next three years. The company was set up by two researchers from a major university who now act as joint managing directors. However, they intend to leave ScanTech once the growth objectives are achieved and the company is large enough to be sold.

The sophisticated imaging devices which ScanTech makes are used by the airline security and health industries. These two markets are very different in terms of customer requirements, although they use the same basic technology.

In recent years, Scantech has seen a significant increase in sales from exports, and as a result its strategic plan anticipates a foreign manufacturing plant being set up within the next three years.

Scantech's current managers are all staff who joined in the early years of the company, and their primary expertise is in research and development. The future growth of the company will require additional staff in all parts of the business, particularly in manufacturing and sales and marketing.

Sue Franklin is HR manager at ScanTech. She is annoyed that HR is the one management function not involved in the strategic planning process shaping the future growth and direction of the company. She feels trapped in a role traditionally given to HR specialists – that of simply reacting to the staffing needs brought about by strategic decisions taken by other parts of the business. However, she feels that HR also has a strategic role to play in helping ScanTech deal with the challenges over the next three years.

Requirements

Discuss how a Human Resource plan could help support Scantech's growth strategy.

See **Answer** at the end of this chapter.

1.2 Roles of human resource management

Dave Ulrich has identified four elements of human resources (HR) activity within an organisation:

HR role	Elements of activity
Strategic partner	Aligning human resources with business strategy and business requirements Manpower planning Environmental monitoring
Administrative expert	Running the organisation's HR processes and 'shared services': - Payroll - Appraisal - Recruitment and selection - Internal communications

HR role	Elements of activity
Employee champion	Listening and responding to employees Providing resources and training to employees Conciliation Grievance procedures
Change agent	Managing transformation and change in the organisation Ensuring capacity for change and development in the organisation – for example, through management development and performance appraisal

However, it is important to recognise that these different roles are inter-reliant. For example, there is little point in trying to change an organisation's culture and structure from an 'individualist' to a 'team-based' approach without also providing training and changing reward procedures. For example, if performance appraisals still focus on individual results rather than team performance there will be little incentive to move towards a team-based approach.

The different elements highlighted in Ulrich's model identify that HRM is important at both a **strategic level** and an **operational level** within organisations, and also that it involves processes as well as people:

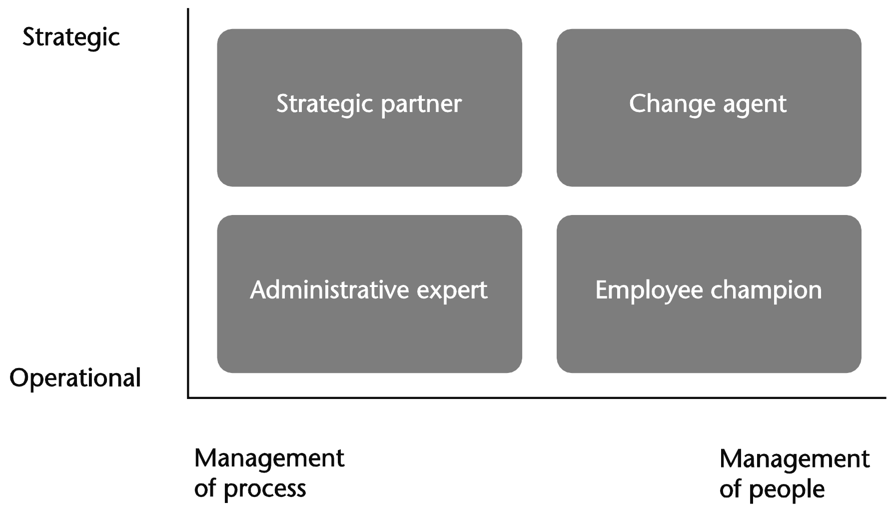


Figure 10.2: HR activities within organisations (based on Ulrich's model)

HRM and personnel management

It is important to distinguish between human resource management (as a strategic activity) and personnel management.

Personnel management deals with day-to-day issues such as hiring and firing, and industrial relations. Unlike HRM, it does not play a strategic role in an organisation.

1.3 Becoming an employer of choice

One area in which HRM can play a particularly important role in an organisation is helping it become an employer of choice.

Many organisations strive to become employers of choice. The status of being an 'employer of choice' implies that people will want to seek employment with the organisation and, once there, will contribute sustained high performance by remaining motivated and committed to the organisation.

For the employer, being an employer of choice should help to attract a high number of well-qualified, suitable and able candidates for any vacancies. Equally, if employees are committed to the organisation and its objectives, this should improve corporate performance and make it a good place to work.

2 The impact of HRM on business strategy

2.1 Approaches to HRM

Section overview

- HRM is based on the assumption that the management and deployment of staff is a key strategic factor in an organisation's competitive performance.
- However, to be successful, the HR strategies an organisation pursues need to be aligned to the organisation's overall business strategy.

Marchington and Wilkinson suggest that there are two main approaches to the relationship between business strategy and HRM strategy: the best fit (contingency) approach and the resource-based approach.

2.1.1 Best fit (contingency) approach to HRM

This approach suggests that HRM strategy needs to be relevant to, and supportive of, the business strategy. This means the strategies need to 'fit' with the internal and external contexts of the organisation.

So, for example, as an organisation moves through its life cycle, different HRM strategies become necessary to support the business strategies at each stage. Thus, HRM strategies are contingent on the life cycle stage.

Similarly, an organisation's HRM strategy will be dependent on its competitive strategy – whether it is pursuing a cost leadership or differentiation approach.

2.1.2 Resource-based approach to HRM

The resource-based approach takes the opposite perspective.

The best-fit approach argues that HRM must be flexed to align an organisation with outside factors in order to deliver effective performance. But the resource-based approach argues that HR activity itself can be strategic, and activities such as training and development can directly influence organisational performance. Therefore HRM can be used strategically in its own right as one of the resources available to an organisation.

In this way, the resource-based approach to HRM encourages organisations to identify those parts of the workforce which have the greatest impact on performance, and then focus attention on how those staff should be used within the organisation (for example, if there is any need to change processes or practices to increase the value they can add to the organisation).

The resource-based approach also encourages organisations to look at the ways inter-personal and team relationships develop within the organisation, and how this can affect performance. In effect, this also highlights the importance of 'culture' in an organisation, helping staff to work productively and efficiently.

Importantly, however, the resource-based approach does not contend that HRM strategy should only consider factors internal to an organisation. There is still a need to consider influences outside an organisation, and how they can affect HRM strategy: for example, education levels, and economic conditions in a country.

2.1.3 Guest's model of HRM

David Guest has also developed a model which aims to show the link between HRM and organisational performance, and how developing an integrated set of HRM practices can improve the performance of individual staff and, in turn, the organisation as a whole.

Guest's model acknowledges the link between HR strategy and general business strategies. However, the central hypothesis of the model is that HR practices should be designed to lead to HRM outcomes of **high employee commitment, high quality** and **flexible employees**.

High employee commitment is seen as a critical HR outcome because it is concerned with the goals of binding employees to the organisation and obtaining behavioural outcomes of increased effort, co-operation and organisational citizenship.

Quality highlights that employee behaviour has a direct impact on the quality of goods and services. Flexibility is concerned with employees' receptiveness to innovation and change.

The right-hand side of the model focuses on the link between HR practices and performance. A critical assumption in Guest's model is that only when all three HR outcomes – commitment, quality and flexibility – are achieved can an organisation expect to generate superior performance outcomes (both financially and non-financially).

Guest's six components					
ℵ **HRM strategy**	ℑ **HRM practices**	ℜ **HRM outcomes**	℘ **Behavioural outcomes**	⊗ **Performance outcomes**	⊕ **Financial outcomes**
Differentiation (innovation) Focus (quality) Cost (cost reduction)	Selection Training Appraisal Rewards Job redesign Involvement Status and security	Commitment Quality Flexibility	Effort Motivation Co-operation Involvement Organisational citizenship	*High:* Productivity Quality Innovation *Low:* Absenteeism Employee turnover Conflict Customer complaints	Profits Return on investment

2.2 Human resources and generic strategies

As Guest's model acknowledges, there is a close link between HR strategy and overall business strategy.

The generic business strategy which an organisation pursues is likely to have a significant impact on human resources management.

For example:

- Cost leadership is often to be associated with terms such as: Theory X (autocratic) management, role culture, tall narrow organisational structures, task specialisation, close direction and control, repetitive tasks, and top-down information flows.
- Differentiation is often to be associated with terms such as: Theory Y (participative) management, task culture, wide flat organisational structure, multi-skilled employees, autonomy and self direction, unique and creative tasks, and multi-directional information flows.

The contrast between Theory X and Theory Y can also be illustrated by the contrast between 'hard' and 'soft' approaches to HRM:

Issue	Hard	Soft
Goals	Meet organisational objectives Workers are a resource to use to achieve those objectives	Develop human resources as asset Workers are valuable to a company as assets
Behavioural assumption	Theory X Financial focus on wages (emphasis on gaining work efficiencies)	Theory Y Develop employees
Management style	Imposed, top-down Tell workers what to do	Consultative, participative Listen to employees' views, and encourage involvement and commitment

Issue	Hard	Soft
Training and development	Training only given to meet needs of current position, in order to fully utilise labour resources	HRM is about developing resourceful people; personal development as well as career development are encouraged
Organisational structure	Centralised	Devolved, delegation, autonomy

As we will see later in this chapter, the system of rewards management and remuneration used by an organisation will also vary according to the nature of its business and the generic strategy it is employs.

2.3 Human resources and Porter's five forces analysis

Human resources can play an important role in reducing the adverse effect of the five forces for an existing member of the industry. Some forces are more susceptible to human resources management than others.

Barriers to entry

To enter an industry, an organisation needs staff of the right quality, ability and cost. Assuming that entry is not achieved by takeover, then almost certainly recruitment will be required, and this can be difficult if there is a shortage of suitable candidates either already trained or wanting to train. Increasingly, many industries have a higher technical content in their jobs today and more qualified employees are therefore needed. Additionally, many economies have moved from manufacturing to service industries and, because more employees have dealings with customers, employees with better interpersonal skills might be needed. Remember, if a poor product is manufactured it can be identified through the quality assurance process. Poor service is often delivered instantly and can cause immediate damage to customer relations.

Suppliers

Supplier power can derive from various factors such as the number of suppliers in the market, how specialised their goods are, geographical proximity and the fact that the organisation requires goods of a certain standard in a certain time.

Human resources management can help to erode supplier power by ensuring that buyers have comprehensive knowledge about suppliers and their products and have good negotiating skills. Additionally, partnership sourcing is becoming more common. This is where a purchaser and supplier build a long-term relationship involving mutual trust and recognise that they need each other if they are to be successful. (This builds on the ideas of supply chain management and networks we have considered earlier in this Study Manual.)

Bargaining power of customers

The bargaining power of customers is high if there are only a few of them and each buys a large quantity, and also if customers buy mainly on price. The bargaining power of customers can be reduced by finding more customers and by trying to lock in all customers. HR, for example through suitable training, can do this by:

(a) Raising switching costs in both cash terms, and in terms of operational inconvenience. An example is where staff provide exceptionally good service, or design, manufacturing and despatch are excellent. If a customer is looked after well, there will be a reluctance to switch to a new supplier. Even if the new supplier is not worse, there will be a period of disruption until the new supplier provides exactly what the customer wants. Therefore the recruitment, training and retention of good staff will help to retain customers.

(b) Finding more customers. Recruitment of and training a good sales team and, increasingly, the establishment of a good internet site (again often dependent on recruiting skilled people) are essential for this.

Rivalry/competition

Winning over competitors depends on the nature of the competition. For example, winning a cost leadership battle depends on keeping costs down, and winning a differentiation battle depends on producing goods and services that are really appreciated by customers. Appropriate human resources management techniques will help with these objectives. Cost levels will be affected by wage levels, recruitment and training. Differentiation will be affected by recruiting talented people and managing them in an appropriate way.

Substitutes

The emergence of substitute products and services is difficult to predict. Substitutes are often caused by technological breakthroughs. For example, mobile phones are a substitute for fixed line phones. Human resources management can, however, play important roles as follows:

(a) The adoption of substitutes. For example, it can be argued that cheap airlines have become a substitute for some car and train journeys. If an airline wants to win part of that type of business it will have to adopt HR policies that are consistent with the cheap airline model with regards to wages, job flexibility and working hours.

(b) The invention of substitutes. The marketing, research and development and production departments can all contribute here. Recruiting and developing creative people in an environment conducive to conceiving new products and services is vital.

2.4 HR implications of business strategy

When looking at strategic decisions an organisation is considering, it may initially seem as if they do not have much to do with HRM. However, this is not the case. Almost all objectives, and almost every issue facing an organisation, have HRM implications.

The following tables illustrate this in two simple examples:

Business strategy – *to grow market share in a new country*

Area of HRM	Application to scenario
Organisation and culture	New sales team needed, based in the country
Recruitment and selection	Recruit local sales people Appoint experienced international manager
Training and development	Sales training Cultural awareness of the new country
Pay and benefits	Local packages, salary and benefits

Strategic issue – *reducing the number of customer complaints in a retail store*

Area of HRM	Application to scenario
Organisation and culture	Assess general culture towards customers Analyse complaints to see if caused by organisational process inefficiencies (such as stock-outs) or by staff issues Are there conflicts between the needs and objectives of individual stores vs head office targets? Are jobs suitably designed?
Recruitment and selection	Are there sufficient staff in the store? Are shift patterns appropriate?
Learning and development	Is any customer-focused training required? Is any other personal skills training needed for in-store staff?
Communications and employee relations	Ensure all staff are aware of the volume and reasons for customer complaints Institute 'service quality' groups
Pay and benefits	Are rewards a source of employee dissatisfaction? Could there be an element of performance related pay, based on customer feedback?
HR policies	Review why staff leave Are any policies (such as overtime requirements, shift patterns) a source of discontent?

Interactive question 2: Financial Service companies [Difficulty level: Intermediate]

Since the beginning of the 1990s financial services institutions (eg banks and insurance companies) have pursued the following business strategies:

- Shift to telephone and internet-based servicing of customer accounts, leading to reductions in the total number of High Street branches
- Expansion in range of financial products offered at branches
- Introduction of 'customer service ethos' with emphasis on providing advice and selling products while increasing reliance on electronic technologies to handle routine transactions
- Increasing use of 'off-shore' call centres and transactions processing centres

Requirement

What impact would these changes have had for the following factors?

- Forecast human resource demand
- Forecast human resource supply
- Training and development
- External recruitment

See **Answer** at the end of this chapter.

2.5 Human resources and the knowledge economy

A knowledge economy is one in which knowledge is the prime source of competitive advantage. Remember, the source of competitive advantage is either cost leadership or differentiation (each with or without focus). Examples of businesses in the knowledge economy include:

- Engineering, such as Rolls-Royce jet engines. The engines are the result of very advanced research, design, development, testing and incremental modification.
- Software, such as Autonomy Corporation Ltd. This company specialises in pattern recognition: speech, faces, and car licence plates.
- Hardware, such as Apple Inc. The invention and design of new concepts and knowing how to produce them (mainly by sub-contracting to suitable companies) reliably and efficiently.
- Biotechnology, such as GlaxoSmithKline Ltd and the development of new pharmaceuticals.

The knowledge economy poses the following challenges to human resources managers:

- Finding and recruiting enough people with the right skills. The skills and abilities required can be very high and very scarce.
- Providing an environment in which employees' skills and abilities are used to their maximum potential.
- Motivating and developing employees.
- Retaining employees. When an employee leaves, valuable knowledge can be lost and can be transferred to a competitor business.

2.6 The human resource cycle

In Section 1 of this chapter, we looked at Fombrun *et al*'s model of the human resource cycle (Figure 10.1) but that model can be adapted to show HR planning, which is a key element of the human resource cycle:

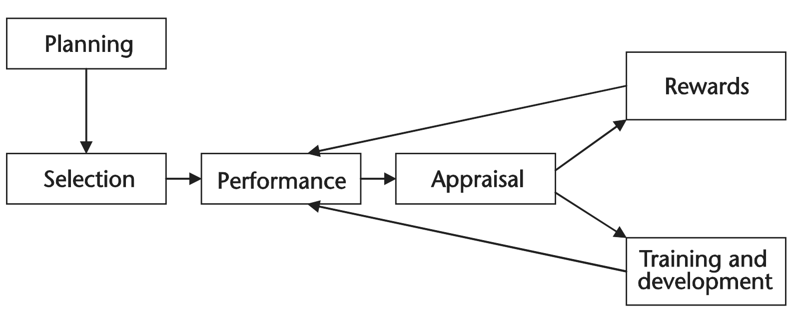


Figure 10.3: HRM and HR planning

Human resource planning

Human resource planning must link back to the organisation's strategic plan. The number of staff needed with given skills will depend on business plans (for example, any plans to develop new products, or expand into new markets); the skills needed might depend on whether strategic advantage relies on cost leadership or differentiation.

Personnel information systems can be of great help at this stage, if not essential, because these systems should hold information about current employees and their skills and be able to predict how many employees might be needed in the future.

For example, assume that every branch of an organisation requires, ideally, one manager, two sales people, three part-qualified engineers and two qualified engineers. If the strategic plan says that 20 new branches are to be opened in the next three years, then the personnel information system can compare current numbers of personnel who have appropriate skills with the number that will be needed after three years. The personnel information system will also be able to identify any current employees who are due to retire, estimate the number who might leave, forecast how many part-qualified engineers should attain full qualification and also how many employees might achieve management status. From these calculations a recruitment and development budget can be identified.

	Managers	*Sales personnel*	*Part-qualified engineers*	*Qualified engineers*
Current Employees (100 branches)	100	190	310	195
Due to retire	(5)	(1)	0	0
Estimated leavers	(10)	(30)	(25)	(70)
Promotion			(100)	100
	85	159	185	225
Employees needed (120 Branches)	120	240	360	240
To be recruited	**35**	**81**	**175**	**15**

HRM and Gap analysis

In the context of business strategy, we have seen that managers can use gap analysis to identify gaps between forecast performance and target performance, with a view to finding new markets, launching new products or finding other ways to close the gap.

However, the idea of gap analysis can also be applied to human resources, as in the example above. The example shows that there is a shortfall between the future forecast number of engineers (if no additional recruitment takes place) and the number of engineers who will be needed to support the organisation's planned branch openings. In turn, this identifies the number of additional engineers who need to be recruited as a result of the planned openings.

An alternative approach to filling a resource gap would be to consider whether some jobs which are currently done manually could be automated. In this way, an organisation might be able to use IT as a substitute for labour to overcome a staffing resource constraint.

Skills gap

Instead of looking purely at the numbers of people employed, organisations also need to consider whether their staff members have the skill sets necessary to deliver a strategy. If there is a 'gap' between the current skill set of a person or group compared to the required skill set, this represents a skill gap. A strategy then needs to be devised to mitigate that gap; for example, by training staff to use a new software program.

2.6.1 The impact of increased job mobility on HR planning

Historically, many employees looked for 'a job for life' and low employee turnover was expected. That pattern still exists in some economies, such as Japan, but in many countries moving from job to job, gaining skills as you go, is the norm. If more people leave, then there is a greater burden on recruitment to replace them. Furthermore, unless the organisation's knowledge management has been successful, people leaving take with them valuable knowledge and this impoverishes the organisation.

2.7 HR planning – overview

HR planning should be based on the organisation's strategic planning processes, with relation to analysis of the labour market (internal and external), forecasting of the external supply and internal demand for labour, job analysis and plan implementation.

Human resource planning concerns the acquisition, utilisation, development and return of an enterprise's human resources. HR planning may sometimes be referred to as 'workforce planning' or 'workforce strategy'. Human resource planning involves:

- Budgeting and cost control
- Recruitment
- Retention (company loyalty, to retain skills and reduce staff turnover)
- Downsizing (reducing staff numbers)
- Training and retraining to enhance the skills base
- Dealing with changing circumstances

Human resources are hard to predict and control:

(a) **Demand.** Environmental factors (eg the economy) create uncertainties in the demand for labour.

Estimating demand: Planning future HR needs requires accurate forecasts of turnover and productivity (eg if fewer staff are required for the same output). The demand can be estimated from:

- Expansion plans in the current market. For example, growing market share from 18% to 22%
- Expansion plans to enter new markets. For example, starting activities abroad
- The possibility of withdrawing from markets
- New products and services to be launched
- Technology changes such as automation and process innovation
- The need to gain efficiencies and cost savings
- Generic strategy – cost leadership or differentiation
- The possibility of relocation
- The possibility of outsourcing some of the organisation's functions
- The shape of the organisation (eg tall-narrow or wide-flat) will determine the amount of supervision that is possible and this will have implications for the type of employees needed

(b) **Supply.** Factors such as education or the demands of competitors for labour create uncertainties in the supply of labour.

The available **supply** of labour, competences and productivity levels may be forecast by considering internal and external factors.

Internal factors

- The competences, skills, trainability, flexibility and current productivity level of the existing work force
- The structure of the existing workforce in terms of age distribution, skills, hours of work, rates of pay and so on
- The likelihood of changes to the productivity, size and structure of the workforce

External factors

The present and potential future supply of relevant skilled labour in the **external labour market** will be influenced by a range of factors. These include general economic conditions, government policy and actions and the changing nature of work. In addition, the HR planner will have to assess and monitor factors such as those given below:

- **Skill availability**: locally, nationally and also internationally: labour mobility throughout the world has had a major influence on Bangladesh work force, for example.
- **Changes in skill availability**, due to education and training trends, resources and initiatives (or lack of these), and rising unemployment (worker availability) due to economic recession.

- **Competitor activity**, which may absorb more (or less) of the available skill pool.
- **Demographic changes**: areas of population growth and decline, the proportion of younger or older people in the workforce in a particular region, the number of women in the workforce and so on.
- **Wage and salary rates** in the market for particular jobs. ('Supply' implies availability: labour resources may become more or less affordable by the organisation).

(c) **Goals.** Employees have their own personal goals, and make their own decisions about whether to undertake further training. When large numbers of individuals are involved, the pattern of behaviour which emerges in response to any change in strategy may be hard to predict. There can sometimes be powerful resistance to change.

(d) **Constraints.** Legislation as well as social and ethical values constrain the ways in which human resources are used, controlled, replaced and paid.

1. STRATEGIC ANALYSIS
- of the environment
- of the organisation's employees' strengths and weaknesses, and the opportunities and threats facing the organisation
- of the organisation's use of employees
- of the organisation's objectives

↓

2. FORECASTING
- of internal demand and supply
- of external supply

↓

3. JOB ANALYSIS
- investigating the tasks performed in each job
- identifying the skills required

↓

4. RECRUITMENT AND TRAINING
- recruiting and selecting required staff
- training and developing existing staff
- redeployment
- redundancies

Figure 10.4: Stages of HR Planning

Case example: Tesco

Tesco enjoyed continuous revenue growth for a number of years until 2012 and during these years of growth it needed to recruit staff on a regular basis for both the food and non-food parts of its business. For example, in 2008/09 4,000 new managers were required to support business growth. Tesco regards workforce planning as vital for the company.

Tesco identifies three main causes for vacancy creation:

- Opening new stores in the UK and internationally
- Retirement, resignation and internal promotion
- The creation of new types of jobs due to changes in processes and developments in technology

Tesco uses a workforce planning table to establish the likely demand for new staff. This considers both managerial and non-managerial positions.

This planning process runs each year from the last week in February. There are quarterly reviews in May, August and November, so Tesco can adjust staffing levels and recruit where necessary. This allows Tesco sufficient time and flexibility to meet its demands for staff and allows the company to meet its strategic objectives, for example, to open new stores and maintain customer service standards.

Tesco seeks to fill many vacancies from within the company. It recognises the importance of motivating its staff to progress their careers with the company. Tesco practises what it calls 'talent planning'. This encourages people to work their way up in the organisation. Through an annual appraisal scheme, individuals can apply for 'bigger' jobs. Employees identify roles in which they would like to develop their careers with Tesco. Their manager sets out the technical skills, competencies and behaviours necessary for these roles, what training this will require and how long it will take the person to be ready for the job. This helps Tesco to achieve its business objectives and employees to achieve their personal and career objectives.

Points to note based on the process of human resource planning:

HR strengths and weaknesses – An organisation's HR strengths and weaknesses need to be analysed so as to identify skills and competence gaps. HR planning is important not simply for analysing overall numbers of staff, but also for looking at the mix of skills within the workforce. While headcount numbers are always likely to be a concern, it is equally important to consider whether the current workforce has the skills and attitudes required to sustain organisational success in the future.

Efficiency – An organisation needs to know how effectively it is using its staff (for example, utilisation statistics, idle time). If staff are currently not fully utilised, how far can future growth be staffed by the existing staff, rather than having to recruit additional staff?

Timescale – If an organisation can identify a 'gap' in advance, this will allow recruitment and training to be planned in advance. However, an unplanned 'gap' which needs filling immediately will require instant recruitment.

The importance of human resource planning

It is arguable that forecasting staff and skill requirements has become more difficult in recent times because of the increasing uncertainty and rate of change in the business environment. However, it has also arguably become more necessary, because the risks of 'getting it wrong' (particularly in an era of global economic recession) are correspondingly greater.

In this respect, human resource planning can be seen as a form of **risk management**. It involves realistically appraising the present and anticipating the future (as far as possible) in order to get the **right people** into the **right jobs** at the **right time** and managing employee behaviour, organisational culture and systems in order to **maximise the human resource** in response to anticipated opportunities and threats.

An attempt to look beyond the present and short-term future, and to prepare for contingencies, is increasingly important. Some manifestations of this are outlined below.

(a) Jobs in innovative and fast-changing contexts may require experience and skills which cannot easily be bought in the market place, and the more complex the organisation, the more difficult it will be to supply or replace highly specialised staff. The need will have to be anticipated in time to initiate the required development programmes. The decline of the 'job for life' and the common desire to gain wide and rounded experience have contributed to higher rates of employee attrition. Leavers must be replaced with suitable staff. At senior levels, succession planning should identify potential replacements, internal or external, for those expected to retire or simply move on.

(b) Employment protection legislation and increasing public demand for corporate social responsibility make downsizing, redeploying and relocating staff (eg in response to economic recession) a slow and costly process.

(c) Rapid technological change is leading to a requirement for human resources that are both more highly skilled and more adaptable. Labour flexibility is a major issue, and means that the career development and retraining **potential** of staff is at least as important as their actual qualifications and skills. Thus, 'trainability' is now a major criterion for selection.

(d) Organisations that differentiate themselves in the market through superior customer service or other people-related activities need to place people at the centre of their corporate strategy. If their people are to be the difference they need to invest time and effort in finding and developing the right ones.

(e) The scope and variety of markets, competition and labour resources are continually increased by environmental factors such as the expansion of the European Union, the globalisation of business and the explosive growth of e-commerce.

(f) Information and Communication Technology (ICT) has made available techniques which facilitate the monitoring and planning of human resources over fairly long time spans: accessing of demographic and employment statistics, trend analysis, 'modelling' of different scenarios and variables, and so on.

(g) Labour costs are a major proportion of total costs in many industries and must be carefully controlled. Cost control action will involve carefully planned remuneration schemes, strict control of headcount and avoidance of waste in such forms as over-staffing and unnecessary activity. Business process re-engineering and the de-skilling of jobs may lead to redundancies, especially among over-qualified staff.

Armstrong sums up the aims of human resource planning as follows:

(a) To attract and retain the number of people required with the necessary skills, expertise and competences

(b) To anticipate potential surpluses or shortfalls which will need to be adjusted

(c) To develop a well-trained and flexible workforce which will support organisational adaptation to external changes and demands

(d) To reduce dependence on external recruitment to meet key skill shortages (by formulating retention and development strategies)

(e) To improve the utilisation of people (most notably by developing flexible working systems)

2.8 Flexible workforces and network organisations

It has been suggested that **long-range, detailed people planning** is a necessary form of risk management, preparing businesses for foreseeable contingencies. However, there has been some disillusionment about the feasibility and value of such planning, given the rapidly evolving and uncertain business environment and the kinds of **highly flexible organisational structures** and cultures that have been designed to respond to it.

(a) The trend in **organisation and job design** is towards functional feasibility (multi-skilling), team working, decentralisation (or empowerment) and flexibly-structured workforces to facilitate flexible deployment of labour.

(b) However, perhaps the most significant change in organisation structure has come from the growth of **network organisations** or **virtual organisations**, with the increased use of freelance or contract workers in place of full-time employed staff.

In this way, the role of HRM is to ensure that the appropriate people are brought together to complete a specific project or task. For example, the workforce could be made up of freelance workers who sell their services to a variety of organisations and work for them on a project by project basis.

However, such a model fundamentally changes the nature of job vacancies, compared to a model in which organisations employ staff on a full-time basis.

2.9 Remote working (Home working)

Another significant development in the way workforces are structured has been the increasing number of remote workers or home workers.

An important factor in the development of remote working is the beneficial impact it can have on employees' work-life balance. Employees value the time and money savings which remote working offers them, compared to having to commute to work. Some employees may also value the autonomy and independence which working at home affords them. Since companies have increasingly recognised the importance of attracting and retaining talented staff, they have also realised the need to offer staff flexibility in their working arrangements.

Remote working could also improve productivity. On the one hand, if remote working leads to higher job satisfaction, higher retention and lower absenteeism, these factors could contribute to increased productivity. On the other hand, remote workers could also be more productive than 'office-based' colleagues because they are able to work without interruption, for example, from office meetings.

Nevertheless, while some employees value remote working, others may not want to work at home; for example, because they feel it isolates them from colleagues and shared knowledge; or because they would prefer to keep their 'private' lives separate from their 'work' lives.

IT and remote working

Developments in technology have been crucial in facilitating the growth of home working. For example, remote workers need a laptop or personal computer, with reliable internet access, and secure remote access to a company's internal networks and internal messaging systems (eg sharepoints) in order to work from home effectively.

Video-conferencing (for example, through Skype or Google Video Chat) can also be valuable for contacting remote employees, particularly in relation to important matters which it may not be appropriate to discuss by email.

In general, technology has been essential for the development of remote working, because it provides opportunities for exchanges of information between employees working remotely and their colleagues or managers in a different location.

Communication and remote working

Nonetheless, poor workplace communication is often seen as the biggest disadvantage of remote working. In this respect, the growth of remote working presents new issues for managers in relation to managing staff.

Socialisation and relationship building are important aspects for helping remote employees to feel included within an organisation. As such, managers' communication skills and relationship building skills will be important in ensuring that remote workers do not feel isolated. Whilst many remote workers value the greater independence which they gain from working at home, it remains important for managers to communicate regularly with these workers in order to build trust and to maintain a relationship with them.

Equally, managers will need to provide the employees with clear goals and expectations for their work, as for any other employee in the company. In order to manage remote employees effectively, managers should adopt a 'management by objectives' approach, as opposed to managing by observation. This will involve setting goals and action plans, and then evaluating employees' performance based on the outputs or results.

2.10 The people plan

Once the analysis of human resource requirements has been carried out, and the various options for fulfilling them considered, the **people plan** will be drawn up. This may be done at a strategic level. It will also involve tactical plans and action plans for various measures, according to the strategy that has been chosen. Typical elements might include the following.

(a) **The resourcing plan**: approaches to obtaining skills/people within the organisation, and by external recruitment

(b) **The internal resource plan**: availability of skills within the organisation; plans to promote/redeploy/develop

(c) **The recruitment plan:** numbers and types of people, and when required; sources of candidates; the recruitment programme; desired 'employer brand' and/or recruitment incentives

(d) **The training plan:** numbers of trainees required and/or existing staff who need training; training programme

(e) **The re-development plan:** programmes for transferring or retraining employees

(f) **The flexibility plan**: plans to use part-time workers, job-sharing, home-working, outsourcing, flexible hours arrangements and so on

(g) **The productivity plan:** programmes for improving productivity, or reducing manpower costs; setting productivity targets

(h) **The downsizing plan:** natural wastage forecasts; where and when redundancies are to occur; policies for selection and declaration of redundancies; redevelopment, retraining or relocation of employees; policy on redundancy payments, union consultation and so on

(i) **The retention plan:** actions to reduce avoidable labour wastage

The plan should include budgets, targets and standards. It should allocate responsibilities for implementation and control (reporting, monitoring achievement against plan).

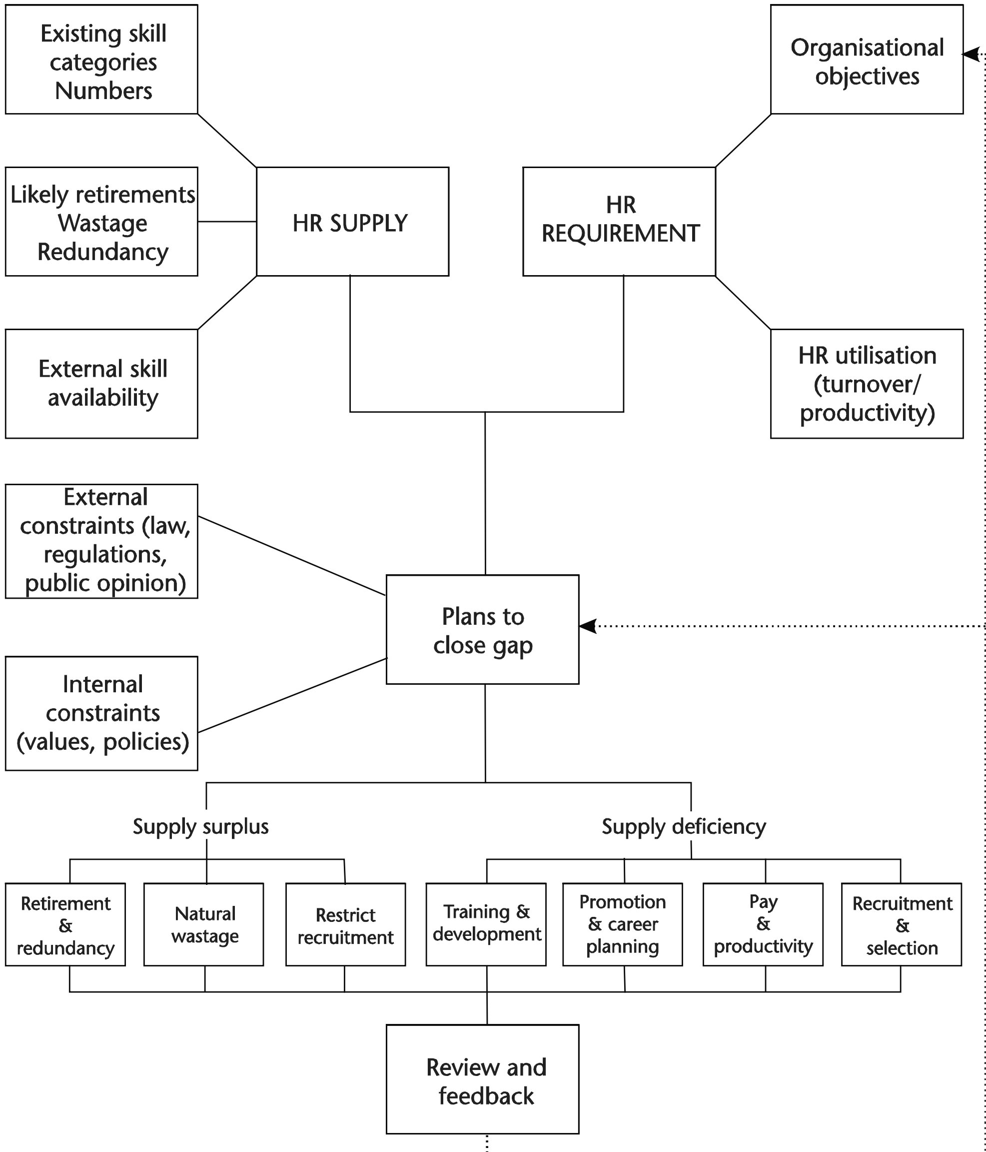


Figure 10.5 HR planning and the people plan

Case example: Human resource planning in action

Singapore Airlines

Corporate strategy

Singapore Airlines (SIA) is generally regarded as a brand leader in the aviation industry, and has managed to maintain this status for over 20 years. It is considered to have three main aspects to its strategy:

(a) Excellent service
(b) Continuous innovation
(c) Technology superiority

The first aspect, service excellence, is of particular interest to Human Resources professionals. The market differentiator that SIA aims to achieve is the passenger service delivered by the cabin crew, the topic this section will mostly focus on.

The second aspect is continuous innovation. SIA were the first airlines to introduce the personal entertainment system and video-on-demand for every seat.

The third aspect is the use of new airplanes. By using newer planes SIA is able to have both lower operational costs and lower maintenance costs.

> Singapore Airlines since its creation has sought to differentiate itself in the market, this has traditionally been represented through the Singapore Girl figure.
>
> Singapore Airlines' customer service standards are symbolised by the gracious 'Singapore Girl'. In her distinctive uniform, a sarong kebaya in batik material designed by Parisian couturier Pierre Balmain, she epitomises Singapore Airlines' tradition of friendly service and Asian hospitality.
>
> The Singapore Girl was created in 1972, when Singapore Airlines was formed following the division of the former Malaysia-Singapore Airlines into two carriers – Malaysian Airline System and Singapore Airlines. She has been a leading figure in Singapore Airlines' international marketing and advertising campaigns ever since the airline's creation.
>
> A Global Icon
>
> The Singapore Girl is a global marketing icon, one of the airline industry's most instantly-recognised figures. This recognition factor gives the airline a great advantage over its competitors.
>
> *Singapore Airlines Website* (2011)

The use of the Singapore Girl continues and she fronts the recruitment site for the airline. The symbol of the Singapore Girl also reinforces how the airline seeks to differentiate itself through its Human Capital. By differentiating itself through its Human Capital the airline seeks to achieve sustainable competitive advantage. Human Capital is the hardest corporate resource to copy and so by adopting this strategy SIA makes it harder for competitors to copy its formula for success.

Human Resources Plan

Singapore Airlines' approach to Human Resources has five elements:

(a) Rigorous selection and recruitment processes
(b) Extensive training and retraining of employees
(c) Cohorts of successful service delivery teams
(d) Empowerment of front-line staff
(e) Motivation of employees

(a) **Rigorous selection and recruitment processes**

More than 80% of all Singapore Girls are either Singaporean or Malaysian. The rest are from countries including China, Bangladsh, Indonesia, Japan, Korea, Taiwan and Hong Kong. Cabin crew applicants are required to meet a multitude of criteria starting with an initial screening looking at age ranges, academic qualifications and physical attributes.

When reviewing these criteria from a European perspective the emphasis on gender and nationality look somewhat alien. From the 16,000 applications received annually, only some 500 to 600 new cabin crew members are hired to cover turnover rates of 10%, including both voluntary and involuntary attrition. After the initial training, new crew members are carefully monitored for the first six months of flying, through monthly reports from the in-flight supervisor during this probationary period. Usually around 75% are confirmed for an initial five-year contract, some 20% have their probation extended, and the rest leave the company.

(b) **Extensive training and retraining of employees**

While many service provider organisations focus on training as a key element of success, SIA remains the airline with the highest emphasis on this aspect. Newly recruited cabin crew members are required to undertake intensive four-month training courses – the longest and most comprehensive in the industry. The syllabus includes:

- Product knowledge including food & beverages
- Service procedures
- Passenger handling
- Deportment & grooming
- Language & communication skills
- Safety equipment procedures
- First aid

Flight crew are also required to embark on 29 months of comprehensive 'online' training before any promotion to first officer.

Singapore Airlines has seven training schools for the seven core functional areas of cabin crew, flight operations, commercial training, information technology, security, airport services training and engineering.

They not only develop job-related skills but they also believe in a programme of continuous training and retraining. The approach of continual training ensures that SIA staff are familiar with continuous change and development and so are able to deliver the new services SIA introduces regularly.

In addition to delivered training, SIA managers often assume the role of mentors and coaches to guide new employees rather than just being managers and superiors.

In addition, SIA also adopts a job rotation approach to allow management to obtain a more holistic picture of the organisation. Rotating to other departments every few years enables managers to develop a deeper understanding of operations at other areas of the organisation; this promotes a corporate outlook, reduces the likelihood of inter-department conflicts and facilitates change and innovation as people bring fresh perspectives and approaches to their new roles.

Note: Investment by the employer in training and development, and long-term career development, are key aspects to employee retention and motivation.

(c) **Cohorts of successful service delivery teams**

Effective teams are often a pre-requisite to service excellence. In view of this, SIA aims to create '*esprit de corps*' among its cabin crew. The 6,600 crew members are formed into teams of 13 where team members are rostered to fly together as much as possible, allowing them to build camaraderie and a better understanding of each other's personalities and capabilities.

(d) **Empowerment of front-line staff**

Employees need to feel empowered in order to expend discretionary effort. It is pertinent that employees are able to make decisions independently, as front-line staff frequently have to handle customers on their own since it is not feasible or even desirable for managers to constantly monitor employees' actions. At SIA, senior management emphasise that staff must have a clear concept of the boundaries of their authority and that it is the responsibility of management to communicate and explain the empowerment limits.

Note: Empowerment and freedom to act are also powerful factors in engaging employees and contributing towards long-term retention.

(e) **Motivation of employees**

Rewards and recognition are key levers that any organisation can use to encourage appropriate behaviour, recognise excellence and emphasise both positive as well as undesirable practices. SIA employs various forms of reward and recognition including interesting and varied job content, symbolic actions, performance-based share options and a significant percentage of variable pay components linked to individual staff contributions and company's financial performance.

SIA's reward and evaluation system is highly aligned with the desired behaviours. The key element is 'on-board assessment', which encompasses image (grooming and uniform turnout), service orientation (crew's interaction and passenger-handling capabilities), product knowledge and job skills, safety and security knowledge and adherence to procedures, work relationship (team-working spirit), and for the crew member in charge, additional factors of people management skills and pre-flight briefing session.

[Based on Heracleous , L & Wirtz, J. 'Strategy and organization at Singapore Airlines: Achieving sustainable advantage through dual strategy.' *Journal of Air Transport Management*. 2009.]

2.11 People and strategic success

Bratton and Gold's definition of HRM (see Section 1 above) highlights that human knowledge and skills are a strategic resource for an organisation, and that they can play a vital role in achieving sustainable competitive advantage.

The **strategic significance** of having the right people working effectively increases as technology becomes more complex, the importance of knowledge work increases and strategy relies more and more on the talents and creativity of human beings.

An important aspect of human resource management (HRM), therefore, consists of the various activities that attempt to ensure the organisation has the people it needs when it needs them. These activities include **recruitment**, **retention** and, when necessary, **reduction** of headcount.

However, aspects of HRM (such as setting **performance objectives** and **reward management**) also play an important role in the performance management and control of the organisation. In this respect, HRM follows a similar control model as is used for the overall strategic and operational control of an organisation:

Step 1: Goals are set
Step 2: Performance is measured and compared with target
Step 3: Control measures are undertaken in order to correct any shortfall
Step 4: Goals are adjusted in the light of experience

However, it is crucial to recognise that these goals link to both strategic and operational success. Effective performance management requires that the strategic objectives of the organisation are broken down into layers of more and more detailed sub-objectives, so that **individual performance** can be judged against personal goals that support and link directly back to corporate strategy.

2.12 People and operational success

Recruitment and selection

Operational success relies on people's ability of people to do their jobs properly. This could include their ability to perform a range of activities such as being able to operate machinery correctly, use computers, manage others, or perform specific technical routines. In this respect, operational success requires the proper **recruitment** and **selection** of people with the right skills for the particular job, and the provision of further training as the requirements may dictate.

An organisation's staff are a very important resource, and they are likely to play a crucial role in an organisation achieving its strategic objectives. Therefore, it is vital that an organisation has the right number (quantity) and the right quality of staff to achieve its objectives.

In this respect, human resource planning is very important – not only in forecasting the numbers and levels of staff an organisation is likely to need, but also in deciding whether, for example, the staff should all work 'in house' or whether it might be more appropriate to outsource some functions, or to move to a more 'network' based organisation rather than using a more formally structured one.

In this way, recruitment and human resource planning play a vital role in ensuring that organisations have the necessary quantity and quality of staff to facilitate their success.

Objectives and performance targets

Staff should also have individual work **objectives** and **performance targets** (for example the number of sales calls made) and their performance should be measured against these objectives. These individual objectives and targets should be derived from department and organisation objectives. This should mean that, in theory, if every individual achieves their objectives then their department will achieve its objectives, and if every department achieves its objectives then the organisation as a whole will achieve its objectives.

Two factors which play an important role in determining whether employees achieve their objectives are **management** and **motivation**. We will look at a number of aspects of employee performance management later in this chapter, but in general terms we can highlight the link between performance and motivation by reference to the following equation (after Vroom):

Performance = Ability × Motivation

(where Motivation = Desire × Commitment)

In this equation, desire is seen as enthusiasm for a task, and commitment is about putting in effort. Therefore, as well as ensuring that employees have the necessary abilities to carry out their jobs, managers also need to make sure that their staff have the desire and commitment to do so efficiently and successfully.

Staff retention

Keeping staff motivated can also help an organisation retain staff more effectively, and in doing so can reduce the costs associated with **staff turnover**. These include the time and costs spent in advertising for and recruiting new staff; time and cost spent training new staff, and the 'learning curve' associated with new staff getting up to speed with their jobs; and the loss of organisational knowledge which occurs when individuals (particularly key employees) leave an organisation.

3 Appraisal and performance management

Section overview

- Appraisal is fundamental to performance management, forming a link between individual members of staff and an organisation's overall strategy.
- However, within this overall setting, appraisal has two different purposes – judgement and development – and there is an inherent conflict between the two which has never satisfactorily been resolved.
- The choice of targets selected for performance measurement systems can also have a significant impact on the effectiveness of those systems. It is possible that unintended consequences of performance targets could end up having an adverse effect on performance.

While the need for some kind of performance assessment is widely accepted, appraisal systems are frequently criticised as bureaucratic, ineffective and largely irrelevant to the work of the organisation. Partly as a response to this view, modern approaches attempt to enhance the relevance of appraisal by linking it to organisational strategy and objectives. This emphasises the use of appraisal as an **instrument of control over the workforce**. However, running in parallel with this trend is an awareness, among HR professionals at least, that appraisal systems are fundamental to the aspirational model of HRM outlined above and to the co-operative psychological contract.

3.1 The purpose of appraisal

Appraisal is a process that provides an analysis of a person's overall capabilities and potential. An important part of the appraisal process is assessment – collecting and reviewing data on an individual's work.

The purpose of appraisal is usually seen as the **improvement of individual performance**, but it may also be regarded as having close links to a wide range of other HR issues, including discipline, career management, identifying training and development opportunities, motivation, communication, selection for promotion and determining rewards. It is also fundamental to the notion of **performance management**, which may be regarded as trying to direct and support individual employees to work as effectively and efficiently as possible so that the individual's goals are aligned with the organisation's goals and business strategy.

Within this wider view, regular appraisal interviews can be seen as serving two distinct purposes:

(a) **Judgement**: Judgemental appraisals are undertaken in order for decisions to be made about employees' pay, promotion and work responsibilities.

These decisions have to be made on the basis of judgements about the appraisee's behaviour, talent, industry and value to the organisation. Such judgements can be uncomfortable for both appraiser and appraisee and lead to hostility and aggression.

(b) **Development**: The focus of developmental appraisals is to assess employees' training and development needs.

Development appraisal can contribute to **performance improvement** by establishing individuals' development needs, progress and opportunities. This is the more supportive aspect of appraisal, but still requires the appraiser to make decisions about the appraisee.

'The tension between appraisal as a judgemental process and as a supportive development process has never been resolved and lies at the heart of most debates about the effectiveness of appraisal at work.' (Bratton & Gold)

Feedback on performance has been widely regarded as an important aspect of the participative style of management which, in turn, has been promoted as having potential to motivate higher performance. However, the link between feedback and motivation is not simple and an important aspect of the judgemental part of appraisal is its potential to **demotivate**.

The classic study which highlighted this was carried out by Meyer *et al* at the General Electric Company (GEC) in 1965. Gold suggests that their findings are still relevant and provides a summary:

(a) Criticism often has a negative effect on motivation and performance.

(b) Praise has little effect, one way or the other.

(c) Performance improves with specific goals.

(d) Participation by the employee in goal-setting helps to produce favourable results. (Don't forget the whole point of performance management is to improve performance!)

(e) Interviews designed primarily to improve performance should not at the same time weigh salary or promotion in the balance.

(f) Coaching by managers should be day to day rather than just once a year.

More recently, Campbell and Lee have pointed out the ways in which discrepancies may arise between people's own opinions of their performance and those of their supervisors.

(a) **Information**. There may be disagreement over what work roles involve, standards of performance and methods to be used.

(b) **Cognition**. The complexity of behaviour and performance leads to different perceptions.

(c) E**ffect**. The judgemental nature of appraisal is threatening to the appraisee and, possibly, to the appraiser.

Since Meyer *et al's* study there has been a long search to find a way of appraising employees which reduces the feeling that feedback is about criticism.

One approach to mitigating the undesirable effects of judgemental appraisal has been the use of **multisource feedback**, including 360 degree appraisal, in order to provide a demonstrably more **objective** review. Such approaches have tended to be used principally for appraisal of managers. Multisource feedback can be seen as empowering for staff. It may also be seen as reinforcing for good management behaviour (since it shows managers how they are seen by others) and likely to improve the overall reliability of appraisal. However, research has shown that the effects can vary significantly.

3.1.1 Appraisal as control or development?

The last of Meyer *et al's* findings 'coaching by managers should be day to day rather than just once a year' highlights the role of managers in the **development** of their staff on a continual basis.

However, any shift towards a more developmental view of appraisal sits uncomfortably with the traditional management objectives of having a means of measuring, monitoring and controlling performance. Most appraisal schemes are still ultimately **performance control schemes**, as illustrated in Figure 10.6 below.

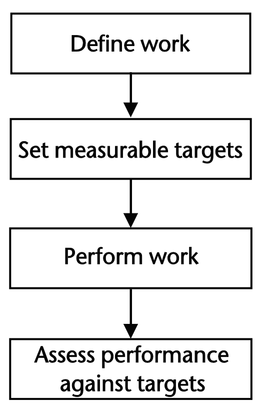


Figure 10.6: Appraisal as performance control system

This somewhat rigid approach, based on the drive for rationality and efficiency in organisations, highlights what Mintzberg has called '**machine bureaucracy**'. According to this approach, getting organised, being rational and achieving efficiency are the best bases on which to structure an organisation.

This mechanistic view of organisations will, almost inevitably, mean that employees will view appraisals as control systems, and employees will feel they are being controlled by appraisal systems. Such a situation is unlikely to motivate employees or to generate trust, commitment and high productivity, though.

Employees' trust and commitment to an organisation will come about through management creating a culture that supports people's long-term development. Assessment and appraisal could play a key part of this shift, but only if human resource managers can convince organisations that, while control remains important, development needs to play a much greater role in the appraisal process.

Interactive question 3: Appraisals [Difficulty level: Intermediate]

The Jackson Business Centre (JBC) provides professional courses for students of accounting, law and marketing.

JBC has operated a formal performance appraisal system, supported by standardised procedures and paperwork, for a number of years. The system has clear organisational objectives, which are based on staff development and improved performance, rather than being a basis for pay reviews or paying individual annual bonuses. However, the scheme is not well regarded by either managers or staff and its objectives are not being met.

Senior managers complain about the amount of time that is taken up holding appraisal interviews and then completing the necessary paperwork.

Exit interviews are conducted whenever someone leaves JBC, and a review of a sample of recorded comments indicates staff feelings on the scheme very clearly: 'appraisal is just a paper exercise', 'a joke', 'a waste of time and effort'.

Requirement

Discuss the possible reasons why the objectives of the formal appraisal system are not being met.

See **Answer** at the end of this chapter.

3.2 HRM and performance management

Performance management systems attempt to integrate HRM processes with the strategic direction and control of the organisation. Remember the cycle of control we mentioned earlier:

Step 1 Goals are set
Step 2 Performance is measured and compared with target
Step 3 Control measures are undertaken in order to correct any shortfall
Step 4 Goals are adjusted in the light of experience

You should be familiar with this kind of management control in business organisations, where the balanced scorecard, for example, is often used as the basis for such an approach.

Performance management requires that the strategic objectives of the organisation are broken down into layers of more and more detailed sub-objectives, so that individual performance can be judged against personal goals that support and link directly back to corporate strategy.

The performance management system, although it emphasises the control aspects of appraisal, must also allow for the **development** aspect of appraisal, providing for coaching and training where needed.

3.3 Performance rating

Intimately linked with the definition of goals is the creation of suitable **performance indicators**. Several different approaches have been used at various times.

Inputs or personal qualities

The diagnosis of **personality traits** such as loyalty, leadership and commitment really requires the use of valid psychometric methods by qualified specialists. When managers attempt to perform this task, bias, subjectivity, and other effects will tend to **undermine the reliability of the output**.

Results and outcomes

Where the cybernetic model is implemented, objective assessment of performance against work targets can be a **reliable method of rating**. Performance against quantified work objectives, such as number of sales calls made, can be used alongside measures of progress within competence frameworks and the overall picture can be enriched with qualitative measures and comments. A **fundamental problem** with this approach is the importance of the way in which objectives are set. Ideally, they should be agreed at the outset, but this requires a degree of understanding of the complexity and difficulty of the work situation that neither party to the appraisal may possess.

Behaviour in performance

Appraisal may be based more on how appraisees carry out their roles than on quantified measures of achievement. This is particularly relevant to managerial and professional activities such as communication, planning, leadership and problem resolution.

Behaviour-anchored rating scales (BARS) enable numerical scoring of performance at such activities. A numerical scale from, say, one to seven, is 'anchored' against careful descriptions of the kind of behaviour that would lead to a maximum or minimum score. This is the kind of scale satirised by the well known parody that has 'leaps tall buildings at a single bound' at the top and 'walks into walls' at the bottom. Appraisers then judge just where the appraisee falls against each scale.

Behavioural observation scales (BOS) are slightly different in two respects.

(a) They break down aspects of behaviour into sub categories: skill at developing people, for example, might be assessed against such activities as giving praise where due, providing constructive feedback and sharing best practice.

(b) Appraisers assess the actual frequency with which such activities are performed against the frequency of opportunities to undertake them. The scores are recorded on numerical scales anchored by 'never' and 'always'.

Both BARS and BOS can enhance objectivity in appraisal and in self-appraisal.

3.4 Target selection

We have noted how performance management acts as a control system in measuring people's achievement against targets. However, in order for performance management to be beneficial, it is important to select the right measures or targets at the outset when setting performance goals.

The adage 'What gets measured, gets done' is often used in relation to corporate performance management, but it is equally relevant here. If the 'wrong' performance measures or targets are set, this could lead to staff behaviour being different to that originally intended, and ultimately adversely affecting performance.

We looked at the **behavioural implications of performance targets** in Section 4.13 of Chapter 4, but they are also important here, in highlighting the impact that remuneration and reward structures can have on organisational behaviour.

Case example: Bankers' bonuses

In the aftermath of the global financial crisis of 2008-9, a lot of media attention focused on bankers' bonuses. A number of investment banks link employees' annual bonuses to the amount of money they earn in that year, a short-term approach which can influence employees' decision-making.

Critics argue that the bonuses encourage risky behaviour that maximizes profits in the short term but could potentially be loss-making in the longer term.

The sub-prime mortgage crisis in the US in 2007 was a good example of this. The mortgage bond market proved extremely profitable for the banks in the short term, but once mortgage-holders started defaulting on their loans the banks had to foreclose them, causing the loans to be written off.

During the bull market (before 2007) certain financial packages made a great deal of money for the banks in the short term, resulting in their staff receiving large bonuses. However, those same financial packages failed shortly afterwards, triggering the financial crisis.

The individual performance measures selected should be relevant to the overall objectives of the organisation. Individuals' objectives must reflect the overall strategic initiatives management are taking. For example, if management is focusing on quality, performance measures must reflect this by measuring employees on their contribution to achieving quality targets.

This sort of situation represents a **contingency approach** to reward: that the organisation's strategy is a fundamental influence on its reward system, and in turn the reward system should support the organisation's chosen strategy.

Targets and motivation

Some employees respond well to difficult targets and are motivated to attain them. Others may find the targets daunting and feel they are unachievable, and indeed there may be valid reasons why they believe this. For example, in an economic downturn, a number of businesses reduce the amount they spend on their IT budgets. Therefore if a salesperson in an IT company was given a target of increasing sales 25% on the prior year they would appear to be justified in thinking this target is unachievable.

Equally, care must be taken when using certain measures, for instance numbers of sales, as the basis for rewarding employees. As an example, here are some possible negative consequences of using sales numbers as a primary performance measure:

- The salesman might offer potential customers large discounts in order to make the sale (but with the effect that the company makes a loss on the sale)
- The salesman is concerned solely with the immediate sale, which may lead to poor after-sales service, low customer satisfaction levels and poor customer retention
- The salesman might use expensive promotions that actually generate less in sales value than they cost, but which allow the salesman to register a number of sales
- Once a salesman has reached his target figure for a period he might look to defer future sales into the next period

It may be better to use a balanced mix of targets – for example, setting customer care and customer profitability targets as well as the number of sales made.

It is also important to make sure whatever goals are set that these are capable of being controlled by the individual, otherwise the individual is likely to become demotivated.

In addition, if processes are being redesigned and job roles are changing, performance measures must be adapted to reflect the new jobs and responsibilities.

However, it is important that people are not given too many objectives and targets. There is a danger that people could become overwhelmed by the sheer number of goals they are expected to meet, but with the result that they do not know what their priorities are or what aspects of their work they should give most attention to.

Finally, it is useful to remember the acronym SMART when setting performance targets: are the targets specific, measurable, achievable, relevant and time-bound?

4 The impact of remuneration and reward packages

Section overview

- A reward system should fulfil three key behavioural objectives: supporting staff recruitment and retention; motivating employees to high levels of performance and promoting compliance with workplace rules and expectations.
- A contingency approach to reward accepts that an organisation's strategy is a fundamental influence on its reward system, and that its reward system should support its chosen strategy.
- Equally, however, an effective reward system should align individuals' goals with an organisation's strategic goals.

4.1 Reward

Employment is fundamentally an economic relationship; the employee works as directed by the employer and, in exchange, the employer provides reward. The relationship inevitably generates a degree of tension between the parties, since it requires **co-operation** if it is to function, but it is also likely to give rise to **conflict** since the employee's reward equates exactly to a cost for the employer.

Definition

Reward: All of the monetary, non-monetary and psychological payments that an organisation provides for its employees in exchange for the work they perform.

Rewards may be seen as **extrinsic** or **intrinsic**.

(a) **Extrinsic rewards** derive from the **job context**; such extrinsic rewards include pay and other material benefits as well as matters such as working conditions and management style.

(b) **Intrinsic rewards** derive from **job content** and satisfy higher-level needs such as those for self esteem and personal development.

The organisation's reward system is based on these two types of reward and also includes the policies and processes involved in providing them.

Reward is a fundamental aspect of HRM and the way an organisation functions. It interacts with many other systems, objectives and activities.

- It should support the overall strategy
- It is a vital part of the psychological contract
- It influences the success of recruitment and retention policies
- It must conform to relevant laws and regulations
- It consumes resources and must be affordable
- It affects motivation and performance management
- It must be administered efficiently and correctly

The dual nature of reward mentioned earlier – a benefit for the employee, a cost for the employer – means that the parties in the relationship have divergent views of its purposes and extent. Employees see reward as fundamental to their standard of living: inflation, comparisons with others and rising expectations put upward pressure on their notion of what its proper level should be. Employers, on the other hand, seek both to control their employment costs and to use the reward system to influence such matters as productivity, recruitment, retention and change.

Case example: Tesco – Remuneration strategy

In Tesco's 2013 Annual Report, the company analyses the principal risks it is facing. One of the risks highlighted is: 'People – Failure to attract, retain, develop and motivate the best people with the right capabilities at all levels could limit our ability to succeed.'

Alongside this risk, Tesco highlights the key controls and mitigating factors which are in place to help the company manage the risk. One of these is: 'Pay, pension and share plan arrangement help us to attract and retain good people.'

The report goes on to highlight how the approach to remuneration throughout Tesco is guided by a framework of common **objectives** and **principles**:

Reward objectives

Attract – Enable Tesco to recruit the right people

Motivate – Incentivise colleagues to deliver our business goals together

Recognise – Acknowledge individual contribution and performance

Align – Create shareholder value by focusing colleagues on making what matters better (see Note)

Retain – Foster loyalty and pride in Tesco so that colleagues want to stay with us and strive to do their best

Reward principles

Competitive

- Competitiveness is assessed on a 'total reward' basis including financial and non-financial rewards
- Reward reflects an individual's role, experience, performance and contribution
- Reward is set with reference to external market practice and internal relativity

Simple

- Reward is simple, clear and easy to understand
- Unnecessary complexity is avoided
- Rewards are delivered accurately

Fair

- Policies are transparent, and applied consistently and equitably
- Reward decisions are trusted and properly governed
- Reward is legal and compliant

Sustainable

- Reward is aligned to the business strategy, reflects the company's performance, and is affordable
- The reward framework is flexible to meet the changing needs of the business
- Rewards are made in a responsible way

Note: This objective means that bonus measures are based on a range of non-financial performance measures as well as financial ones; for example, improving service to customers, because this was recognised as a key success factor in making Tesco a successful and sustainable business for the long term.

4.2 A reward management model

An effective reward system should facilitate both the **organisation's strategic goals** and also the goals of **individual employees**.

Within this, an organisation has to make three basic decisions about monetary reward:

(a) How much to pay
(b) Whether monetary rewards should be paid on an individual, group or collective basis
(c) How much emphasis to place on monetary reward as part of the total employment relationship

However, there is no single reward system that fits all organisations.

Bratton proposes a model of reward management based on five elements.

(a) The **strategic perspective**
(b) Reward **objectives**
(c) Reward **options**
(d) Reward **techniques**
(e) Reward **competitiveness**

4.2.1 The strategic perspective

A **contingency approach to reward** accepts that the organisation's strategy is a fundamental influence on its reward system and that the reward system should support the chosen strategy.

Thus, for example, cost leadership and differentiation based on service will have very different implications for reward strategy (and, indeed, for other aspects of HRM). This is because each strategy needs a reward which is appropriate for it. The closer the alignment between the reward system and the strategic context, the more effectively the organisation can implement its strategy. The following example illustrates this.

Example of strategic perspective

Bratton and Gold in their text *Human Resource Management* provide an illustration of how two different businesses with different generic strategies have completely different rewards systems.

The first business produces high-quality, custom-made machine tools for a high-tech industry. The production process is complex and workers are highly-skilled and capable of performing various jobs. They all work in self-managed teams.

In contrast to the industry norm, these skilled machine operators are not paid an hourly wage, but instead they receive a base salary which is increased as they learn new skills. The employees receive an excellent benefits package and profit-sharing bonuses. Not surprisingly, staff turnover is very low.

Labour costs at this company are above the industry average, but the company is successful nonetheless because its reward system is aligned to its strategy. It is following a differentiation strategy, and its reward system encourages commitment from its staff. The system also encourages higher productivity than its competitors because of the increased functional flexibility of having multi-skilled staff. The incentive of their salary increasing as they learn new skills encourages the staff to become multi-skilled. In turn, having a multi-skilled workforce reduces machine downtime and scrap rates. Because the teams are self-managed, the company does not need to employ supervisors or quality inspectors (the teams self-regulate their own quality). Because staff turnover is low, recruitment and training costs are similarly low.

Therefore, although the company's labour costs are above the industry average, these additional costs deliver benefits elsewhere and support its differentiation strategy.

Against this, Bratton and Gold contrast a production process producing frozen food. The work is low-skilled and monotonous, and requires little employee commitment. The production line is automated and managers – not workers – control the speed of the line.

The workers are paid an hourly wage marginally above the minimum wage, and there are no additional payments or benefits. Not surprisingly, labour turnover is very high.

However, again this company is successful, because its reward system is aligned to its strategy. It is following a cost leadership strategy and so low-cost production is essential. The high labour turnover is not a problem because unskilled workers are easy to recruit and training costs are low. Therefore, the company's policy of paying near-minimum wage only is appropriate to a strategy in which little commitment or loyalty is required from the employees.

It is vital that reward systems are aligned to an organisation's objectives and its critical success factors, as well as to the job in question. As the scenarios above illustrate, if the organisation has highly-skilled employees who are crucial to its competitive success, then the reward system should be designed to try to retain such staff.

However, it is also important to recognise the impact that implementing a reward system can have on employees' day-to-day performance. Once again, the idea that 'What gets measured, gets done' is relevant here. For example, if a reward system is based primarily around individual performance, then staff will focus on their own individual results and teamwork could suffer as a result.

More generally, if a reward system is not appropriate for the context in which it is used, there is a danger it could have a negative impact on an organisation's performance.

4.2.2 Reward objectives

The reward system should pursue three behavioural objectives:

(a) It should support **recruitment and retention**.

(b) It should **motivate** employees to high levels of **performance**. This motivation may, in turn, develop into commitment and a sense of belonging, but these do not result directly from the reward system.

(c) It should promote **compliance** with workplace rules and expectations.

Recruitment and retention

The reward system should support **recruitment and retention**. Several influences are important here. Employees will certainly assess their pay and material benefits against what they believe to be the prevailing market rate. They will also take account of disadvantageous factors, such as unpleasant working conditions, in their assessment of the degree of equity their reward achieves for them. Finally, they will be very sensitive to comparisons with the rewards achieved by other employees of the same organisation. Failure to provide a significant degree of satisfaction of these concerns will lead to enhanced recruitment costs.

Motivation

The reward system should **motivate employees** to high levels of performance.

Despite the apparently tenuous link between performance and level of pay (for example, with Herzberg arguing that pay is a hygiene factor rather than a motivating factor), traditional pay systems have featured incentives intended to improve performance; there has also been a tendency for British and North American companies to adopt systems of individual performance related pay intended to support overall organisational objectives rather than simply to incentivise individual productivity.

Compliance

The reward system should **promote compliance** with workplace rules and expectations. The psychological contract is complex and has many features, including material rewards. The incentives included in the reward system play an important role in **signalling to employees the behaviour that the organisation values**. It is also an important contributor to the way employees perceive the organisation and their relationship with it.

4.2.3 Methods of reward

Material reward may be divided into three categories:

(a) **Base pay** is a simply established reward for the time spent working.

(b) **Performance pay** is normally added to base pay and is intended to reward performance learning or experience.

(c) **Indirect pay** is made up of benefits such as health insurance, child care and so on and is provided in addition to base pay or performance pay.

Base pay

Base pay is usually related to the value of the job as established by a simple estimate, a scheme of **job evaluation** or reference to prevailing employment market conditions. It is **easy to administer** and shows a **commitment by the employer** to the employee that goes beyond simple compensation for work done. A distinction may be made between hourly or weekly paid **wages** and monthly paid **salary**. The latter is normally expressed as an annual rate.

Performance pay

Performance pay takes many forms, including **commission**, **merit pay** and **piecework pay**.

Performance pay differs from base pay in that it can be designed to support **team working** and **commitment to organisational goals**. Team working is supported by a system of bonuses based on team rather than individual performance. The size of the team may vary from a small work group to a complete office or factory. Overall organisational performance is supported by various schemes of **profit sharing**, including those that make payments into pension funds or purchase shares in the employing company.

However, the extent to which an organisation emphasises performance pay will depend on whether this type of reward supports its strategy.

Indirect pay

Indirect pay is often called 'employee benefits'.

Benefits can form a valuable component of the total reward package. They can be designed so as to resemble either base pay or, to some extent, performance pay. A benefit resembling base pay, for example, would be use of a subsidised staff canteen, whereas the common practice of rewarding high-performing sales staff with holiday packages or superior cars looks more like performance pay. Again though, the extent to which an organisation offers indirect pay should reflect whether this type of reward supports its strategy.

There is a trend towards a **cafeteria** approach to benefits. Employees select the benefits they require from a costed menu up to the total value they are awarded. This means that employees' benefits are likely to match their needs and be more highly valued as a result.

Types of indirect pay include:

- Private health care
- Private dental care
- Pension plans
- Car allowance
- Discounted insurance
- Extra vacation days
- Child care
- Shopping/entertainment vouchers

Share options

One further type of reward option we should consider is share options (or employee share option plans (ESOP)).

Share options give directors – and possibly other managers and staff – the right to purchase shares at a specified exercise price after a specified time period in the future.

The options will normally have an exercise price that is equal to, or slightly higher than, the market price on the date that the options are granted. The time period (vesting period) that must pass before the options can be exercised is generally a few years. If the director or employee leaves during that period, the options will lapse.

In this respect, share options can be seen as a way of rewarding directors and employees for remaining with a company. In turn, this could mean that they are concerned with the longer-term success of the company, rather than simply focusing on short term performance.

Share options will generally be exercisable on a specific date at the end of the vesting period. In the UK, the Corporate Governance Code states that shares granted, or other forms of remuneration, should not vest or be exercisable in less than three years. Directors should be encouraged to hold their shares for a further period after vesting or exercise. If directors or employees are granted a number of options in one package, these options should not all be able to be first exercised at the same date.

If the price of the shares rises so that it exceeds the exercise price by the time the options can be exercised, the directors will be able to purchase shares at lower than their market value, which is clearly advantageous for the directors exercising the options. Share options can therefore be used to **align management and shareholder interests**, because the directors have an interest in ensuring that the share price increases over time such that it is higher than the exercise price when the options come to be exercised. This is particularly relevant for options held for a long time when value is dependent on long-term performance.

However, the main danger with share options is that they could give directors an incentive to manipulate the share price if a large number of options are due to be exercised.

Alternatively, granting options could be used as a way of encouraging cautious (or risk averse) directors to take positive action to increase the value of the company.

Again, this could help align the interests of directors and shareholders, if the directors would not otherwise be prepared to accept the same risks which the shareholders would tolerate by themselves.

The upside risk of share options is unlimited because there is no restriction on how much the share price can exceed the exercise price. However, there is no corresponding downside risk for the directors. If the share price is less than the exercise price, the intrinsic value of options will be zero and the options will lapse. In these circumstances it will make no difference how far the share price is below the exercise price.

If directors hold options, the value of their options will rise if a strategic investment succeeds and they will not suffer any loss on their options if the investment fails. Therefore, granting the options might encourage the directors to take actions they would not otherwise be prepared to take.

Risk, reward and performance

Although we have noted that share options could encourage cautious directors to be less cautious, it is equally important that reward structures do not encourage directors and managers to take excessive risks.

Since the collapse of Northern Rock bank in 2007, and throughout the ensuing financial crisis, there has been much political and media interest in the issue of reward management. This has focused on the role which reward structures were perceived to have played in encouraging excessive risk-taking in the financial services sector and, in turn, what role this risk-taking played in the problems which have affected the sector.

Additionally, there has been increasing concern about the extent to which the level of remuneration given to senior executives reflects (or does not reflect) the value their companies generate for their shareholders.

In the UK, in a speech to the High Pay Commission and the Institute for Public Policy Research (January 2012) the Labour MP Chuka Umunna highlighted the extent to which the value of incentive packages for executives has risen disproportionately to improvements in company performance. In the first decade of the 21st century, FTSE 350 firms increased their pre-tax profits by 50% and their earnings per share by 73%, while year end share prices fell by 5%. Over the same period, bonuses for executives in these companies rose by 187% and long term incentive plans by 254%.

And, as Mr. Umunna pointed out, in the worst cases 'you end up with perverse incentive structures which encourage the wrong kind of decision-making, as the failures in many financial institutions in the wake of the 2008/9 financial crises so clearly illustrated.'

Another issue which causes increasing anger and frustration among shareholders is the level of bonuses being awarded by companies that were rescued by taxpayer funds.

This is perhaps symptomatic of a potentially wider issue: the extent to which companies are perceived to be **rewarding failure**. The senior executives of failed companies often walk away with significant payouts, while large numbers of other managers and staff lose their jobs and their incomes**.**

Critics have argued that if companies are serious about improving performance, then they need to stop rewarding failure.

Case example: Rewards for failure

In 2009, Carol Bartz was appointed CEO of Yahoo. She was brought in to help turn the company around.

According to Equilar, a firm which researches executive compensation, she was given a signing-on package worth over $47.2 million in cash and stock options, and she received pay worth an additional $11.9 million in 2010.

However, Bartz's plans to revive the beleaguered search company failed, and in September 2010 Yahoo's board fired her.

Nonetheless, she walked away with a large allocation of deeply discounted stock options as well as cash severance worth about $5.2 million.

At around the same time Lloyd Doggett, a senior member of the 'Ways and Means' Committee in the US House of Representatives, said that the size of the severance packages senior executives receive was 'outrageous.' 'The whole concept that the only way to get rid of bad management is to buy them off is fundamentally wrong,' he said.

4.2.4 Reward techniques

Reward systems must attempt to achieve **internal equity.** This means when employees make comparisons between their own rewards and those of others, they see the overall structure as fair. If internal equity is not achieved, employees will conclude that the psychological contract has been breached and their behaviour will be affected. They may become less co-operative or they may leave.

Three techniques contribute to the establishment of internal equity.

Job analysis

Job analysis is the 'systematic process of collecting and evaluating information about the tasks, responsibilities and the context of a specific job' (Bratton). The data collected during job analysis identifies the major tasks performed by the job-holder, the outcomes that are expected, and how the job links to other jobs in the organisation. This data is used to prepare job descriptions, job specifications and job performance standards. (Note that in practice the terms job description and job specification may be used loosely and a *job specification* is often referred to as a *person specification.*)

This information is useful in itself for a range of HRM purposes, including recruitment and training needs analysis, and it also forms the basis for **job evaluation**.

Note also that job analysis is an important aspect of quality and process re-design initiatives and is almost certainly required when e-business methods are adopted.

Job evaluation

Job evaluation is a systematic process designed to determine the relative worth of jobs within a single work organisation. The process depends on a series of subjective judgements and may be influenced by organisational politics and personal preconceptions. In particular, it can be difficult to separate the nature of the job from the qualities of the current incumbent.

Evaluation may be carried out in four ways.

(a) **Ranking** simply requires the arrangement of existing jobs into a hierarchy of relative value to the organisation.

(b) **Job-grading** starts with the definition of a suitable structure of grades in a hierarchy. Definitions are based on requirements for skill, knowledge and experience. Each job in the organisation is then allocated to an appropriate grade.

(c) **Factor comparison** requires the allocation of monetary value to the various factors making up the content of a suitable range of benchmark jobs. This method is complex and cumbersome.

(d) **Points rating** is similar to factor comparison, but uses points rather than monetary units to assess the elements of job content.

Whichever method is used, the end point of a job evaluation exercise is the production of a **hierarchy of jobs** in terms of their relative value to the organisation. The **pay structure** is then set by reference to this hierarchy of jobs.

Performance appraisal

Performance appraisal has already been discussed in Section 3 earlier in this chapter.

4.2.5 Reward competitiveness

The level of rewards an organisation offers will inevitably be subject to factors external to the organisation:

(a) The **labour market** as it exists locally, nationally and perhaps globally, as relevant to the organisation's circumstances

(b) The pressure for **cost efficiency** in the relevant industry or sector

(c) **Legislation** such as the level of any applicable minimum wage

4.3 Setting reward levels in practice

Many companies use commercially available **survey data** to guide the overall level of the rewards they offer. This approach can be combined with the reward techniques outlined above.

An element of **flexibility** must be incorporated to reflect both the different levels of skill, knowledge and experience deployed by people doing the same work and their effectiveness in doing it.

Governments influence pay levels by means other than outright legislative prescription:

(a) They affect the demand for labour by being major employers in their own right:

(b) They can affect the supply of labour by, for example, setting down minimum age or qualification requirements for certain jobs.

(c) Their fiscal and monetary policies can lead them to exert downward pressure on public sector wage rates.

4.3.1 Problems with reward systems

Reward systems are subject to a range of pressures that influence their working and affect the psychological contract.

(a) Where **trade unions** are relatively weak, employers have more freedom to introduce performance related pay.

(b) **Economic conditions** may prevent employers from funding the rewards they might wish to provide in order to improve commitment. The result would be disappointment and dissatisfaction.

(c) Performance pay systems are prone to **subjective and inconsistent** judgement about merit; this will discredit them in the eyes of the employees.

Case example: Failure of reward systems

Why reward systems fail to deliver IT transformation

(A short article on the technology website www.zdnet.com looks at some examples of failings in reward systems in relation to IT projects.)

An organisation had a plan for an enterprise-wide service-oriented approach which was well thought through and should have worked well. But when the project was implemented it turned out to be a failure. One of the reasons for the failure was the way IT professionals and managers were rewarded, highlighting the importance of rewarding the right behaviour in any IT-driven transformational project.

The article highlights four common misconceptions in reward systems:

- **Rewarding programmers for lines of code produced, or based on program complexity**. This type of reward system will encourage programmers to develop more complex or difficult programs without considering what the organisation needs. It may not need – or want – complex or difficult programs.
- **Rewarding developers based on long hours worked.** There is a danger with this kind of measure that **quantity** gets rewarded rather than **quality**. A programmer may end up working very long days simply because they did a poor job of estimation and planning up front, or the long hours could be an indication that there is a lot of code-rewriting going on, to correct mistakes which the programmer had made initially.
- **Rewards based on salary surveys.** Basing IT salaries on industry averages means that some of the competitor companies in the market are paying more (although some are also paying less). However, if you simply pay an average rate, as soon as the economy becomes more buoyant and demand for workers heats up, programmers will defect and move to higher-paying rival companies.
- **Rewarding people based on the number of problem statements they close.** This is problematic because some people will solve multiple problems with one problem statement, while others will open and solve as many problem statements as they can to inflate the number of problems solved.

(Based on: McKendrick, J. (2010), Why reward systems fail to deliver IT transformation, www.zdnet.com)

4.4 Benefits and adverse consequences of linking reward schemes to performance measurement

4.4.1 Benefits for the organisation

It is clear how objectives set at higher levels can be translated into individual goals, thereby linking strategy to outcomes for the individual. This is illustrated in Bratton's model where the strategic perspective explains that the reward system should support strategy, and the two should be closely aligned.

A reward scheme should also provide an incentive to achieve a good level of performance, and the existence of a reward scheme can help to attract and retain employees who make favourable contributions to the running of the organisation.

A reward scheme can also help emphasise the key performance indicators of the business, if these are incorporated into the performance measures which underpin the scheme. This will help reinforce to employees the key aspects of their performance which contribute most to the organisation's success.

4.4.2 Drawbacks for the organisation

However, the financial crisis of 2007-9 showed the dangers of linking reward schemes to performance measures if those **performance measures are poorly designed**. We highlighted this in the case study about bankers' bonuses earlier in the chapter, suggesting that the bonus culture encouraged a focus on short-term decision making and risk taking.

A European Commission report into the financial crisis suggested that 'Excessive risk taking in the financial services industry…has contributed to the failure of financial undertakings…Whilst not the main cause of the financial crises that unfolded…there is widespread consensus that inappropriate remuneration practices…also induced excessive risk taking.'

In this case, there appears to be a direct link between the profit measures (short term profitability) and the **risk appetite of employees**. Employees were prepared to take greater risks in the hope of making higher profits and therefore getting larger bonuses.

However, a second potential drawback for an organisation arises if it is unable to reward individuals for good performance (for instance, due to a shortage of funds) because then the link between reward and motivation may break down.

4.4.3 Benefits and drawbacks for the individual

If an individual's goals are linked to the objectives of the organisation, then it is clear to the individual how their performance is measured and why their goals are set as they are. However, on occasion there may be a problem in linking individual rewards directly to organisational outcomes, especially if the outcomes are uncertain.

Another drawback is that in striving to meet targets some individuals may become cautious and reluctant to take risks given they have a stake in the outcome. Conversely, other individuals may choose riskier behavior especially if reward is linked to, say, revenue generation or levels of output.

4.4.4 Risk and reward

Overall, a reward system needs to achieve a balance between risk and reward:

Recruitment and retention: Rewards need to be structured in such a way that they attract and retain key talent. If an organisation's reward system is not deemed to be attractive, then there is a risk it will not be able to attract or retain the staff it needs to be successful.

Alignment with business strategy and culture: If reward strategy is not aligned to organisational goals then there is a risk the organisation will not achieve those goals. Equally, the reward system needs to encourage styles of behaviour that fit with the organisation's culture.

Reputation/brand: If the organisation's reward systems generate negative press coverage (as has been the case with some banks in the recent financial crisis) there is a risk this will adversely affect the organisation's reputation or brand.

Interactive question 4: Reward packages **[Difficulty level: Intermediate]**

The Superior Business Consultancy (SBC), based in Jayland, provides clients with a range of business consultancy services as well as IT services and support.

Currently, SBC pays all its consultants a fixed salary. However, some of the IT consultants are unhappy that their salaries are lower than those earned by the other types of consultant. Recently, four of SBC's longest-serving IT consultants resigned to go and work for rival consultancies. All of them said that the reward packages available had played a significant part in their decisions.

The directors are worried about the prospect of more consultants leaving SBC and joining rival consultancies. As a result, the directors are reviewing SBC's reward packages. The directors are aware that all the major software providers in Jayland pay a commission to consultancy firms if the firm recommends their software to a client. Currently, this commission is payable to SBC as a whole, but the directors are considering whether it should be paid to individual consultants. They are also considering a proposal under which the IT consultants would receive a lower basic salary, but would then be entitled to receive any commissions earned from the software providers.

Requirement

Evaluate the directors' proposal to revise the way SBC's IT consultants are paid.

See **Answer** at the end of this chapter.

4.5 Remuneration and corporate reporting

In addition to considering the impact of proposed remuneration policies on employees and their organisations, and how shareholders and other stakeholders might react to any proposed benefit packages, we also need to consider how employee benefits will be accounted for in an organisation's financial statements.

Two accounting standards are relevant here: *IAS 19 – Employee benefits*, and *IFRS 2 – Share-based payments.*

We have already looked at these two standards in Chapter 4, where we noted the concern which British Airway's large pension deficit caused in relation to the merger between British Airways and Iberia.

Crucially, British Airways' main pension scheme was a defined benefit scheme. As Section 4.5.1 below explains, the corporate reporting consequences of operating a defined benefit scheme are significantly different from operating a defined contribution scheme.

Therefore, when deciding what type of pension scheme to offer employees (as part of their reward package) it will also be important for an organisation to consider the corporate reporting implications of that decision.

4.5.1 IAS 19 – Employee Benefits

The objective of this Standard is to prescribe the accounting and disclosure for employee benefits, where employee benefits are all forms of consideration, for example cash bonuses, retirement benefits and private health care, given to an employee by an entity in exchange for the employee's services.

The Standard requires an entity to recognise:

(a) A liability when an employee has provided service in exchange for employee benefits to be paid in the future; and

(b) An expense when the entity consumes the economic benefit arising from service provided by an employee in exchange for employee benefits

However, accounting issues could arise due to:

- The valuation problems linked to some forms of employee benefits; and
- The timing of benefits, which may not always be provided in the same period as the one in which the employee's services are provided

Two elements of IAS 19 are particularly relevant to remuneration structures:

- **Short-term employee benefits** (falling due within 12 months from the end of the period in which the employees provide their services) such as wages, salaries, bonuses and paid holidays, non-monetary benefits such as private medical care or company cars

  These benefits should normally be treated as an expense, with a liability being recognised for any unpaid balance at the year-end.

- **Post-employment benefits** such as pensions and post-retirement health cover

  Pension schemes can either be **defined contribution** or **defined benefit** plans. The accounting for defined benefit plans is much more complex than for defined contribution plans.

Defined contribution plan

Contributions by an employer into a defined contribution plan are made in return for services provided by an employee during the period. The employer has no further obligation for the value of the assets of the plan or the benefits payable.

- The entity should recognise contributions payable as an expense in the period in which the employee provides services (except to the extent that labour costs may be included within the cost of assets).
- A liability should be recognised where contributions arise in relation to an employee's service, but remain unpaid at the period end.

Defined benefit plan

Under a defined benefit plan, the amount of pension paid to retirees is defined by reference to factors such as length of service and salary levels (ie it is guaranteed). Contributions into the plan are therefore variable depending upon how the plan is performing in relation to the expected future obligation (ie if there is a shortfall contributions will increase and vice versa).

Accounting treatment and impact on corporate reporting:

IAS 19 requires that the defined benefit plan is recognised in the sponsoring entity's statement of financial position as either a liability or asset depending on whether the plan is in deficit or surplus.

The deficit or surplus of the plan is determined by deducting the fair value of the plan assets from the present value of the defined benefit obligation.

Components of the cost of defined benefit plans are broken down into constituent parts and accounted for separately:

- Service cost is included in profit or loss
- Net interest on the net defined benefit liability (asset) is included in profit or loss
- Re-measurements of the net defined benefit liability (asset) are included in other comprehensive income

Importantly, defined-benefit schemes in the UK are heavily in deficit at the moment, and companies are under increasing pressure to reduce the funding gaps. From an investment perspective, these deficits have been driven by a fall in equities (which have reduced the value of plan assets). At the same time, falling mortality rates and increasing life expectancy are also a problem – if people are living longer, the defined benefit obligations (and hence the deficit) also increase.

An article in *Economia* (July 2012) reported that the aggregate FTSE 350 pension deficit increased from £43 billion to £67 billion during 2011.

4.5.2 IFRS 2 – Share-based payment

We have already mentioned IFRS 2 – *Share-based payment* briefly in Chapter 4 in the context of performance management, recognising that share options could be used to encourage directors to focus on the longer-term performance of their companies and not just on short term results.

However, if a company considers offering share options to its directors, it is important to weigh the potential impact these could have on its financial position.

IFRS 2 requirements

Prior to the publication of IFRS 2 there appeared to be an anomaly to the extent that if a company paid its employees in cash, an expense was recognised in profit or loss, but if the payment was in share options, no expense was recognised.

IFRS 2 resolved this anomaly by requiring an expense to be recognised in profit or loss in relation to share-based payments.

However, the introduction of the IFRS (in 2004) and the requirement to recognise share-based payments as an expense caused huge controversy, with opposition especially strong among hi-tech companies. The arguments over expensing share-based payments polarised opinion, especially in the US.

- The main argument *against* recording an expense was that no cash changes hands as part of such transactions, and therefore there is no true expense.

- The main argument *for* recording an expense was that share-based payments are simply another form of compensation that should go into the calculation of earnings for the sake of transparency for investors and the business community.

Practical application of IFRS 2

In practice, the implementation of IFRS 2 has resulted in earnings being reduced, sometimes significantly. It is generally agreed that as a result of the IFRS companies now focus more on the earnings effect of different rewards policies.

Following the adoption of IFRS 2, some companies have admitted that they are re-evaluating the use of share options as part of employee remuneration.

Impact on earnings and financial position

In the financial statements, entities should disclose information that enables users of the financial statements to understand the effect of share-based payment transactions on the entity's **profit or loss for the period** and on its **financial position**.

- The **total expense recognised for the period** arising from share-based payment transactions, including separate disclosure of that portion of the total expense that arises from transactions accounted for as equity-settled share-based payment transactions.
- For **liabilities** arising from share-based payment transactions:
  - The **total carrying amount** at the end of the period
  - The **total intrinsic value** at the end of the period of liabilities for which the counterparty's right to cash or other assets had vested by the end of the period
- Although not mentioned specifically by IFRS 2 in the context of disclosures, share-based payment transactions will have an impact on equity, being the other half of the double entry:

  DEBIT Expense

  CREDIT Equity (if equity settled)

Impact of share-based payments on Earnings per Share (EPS)

IAS 33 *Earnings per Share* requires that for calculating diluted EPS all dilutive options need to be taken into account. Employee share options with fixed terms and non-vested ordinary shares are treated as options outstanding on grant date even though they may not have vested on the date the diluted EPS is calculated. All awards which do not specify performance criteria are treated as options.

4.5.3 Share-based transactions with employees (share options)

Transactions with employees are normally:

- Measured at the **fair value** of equity instruments granted **at grant date**
- Spread over the vesting period (often a specified period of employment)

In accordance with IFRS 2 *Share-Based Payment* (paragraphs 16 and 17), where a transaction is measured by reference to the fair value of the equity instruments granted, fair value is based on market prices where available. If market prices are not available, the entity should estimate the fair value of the equity instruments granted using a suitable valuation technique (such as the Black-Scholes model, the Binomial model or Monte Carlo simulation).

Worked example: Employee transactions – indirect method

A company provides each of 10 key employees with 1,000 share options on 1 January 20X7. Each option has a fair value of CU9 at the grant date, CU11 on 1 January 20X8, CU14 on 1 January 20X9 and CU12 on 31 December 20X9.

The options do not vest until 31 December 20X9 and are dependent on continued employment. All 10 employees are expected to remain with the company.

Requirement

What are the accounting entries to be recorded in each of the years 20X7, 20X8 and 20X9?

Solution

The changes in the value of equity instruments after grant date do not affect the charge to profit or loss for equity-settled transactions.

Based on the fair value at grant date, the remuneration expense is calculated as follows.

Number of employees × number of equity instruments × fair value of equity instruments at grant date

= 10 × 1,000 × CU9 = CU90,000

The remuneration expense should be recognised over the vesting period of three years. An amount of CU30,000 should be recognised for each of the three years 20X7, 20X8 and 20X9 in profit or loss with a corresponding credit to equity.

4.5.4 Modifications and re-pricing

Equity instruments may be modified before they vest. For example, a downturn in the equity market may mean that the original option exercise price set is no longer attractive. Therefore the exercise price is reduced (the option is 're-priced') to make it valuable again.

Such modifications will often affect the fair value of the instrument and therefore the amount recognised in profit or loss.

The accounting treatment of modifications and re-pricing is:

- Continue to recognise the **original** fair value of the instrument in the normal way (even where the modification has reduced the fair value).
- Recognise any **increase** in fair value at the modification date (or any increase in the number of instruments granted as a result of modification) spread over the period between the modification date and vesting date.
- If modification occurs after the vesting date, then the additional fair value must be recognised immediately, unless there is, for example, an additional service period, in which case the difference is spread over the additional period.

4.5.5 Cancellations and settlements

An entity may settle or cancel an equity instrument during the vesting period. Where this is the case, the correct accounting treatment is:

- To immediately charge any remaining fair value of the instrument which has not been recognised to profit or loss (the cancellation or settlement accelerates the charge and does not avoid it).
- Any amount paid to the employees by the entity on settlement should be treated as a buy-back of shares and should be recognised as a deduction from equity. If the amount of any such payment is in excess of the fair value of the equity instrument granted, the excess should be recognised immediately in profit or loss.

4.5.6 Market based and non-market based vesting conditions

When share-based payments are offered to employees, there are likely to be some conditions (vesting conditions) which have to be satisfied before the employee is entitled to receive the share-based payment.

IFRS 2 distinguishes between two different types of vesting conditions:

Market based vesting conditions

Market-based performance or vesting conditions are conditions linked to the market price of the shares in some way. Examples include vesting dependent on achieving:

- A minimum increase in the share price of the entity
- A minimum increase in shareholder return
- A specified target share price relative to an index of market prices

Non-market based vesting conditions

These are conditions other than those relating to the market value of the entity's shares. Examples include vesting dependent on:

- The employee completing a minimum period of service (eg remaining with the company for a further three years) – also referred to as a service condition
- Achievement of minimum sales or earnings target
- Achievement of a specific increase in profit or earnings per share
- Successful completion of a flotation
- Completion of a particular project

The distinction between the two different types of vesting conditions has important implications for the accounting treatment of the shares:

Market-based vesting conditions

- These conditions are taken into account when calculating the fair value of the equity instruments at the grant date.
- They are not taken into account when estimating the number of shares or share options likely to vest at each period end.
- If the shares or share options do not vest, any amount recognised in the financial statements will remain.

Non-market based vesting conditions

- These conditions are taken into account when determining the expense which must be taken to profit or loss in each year of the vesting period. (They are not taken into account when calculating the fair value of the equity instruments at the grant date.)
- Only the number of shares or share options expected to vest will be accounted for.
- At each period end (including interim periods), the number expected to vest should be revised as necessary. The movement in cumulative expense is charged to profit or loss.
- On the vesting date, the entity should revise the estimate to equal the number of shares or share options that do actually vest.

Vested options not exercised

If after the vesting date options are not exercised or the equity instrument is forfeited, there will be no impact on the financial statements. This is because the holder of the equity instrument has effectively made that decision as an investor.

The services for which the equity instrument remunerated were received by the entity and the financial statements reflect the substance of this transaction. IFRS 2 does, however, permit a transfer to be made between reserves in such circumstances to avoid an amount remaining in a separate equity reserve where no equity instrument will be issued.

4.6 Executive remuneration and remuneration reports

In Chapters 3 and 4 of this Study Manual we mentioned the principal-agent problem, and the importance of aligning directors' (agents') interests with those of their company's shareholders (principals).

Granting share options to directors is one way of aligning directors' interests with those of the company's shareholders.

More generally, however, there has been increasing pressure on companies to be more transparent about the way directors' pay is set, and to improve accountability to shareholders. In the UK, the 'Directors' Remuneration Report Regulations' (2002) require all quoted companies to produce a detailed annual directors' remuneration report, and to hold a shareholder vote on that report.

The purpose of the Regulations is to:

- Enhance transparency in setting directors' pay
- Improve accountability to shareholders; and
- Provide for a more effective performance linkage

In this respect, the Regulations were also designed to enable shareholders to see the rationale behind directors' remuneration more clearly; although, perhaps surprisingly, the Regulations did not require companies to disclose information relating to their bonus policies. A company's bonus policy is likely to be an area of particular interest to shareholders.

In the context of Strategic Business Management, the linkage between remuneration and performance is also particularly important.

As the Foreword to the Department of Business, Innovation & Skills' (BIS) discussion paper 'Executive Remuneration' (2011) notes:

> '*Executive remuneration that is well-structured, clearly linked to the strategic objectives of a company, and which rewards executive directors who contribute to the long-term success of that company, is important in promoting business stability and growth. Shareholders want to see remuneration being used effectively to attract, incentivise and appropriately reward executives, so that the value of the companies they invest in increases over time.*'

Generous rewards can be justified when a company has delivered strong long-term performance and growth. However, as the BIS discussion paper highlights, the recent financial crisis has made shareholders, wider stakeholders (such as employees and customers), and the public at large more aware of the apparent disconnect between pay and performance. For example, one area of concern is that the remuneration of the highest paid executives in large companies seems to rise virtually every year, regardless of the performance of the company.

The link between strategy, pay and performance should therefore be an important factor for shareholders to consider when assessing remuneration proposals. The BIS discussion paper proposes that companies should provide a clearer statement on how executive remuneration relates to a company's achievement of its strategic objectives over the previous year.

However, as well as justifying its current payments, it is equally important for a company to describe its pay policy for the year ahead, so that shareholders can gauge how effectively future pay is linked to company strategy and performance.

In this respect, the draft regulations in the UK government's consultation document '*Directors' pay; revised remuneration reporting regulations*' (June 2012) have important implications for the information which companies have to disclose in remuneration reports.

The draft regulations provide that a remuneration report should set out a company's forward-looking policy on remuneration and potential payments. In particular, the report should include a table setting out the key elements of pay, along with supporting information such as their potential value, performance metrics, and how each element of performance supports the achievement of the company's short and long-term strategic objectives. Moreover, once this policy is approved by shareholders, the company will only be able to make payments within the limits the policy allows.

The draft regulations also require better information about how directors' pay relates to that of the wider workforce. Not only will this provide increased transparency on employee pay, but it will also highlight the difference between rises in directors' pay and the pay rises given to the rest of a company's employees.

This issue of the 'pay gap' between the rewards paid to senior executives and the remuneration received by the workforce at large has become increasingly pertinent in recent years. Shareholders are becoming increasingly sensitive to the idea that it is unfair for executives to get significantly higher increases than everyone else. Similarly, shareholders are also starting to ask whether the package of rewards received by each director is fair and justified in the context of their contribution to the business. Both of these issues should also serve as a warning that shareholders could vote against executive pay deals if they believe them to be unfair or unjustified.

However, the increased focus on performance and rewards could also pose some questions for the performance measures which are used to determine rewards, and how weightings are assigned to different measures. For example, should directors be rewarded for meeting environmental targets in a year when profits have decreased?

5 HRM and change management

Section overview

- We discussed the importance of change management in strategy implementation in Chapter 3 of this Study Manual. However, the link between change management and HRM is important because 'change' will also inevitably affect the people in an organisation.
- Therefore, in order for the change to be implemented successfully, the way the change is communicated to the people in an organisation and the way those people respond to and adapt to the change will also have to be managed effectively.

5.1 HRM and change agents

One of the four roles for HRM highlighted in Dave Ulrich's model (see Figure 10.2) is that of change agent.

HR departments in nearly every business have a key role in managing change effectively. Although some changes occur as clearly-defined episodes in response to external environmental factors, change can also be a continuous process within organisations (as implied by the notion of the learning organisation). Learning new knowledge could itself be a catalyst for change.

Moreover, change comes in different forms and can occur at different levels within an organisation:

- Individuals
- Structures and systems
- Organisational climate

Changing individuals involves changing their skills, values, attitudes and behaviours. Any such individual changes have to support the overall organisational changes required. However, ultimately organisational changes can only be achieved if the individual people working for an organisation change as necessary.

Changing structures and systems involves changing the formal and informal organisational structures in place: for example, changing business processes, or changing roles, responsibilities and relationships.

Changing the organisational climate involves changing the way people relate to each other in an organisation; the management style; and the overall culture of the organisation. For example, this might involve creating a culture of high interpersonal trust and openness between staff.

The presence of these three levels means a change manager needs to ensure that appropriate methods exist in order that the desired change is achieved at each level.

5.1.1 HRM and organisational change

Despite the range of possible change scenarios which might arise in an organisation, HR functions can still play a central role in the change process. Key activities might include:

- The recruitment and/or development of people with the necessary leadership skills to drive change, and staff with the necessary technical and operational skills to deliver the change
- Advise project leaders about reward and job design
- Communicating the benefits and effects of change to staff, and encouraging staff involvement in the change process
- Identifying the appropriate medium of communication to reach different stakeholder groups
- Understanding staff (or other stakeholders') concerns about changes, and helping to deal with them
- Negotiating and dealing with conflict; engaging with various stakeholders; understanding stakeholder concerns in order to anticipate problems with change programmes
- Assessing the impact which changes in one business area/department/location could have on other parts of an organisation
- Providing a structured framework for change, and helping people cope with change
- Constructing reward systems which underpin the change process and motivate staff to support the changes

The CIPD have identified seven areas of activity ('the seven Cs of change') which increase the probability of change programmes being successful. HR practitioners have a key role to play in each of the seven:

- Choosing a team
- Crafting the vision and path
- Connecting organisation-wide change
- Consulting stakeholders
- Communicating
- Coping with change
- Capturing learning

Alongside these specific areas of activity we could also suggest, more generally, that HR managers can play a key role as **change agents** in leading change.

The Study Manual for the *Business Strategy* syllabus identifies that the role of the change agent could include:

- Defining the problem
- Examining what causes the problem and considering how this can be overcome
- Suggesting possible solutions
- Selecting an appropriate solution

- Implementing the change
- Communicating information about the change throughout the organisation
- Gaining support from all involved to deliver the solution

In order to be effective, a change agent should have the following skills and attributes:

- Communication skills – and the ability to communicate effectively with people at all levels within an organisation
- Networking skills to establish and maintain contacts, both within and outside an organisation
- Negotiation and 'selling' skills – negotiating with stakeholders in the business to obtain resources for a project, or to resolve conflict; selling the vision of change to key stakeholders to increase support for a change programme. A change agent also needs to have influencing skills, to be able to convince potential sceptics about the benefits of a change programme, and thereby to overcome their resistance to it
- An awareness of organisational 'politics'
- Sensitivity to the impact changes will have on different stakeholders, and sensitivity in dealing with different stakeholders
- An understanding of the relevant processes
- Financial analysis skills: to assess the financial impacts of proposed changes, or to be able to look at how changes to operations and systems can deliver a desired financial goal
- Flexibility to be able to respond to shifts in project goals or objectives, or to adapt in response to internal or external factors which affect the change process
- An important point that Kanter highlights is that a change agent needs to be able to adapt to cope with the complexities of modern organisations

In particular, a change agent needs to:

- Be able to work across a range of business units and functions, and across a network of different stakeholders
- Be an effective collaborator, able to work in ways that enhance collaboration across different functions and divisions

These skills should resonate with the HRM competencies of an organisation.

Importantly though, a change agent should not be selected just because they have good general project management skills. The change agent must be **directly involved in the change process** and must see clear linkages between their future success in an organisation and the effective implementation of the change.

5.2 Models of change

Lewin's stage model of change

We have already looked at change management in Chapter 3 of this Study Manual, but it is worth noting how the elements of 'unfreeze', 'change' and 'refreeze' contain elements of HRM. In particular, a key element of the 'refreeze' stage is the use of positive reinforcement to reward and validate successful change, which could be linked to bonus and reward schemes where the bonuses are dependent on staff members adopting new approaches or methodologies.

Kotter's eight step model of change

Another widely-cited model of change is Kotter's eight 'lessons' which organisations need to address when implementing change. Again, however, these 'lessons' highlight the importance of 'people' in successful change management, as well as highlighting the importance of having a 'felt need' for change in an organisation, and the importance of communication throughout the change process.

1. **Establish a sense of urgency** – Discuss the current competitive position and look at potential future scenarios. Increase the 'felt need for change' (in other words, promote the driving forces for change).
2. **Form a powerful guiding coalition** – Assemble a powerful group of people who can work well together to promote the change.

3. **Create a vision** – Build a vision to guide the change effort, together with strategies for achieving it.
4. **Communicate the vision** – The vision, and accompanying strategies and new behaviours, need to be communicated. Kotter stresses that effective communication is crucial in change management.
5. **Empower others to act on the vision** – This includes getting rid of obstacles to change such as unhelpful structures or systems. People need to be allowed to experiment.
6. **Plan for and create short-term wins** – Look for and advertise short-term visible improvements because these will help sustain the driving forces for change. Kotter suggests that these short-term wins should be planned into the change programme, and people should be publicly rewarded for making improvements.
7. **Consolidate improvements and produce still more change** – Promote and reward those who are able to promote and work towards the vision. Maintain the energy behind the change process by introducing new projects, resources and change agents.
8. **Institutionalise new approaches** – Ensure that everyone understands that the new behaviours and systems will lead to corporate success.

Kotter's model can also be used to analyse the reasons why change initiatives have been unsuccessful – in effect, where the eight 'lessons' have not been followed successfully:

Reason for failure	Possible antidotes
Not enough sense of urgency	**Establish a sense of urgency by:** • Examining market or competitive pressures • Identifying potential crises or major opportunities • Ensure levels of dissatisfaction with current position or perception of future threat are sufficient to kick-start the change and maintain momentum
Failure to create a powerful support base	**Form a powerful guiding coalition by:** • Assembling a group with enough power to **lead the change effort** (Without an effective change management team, any change management project is likely to fail) • Encouraging the group to work together as a team • Ensure that key stakeholders are engaged
Vision not clearly developed	**Create a vision by:** • Having a clear understanding of what the change needs to achieve • Developing clear strategies for achieving the vision
Vision poorly communicated	**Communicate the vision by:** • Using a variety of media to communicate the new vision and strategies. Within this, it will also be important to **highlight the benefits** of the changes • Teaching new behaviours by the example of the guiding coalition of senior management • Ensuring people have a shared understanding and commitment to the direction of the change
Obstacles block the vision	**Empower people to act on the vision:** • Senior management demonstrably tackling obstacles to change • Ensure that all the people who are needed to make the change happen have the necessary resources and authority to achieve their goals
Failing to create short-term wins	**Plan for and create short-term wins by:** • Planning for visible performance improvements • Identifying smaller goals along the way to the ultimate target so that success can be demonstrated. Being able to demonstrate success will maintain momentum • Recognising and rewarding employees involved in improvements

Reason for failure	Possible antidotes
Systems, policies and skills not aligned	**Consolidate improvements and produce more change by:** • Changing systems, structures and policies that don't fit the vision • Hiring, promoting and developing employees who can implement the vision • Building on improvements in the organisation as and when they occur to continue to move the change forward
Failing to anchor changes in the corporate culture (not refreezing)	**Institutionalise new behaviours by:** • Explaining how the new behaviours will deliver corporate success • Developing the means to ensure leadership development and succession • Ensuring knowledge about the new approaches is captured and shared

(*Source*: Adapted from *Cameron & Green*, 'Making sense of change management' and based originally on an article by *Kotter* in the Harvard Business Review)

One additional factor which could jeopardise the success of a change management project is a **lack of change management/implementation expertise** and skills within an organisation's senior management team. Change does not just happen on its own; management need to define the change programme, ensure the necessary resources are allocated to it, and drive it forward. However, for example, if the senior management team do not have any previous experience of change programmes and do not allocate sufficient resources to a change programme, this could jeopardise its success.

5.3 Maintaining internal consistency

When planning or implementing change in an organisation, it is important that the proposed changes 'fit' with the existing context of the organisation.

Successful change management requires more than simply recognising a change trigger and acting on it. Instead, successful exploitation of a change situation requires:

- Knowledge of the circumstances surrounding a situation
- Understanding of the interactions in that situation
- Awareness of the potential impact of the variables associated with the situation

McKinsey 7-S model

The McKinsey 7-S model provides a framework for looking at an organisation as a set of interconnected and interdependent subsystems. This interdependence highlights that strategies adopted in any one area of an organisation (or changes to the strategies pursued in any area of the organisation) will have an impact on other parts of the organisation.

Therefore, when considering changes in an organisation, it could be useful to think about how the proposed changes fit with the 7 S's:

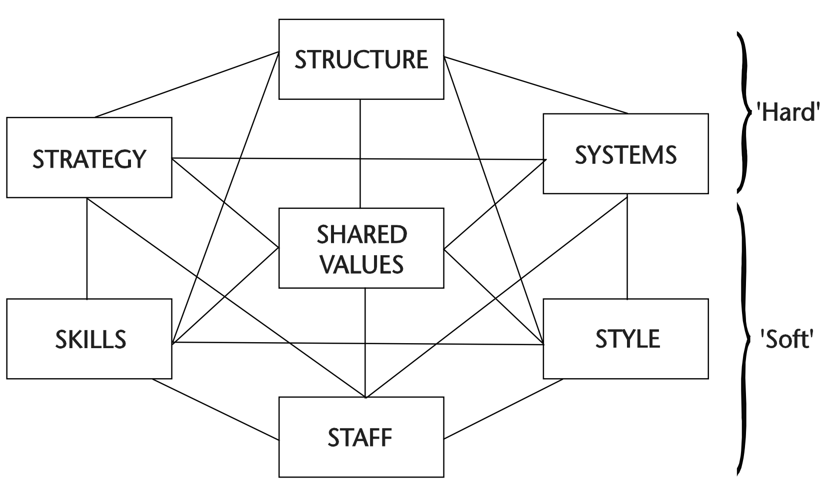


Figure 10.7: McKinsey 7-S model

There are three '**hard'** elements of business behaviour

(a) **Structure**. The organisation structure refers to the formal division of tasks in the organisation and the hierarchy of authority from the most senior to junior.

(b) **Strategy**. How the organisation plans to outperform its competitors, or how it intends to achieve its objectives. This is linked to shared values.

(c) **Systems**. These include the technical systems of accounting, personnel, management information and so forth. These are linked to the skills of the staff.

These 'hard' elements are easily quantified and defined, and deal with facts and rules.

'Soft' elements are equally important.

(a) **Style** refers to the **corporate culture** that is the shared assumptions, ways of working, attitudes and beliefs. It is the way the organisation presents itself to the outside world.

(b) **Shared values** are the guiding beliefs of people in the organisation as to why it exists. (For example, people in a hospital seek to save lives.)

(c) **Staff** are the people in the organisation.

(d) **Skills** refer to those things that the organisation does well. For example, the telecom company BT is good at providing a telephone service, but even if the phone network is eventually used as a transmission medium for TV or films, BT is unlikely to make those programmes itself.

All elements, both hard and soft, **must pull in the same direction for the organisation to be effective**.

For example, an organisation will not benefit if it installs the most sophisticated, up-to-date management information systems, yet its managers continue to want to receive the same reports as they always have because they don't understand or trust the new technology. In this simple example, there is a **mismatch** between systems and staff/skills.

5.4 Leadership and change

Change management is a comprehensive effort to lead an organisation through transformation. To be successful, the transformation effort must be actively led and managed with a clear set of objectives and an agreed plan for achieving these objectives.

A crucial problem organisations have to address is how they can **manage change** in the fast-moving environment of contemporary business while also **maintaining control** and their **core competencies**.

Designing, evaluating and implementing successful change strategies depends to a significant extent on the quality of the senior management team, and in particular that team's ability to design the organisation in a way to facilitate the change process.

5.4.1 Who leads change?

Although a CEO plays an important role in leading strategic change, leading change is not only the responsibility of the CEO.

Whetten and Cameron have pointed out:

> '…the most important leadership demonstrated in organisations usually occurs in departments, divisions, and with teams and with individuals who take it upon themselves to enter a temporary state of leadership...'

Inevitably, though, leading change will also require competencies in influencing and conflict handling, because people may need to be persuaded of the value and benefits of change.

Change may create conflict between individuals and their environment – and, often, within individuals themselves.

Change can often make people uncomfortable, which is why many people resist it. Organisational change also creates potential conflict between management (who may be identified as the causes or agents of change) and employees (who often feel like the 'victims' of it).

Managing change is in essence a process of facilitating internal and external conflict resolution.

So change leaders have to play a dual role of not only leading a business forward, but also resolving any conflicts which are created during the course of the change process.

5.4.2 Change roles

We can identify a number of key players in the change process.

Change leader: The success of the change programme is based on a key, pivotal figure. This leader may be the CEO, the MD, or another senior manager acting as an internal change agent.

Change advocate: who proposes the change.

Change sponsor: who legitimises the change.

Change agent: who implements the change. Change agents seek to initiate and manage a planned change process.

Change targets/recipients: although they do not lead the change, it is important in any change programme to remember the change targets – these are the people who undergo the change.

Other change roles to consider are:

External facilitators: External consultants may be appointed to help co-ordinate the change process.

Change action team: A team of people within the organisation may be appointed to lead the changes. This team may take the form of a steering committee. If the team does not include any influential senior managers it will need the backing of more powerful individuals to support any major change efforts.

Functional delegation: The responsibility for managing change may be assigned to a particular function – often the HR department. This approach is probably most suitable when the skills needed to manage the change reside within a particular department. However, unless the department head is a powerful authority figure, he or she will need the backing of a more powerful figure to spearhead major change efforts.

5.5 Strategy, change management and HRM

Ultimately, change is inevitable in any progressive organisation. Any business that wants to thrive in an ever-changing world needs to adapt to its environment.

One of the key responsibilities for an organisation's management is to detect trends inside and outside the organisation to identify changes that are needed and then to initiate a change management process to introduce those changes.

The change management process can be summarised in three steps:

(a) **Strategic planning and design:** form a change management team, define the vision and strategy, design a programme from which to manage the change and determine the tools needed for implementation

(b) **Strategy implementation:** communicate the vision and implementation to staff, manage staff responses and lead them through the change; maintain momentum

(c) **Evaluation and readjustment:** look at the results, track performance against targets, modify structure if necessary, plan for the future but continue to monitor performance

However, it is important to remember that change can affect all the aspects of an organisation and, in turn, how implementing a business strategy could require changes in all the aspects of an organisation.

As the diagram below illustrates, people are likely to be central to strategy implementation and change management within organisations. Consequently, HRM also needs to be considered as an important element of change management.

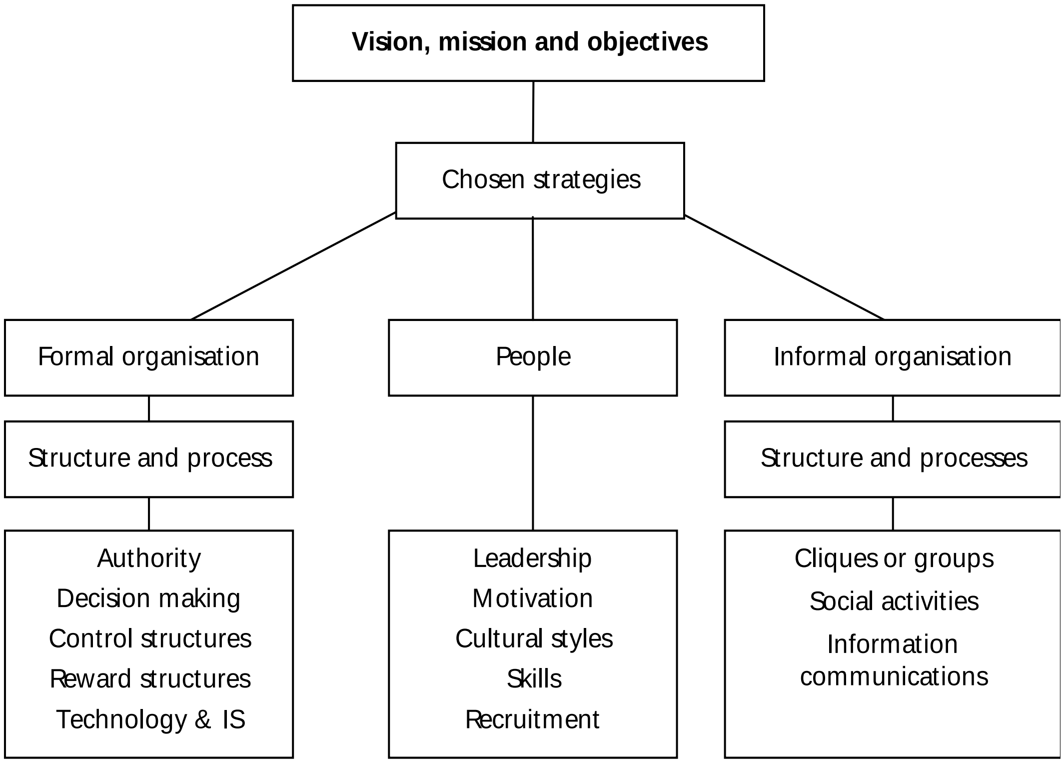


Figure 10.8: HRM and strategy implementation

5.6 HRM and acquisitions

Although we have so far looked at the role of HRM in managing internal changes within an organisation, HRM is also a crucial part of an acquisition or merger.

Managing the 'human' side of an acquisition or merger is critical for maximising the value of the deal, and a number of the key issues involved in any such deal relate directly to HR issues:

- Determining the organisational structure of the new company
- Integrating the organisational cultures of the different companies
- Retaining key talent and key managers
- Communicating to staff in both companies, and addressing any concerns they may have
- Dealing with any redundancies which may be necessary
- Aligning the remuneration and reward systems of both companies
- Deciding on HR policies and practice for the new company

5.6.1 HRM and due diligence

Not only could protecting and developing the rights and interests of human resources be crucial to a successful acquisition, there may also be legal obligations associated to it (for example, obligations relating to a pension scheme, or obligations arising if employees' terms and conditions of employment are protected when a business is transferred from one owner to another).

In this respect, human resource due diligence will be an important element of a take-over. The functions which are relevant to HR due diligence are likely to include the following:

- HR audit:
  - Benefits and compensation programmes
  - Recruitment process
  - Practices for recruitment and dismissal
  - Exit procedures
  - Employee contracts and employee handbooks

  - Personnel files
  - Organisation charts
  - Performance reviews, and guidelines for how employee performances are evaluated
  - Training and education programmes
  - HR strategy

- Obligations under the pension scheme

- Union contracts/union memberships

- Evaluation of synergies, gaps and duplications in numbers and skills

- Review of potential redundancies (and redundancy costs, including senior management compensation plans) and cost savings post-acquisition

- Talent retention

- Legal compliance (eg group insurance, employment legislation, health and safety)

As we have already noted, the pre-acquisition process also needs to review organisational structure (eg number of management layers, centralisation vs decentralisation) and the organisational 'fit' (culture and values) between the two companies.

Summary and Self-test

Summary

Successful strategic implementation requires the effective recruitment, training and organisation of staff, coupled with effective leadership and performance management.

Human resource management is vital in ensuring that an organisation attracts, and retains, the number and quality of staff it needs in order to achieve its organisational goals.

To be successful, an organisation's HRM strategies need to be aligned to its business strategy. The systems of reward management and remuneration used by an organisation will vary according to its business and the generic strategy it is pursuing.

Performance measurement and management are equally important in the context of HRM as they are in relation to the overall strategic and operational control of an organisation. Appraisals are a key part of performance management, and provide a link between individual's performance and an organisation's overall strategy.

It is important to recognise the potential behavioural implications of performance targets. Poorly designed performance targets may lead to an adverse impact on employees' performance and, consequently, on an organisation's ability to implement its strategy successfully.

Reward systems should have three overall objectives: to support staff recruitment and retention; to motivate employees to high levels of performance; and to promote compliance with workplace rules and expectations.

When formulating employee benefit packages, an organisation also needs to consider the corporate reporting implication of the decision. This has been a particular issue for defined benefit plans (in relation to IAS 19, *Employee benefits*) in which pension scheme deficits have created large liabilities in company's statements of financial position.

Human resources departments are likely to have a key role in managing change effectively. The majority of changes will be internal within an organisation, but HRM will also be crucial in relation to an acquisition or merger.

Self-test

Self-test question 1

Connie Head was the recently appointed HR manager in a medium sized accounting firm. Her appointment was a belated recognition by the senior partners of the firm that their ambitious corporate growth goals were linked to the performance of the individual business units and the accountants working in those units. Connie was convinced that performance management and an appraisal system were integral elements in helping the firm achieve its strategic objectives. This reflected her experience of introducing an appraisal system into the corporate finance unit for which she was responsible. The unit had consistently outperformed its growth targets and individual members of the unit were well motivated and appreciative of the appraisal process.

However, the senior partner of the firm remained unconvinced about the benefits of appraisal systems. He argued that accountants, through their training, were self-motivated and should have the maximum freedom to carry out their work. His experience of appraisal systems to date had shown them to lack clarity of purpose, be extremely time consuming, involve masses of bureaucratic form filling and create little benefit for the supervisors or their subordinates. Certainly, he was resistant to having his own performance reviewed through an appraisal system. Connie, however, was convinced that a firm-wide appraisal system would be of major benefit in helping the achievement of growth goals.

Requirement

(a) Evaluate the extent to which an effective appraisal system could help the accounting firm achieve its goals.

(b) Using models where appropriate, assess the contribution, if any, of performance management to the strategic management process.

Self-test question 2

Elegard offers warranties for electrical and electronic equipment to both business and household customers. For a fixed annual fee the company will provide a free fault diagnosis and repair service for equipment covered by the warranty. A warranty lasts for one year and customers are invited to renew their warranty one month before it expires. Elegard employs 350 full-time engineers around the country to undertake these repairs. It costs about CU7,000 to train a newly recruited engineer.

When equipment breaks down the customer telephones a support help line where their problem is dealt with by a customer support clerk. This clerk has access to the work schedules of the engineers and an appointment is made for a visit from an engineer at the earliest possible time convenient to the customer. When the engineer makes the visit, faults with equipment are diagnosed and are fixed free of charge under the terms of the warranty.

Elegard is extremely concerned about the relatively high labour turnover of its engineers and has commissioned a report to investigate the situation. Some of the findings of the report are summarised in the following table (Table 1). It compares Elegard with two of its main competitors.

Table 1

Company	*Labour turnover**	*Average salary (CU)*	*Profit sharing scheme*	*Average days holiday/year*	*Performance related pay*	*Average training spent per year per engineer (CU)*
Elegard	12%	32,000	No	21	No	1,000
Safequip	8%	30,000	Yes	24	Yes	1,500
Guarantor	7%	29,500	Yes	26	Yes	1,250

* Labour turnover is the number of engineers leaving in the last year as a percentage of the number of engineers employed at the beginning of the year

An exit survey of engineers leaving the company recorded the following comments:

(a) 'This is the first place I have worked where learning new skills is not encouraged. There is no incentive to improve yourself. The company seems to believe that employees who gain new skills will inevitably leave, so they discourage learning.'

(b) 'There is no point in doing a good job, because you get paid no more than doing an ordinary one. Average work is tolerated here.'

(c) 'The real problem is that the pay structure does not differentiate between good, average and poor performers. This is really de-motivating.'

The HR director of Elegard is anxious to address the high turnover issue and believes that quantitative measurement of employee performance is essential in a re-structured reward management scheme. He has suggested that the company should introduce two new performance related pay measures. The first is a team based bonus based on the average time it takes for the company to respond to a repair request. He proposes that this should be based on the time taken between the customer request for a repair being logged and the date of the engineer attending to fix the problem. He argues that customers value quick response times and so the shorter this time the greater the bonus should be for the whole team.

In addition, he proposes an individual bonus. This will be based on the average time taken for an engineer to fix a reported fault and complete the job once they have arrived at the customer's address and started work on it. He argues that the company values quick repair time as this increases business efficiency and so the quicker the fix the greater the bonus should be for the individual.

Required

(a) Assess the deficiencies of Elegard's current rewards management scheme.

(b) Analyse the limitations of the proposed performance measures suggested by the HR director.

Self-test question 3

Grateley Ltd ('Grateley') is a listed company which manufactures clothing. About 60% of its output is sold to Bloomsdale Ltd ('Bloomsdale'), a major Bangladesh -based chain of clothes stores. Clothes are sold under Bloomsdale's own label and are regarded as being in the mid- to up-market range. The clothes are manufactured at Grateley's three factories, all of which are in Bangladesh and are of approximately equal size.

The workforce at Grateley is largely unskilled or semi-skilled. There is poor morale, low motivation and a high staff turnover. There is little opportunity for career progression as manual employees are all at the same level, reporting directly to section managers. Trade unions frequently complain about both the repetitive nature of the production line work and about the low pay. There have been three strikes at Grateley's factories in the last five years.

The management philosophy of Grateley is prescriptive and top-down, with the imposition of budgets and quotas. Little training or staff development is given, with the major focus on the achievement of output and quality targets. Employees are, however, given bonuses which are based on two different targets. First, when monthly factory output achieves predetermined levels; and second, if quality thresholds are satisfied based on the monthly number of items returned by customers as defective. On average, these targets are achieved only one month in every three.

Bloomsdale has been a major customer of Grateley for about 30 years, but a new management team has now taken over at Bloomsdale. It informed the board of Grateley that a new annual contract is to be arranged which would involve a major reduction in prices offered, and that the volumes purchased by Bloomsdale from Grateley next year would be only have that of previous years. It was also made clear that further price reductions would need to take place in future years if the contract is to be maintained at the new lower volumes.

As employees became aware of the increasingly competitive conditions, the possibility of factory closure emerged and there was increasing unrest at all three factories.

At the crisis meeting the board of Grateley identified two options:

Option 1 Close one factory and attempt to cut costs at the other two factories through a policy of efficiency improvements and redundancies.

Option 2 Close two factories and open a new factory in Congo where labour costs are significantly lower than in Bangldesh. Efficiency improvements and redundancies would also take place at the sole remaining Bangladehi factory.

Requirement

As the human resources director of Grateley, write a memorandum to the board evaluating the human resource management issues which may arise under each of the two strategic options identified.

Refer to relevant studies or evidence where appropriate.

Technical Reference

IFRS 2, *Share Based Payments*

- The objective of IFRS 2 is to specify the financial reporting by an entity when it undertakes a share-based payment transaction. IFRS 2 requires an entity to recognise share-based payment transactions (such as shares granted, or share options) in its financial statements. This includes transactions with employees or other parties to be settled in cash, other assets, or equity instruments of the entity. **Overview**

IAS 19, *Employee Benefits*

- Outlines the accounting requirements for employee benefits, including short-term benefits (eg wages and salary, annual leave); post-employment benefits (eg retirement benefits); and termination benefits. The standard requires that the cost of providing employee benefits should be recognised in the period in which the benefit is earned by the employee, rather than when it is paid or payable. The standard also outlines how each category of employee benefits are measured, and it provides detailed guidance about post-employment benefits. **Overview**

IAS 33, *Earnings Per Share*

- The objective of IAS 33 is to prescribe principles for determining and presenting earnings per share (EPS) to improve performance comparisons between different entities in the same reporting period, and between different reporting periods for the same entity. IAS 33 sets out how to calculate both basic EPS and diluted EPS. The calculation of basic EPS is based on the weighted average number of ordinary shares outstanding during the period, whereas diluted EPS also includes dilutive potential ordinary shares (such as options and convertible instruments) if they meet certain criteria. **Overview**

Answers to Interactive questions

Answer to Interactive question 1

Human resource planning and strategy

ScanTech's growth plans envisage the company doubling in size over the next three years. This will require the employment of extra staff, particularly in marketing, sales and manufacturing. The ambitious planned rate of growth and the high technology base of ScanTech's business mean that these extra staff must be of very high quality. Human resource (HR) management is thus an essential component of the company's business strategy and so should be integrated with its development. The alternative is increased potential for serious shortages of staff and mismatches between job requirements and staff availability.

The proposed opening of a foreign manufacturing plant will complicate all HR issues significantly and will demand very careful consideration.

The following elements of human resource planning could be useful at ScanTech:

An **audit of existing staff** should reveal those with potential for promotion or employability in new specialisations. It would also indicate where shortages already exist.

Concurrently, an analysis of **likely future staff requirements** could be carried out. It seems inevitable that ScanTech will need to employ more staff in the areas already mentioned, but it does not seem to know how many will be required, whether other functions will need to be increased in size, or if more support and administrative staff will be needed. There are also the related and sensitive issues of **management succession** and **internal promotion** to consider. In particular, ScanTech needs to consider the eventual replacement of the existing joint Managing Directors, who are expected to leave once the current growth objective has been achieved.

These two elements of analysis should help ScanTech to identify the gaps that it will need to fill if it is to have the staff required for its overall growth strategy.

Recruitment will be the logical next step once the analysis of resource requirements have been completed **–** in the sense of attracting applicants, and **selection** from within the pool of applicants. Recruitment work is often **outsourced** (to a recruitment agency) and it will be necessary for ScanTech to decide whether the **expertise** and **economies of scale** offered by outsourcing outweigh the need for deep familiarity with our operations on the part of the recruiters.

Reward policy must be considered. At the moment, ScanTech's staff profile is heavily biased towards people with a background in research and development. Different types of people will be required in the future and their expectations for their rewards and remuneration are likely to vary from those of the existing staff.

A doubling in size to, say, 220 employees is likely to take the company into an area of HR complexity in which a formal reward policy and structure is required. Informal decisions about pay and benefits will not be satisfactory.

Increasing size is also likely to require the establishment of a policy on **appraisal and performance management**. This should be linked to a programme of **training and development**. It is likely that ScanTech will continue to hire well-qualified technical staff, but there will be a need for development of staff in other functions and for management development in particular.

Answer to Interactive question 2

Forecast human resource demand

- Reduction in numbers of staff required in the future
- Roles – amalgamation up of management roles due to reduction in number of branches
- Skills – need for staff with customer skills rather than bureaucratic and professional banking skills

- Availability – requirement for more flexible working practices, eg late/weekend opening, 24/7 cover of call centres
- Location shift – staff will be required in off-shore centres with reductions in city centres

Forecast human resource supply

- Potential excess supply of staff internally as internal jobs contract and external opportunities diminish
- Increased availability of staff on external labour market due to downsizing by other banks may make this a cheap source of staff – eg on short-term contracts
- Need to consider the forecast supply in off-shore locations

Training and development

- Change in the skills and competencies away from professional qualification of Chartered Institute of Bankers or Chartered Insurance Institute
- Requirement for some staff to pass compulsory regulatory exams to sell new financial products
- Regular updating of staff in new products and legal/regulatory issues

External recruitment

- Potential for cheaper sources of staff externally than internally
- Reduction in intake of school-leavers and graduates due to surplus of staff internally
- Need to access new sources of staff to cover new technologies (eg IT recruitment)
- Recruitment will also take place off-shore

Answer to Interactive question 3

There is only limited information available about JBC's appraisal system. However, it is clear that the organisation has taken a formal approach using standardised forms with clear objectives for staff development and performance improvements.

Problems with the system can be considered under two headings – firstly inherent problems with the design and implementation of the system, and secondly problems concerning its operation.

Design and implementation problems

The system may have been poorly designed in the first place. For example, it may be based on systems used by other organisations and no thought given to whether it is suitable for JBC.

The design of the system may have reflected the needs of the organisation at that time but is no longer relevant because the company has 'moved on'.

There may have been a lack of consultation and communication with senior managers when the system was being developed. They may view it as being imposed on them and therefore are not interested in making it work.

Appraisal schemes should provide **benefits** which justify the cost and effort put into them. Senior management comments such as 'a waste of time and effort' indicate that there is an imbalance between what is put into the scheme and what comes out – for example, whether or not any staff development needs which are identified during an appraisal are actually subsequently addressed.

This imbalance may have been caused by the system being put into place because senior management thought they should be seen to have an appraisal system, rather than it being a genuine method of improving staff development and performance.

Operational problems

Senior managers may have **insufficient time** to conduct the appraisal process properly. This may reduce the scheme into a form filling exercise just to meet HR requirements, missing the point of the scheme and its objectives.

The scheme focuses on staff development needs. This is likely to involve some **additional training costs,** and may also reduce the amount of time that academic staff are available for teaching (if they are attending training courses of their own). Therefore, managers may not see it as being in their interest to have staff undergo training. This, of course, is a short-sighted view, as properly structured training should improve JBC's performance in the long run. However, managers may not wish to wait for such benefits to materialise, preferring to focus on short-term issues and performance instead.

The scheme is **not linked to annual bonuses**. Employees are likely to act in a manner that maximises their bonus, which may be at odds with the objectives of the appraisal system.

Standard procedures indicate a **bureaucratic** or mechanical approach to appraisals. Senior managers will be faced with a large volume of identical paperwork that needs to be processed in addition to their existing work load. There is likely to be a temptation to rush through the process with not much thought to the objectives.

Appraisal schemes often involve **subjective judgements** and **opinions** by senior managers over their staff. There is a risk that employees are not assessed correctly or consistently meaning that some staff who do not require training are offered it while others that need help to improve their performance are not.

Answer to Interactive question 4

Staff retention – It appears that SBC's current reward package for its IT consultants is not as competitive as that offered by some of its rivals. If this continues, then SBC's staff turnover could increase further, which is likely to be costly for SBC both in terms of having to recruit and train new staff and also in terms of the loss of knowledge which occurs when consultants leave.

If the new proposal means that the overall value of the consultants' salary increases, then this could help to reduce staff turnover which should be beneficial to SBC.

Value of commissions – However, it is not clear what impact the proposed changes will have on the consultants' salaries. The scenario does not indicate how much lower the new basic salary will be than the consultants current salaries, nor does it indicate the size of the commissions received from the software companies.

It is possible that the proposal could actually end up reducing the consultants' salaries, which will have the opposite effect to what the directors are trying to achieve.

Impact on SBC's profits – Equally, however, the directors will need to ensure that the changes are not too generous in favour of the consultants because they are likely to reduce SBC's profit margins, for example because the commissions will no longer be income for the company. Moreover, if the commission system doesn't stimulate higher sales revenue, the effect of the commissions will be to reduce profits overall. Therefore, a key issue surrounding the acceptability of the proposal is whether it will result in higher revenues being generated.

Other consultants – The directors also need to consider how the other types of consultant will respond. Again, it is not clear how much communication there is between the three types of consultant, but if advertising and recruitment consultants find out the IT consultants have had their rewards schemes revised, they may want something similar themselves.

Risk to customers – When SBC's clients are looking to select a new software system, a key factor in their choice should be how well the system fits their requirements. Advice about the suitability of different systems is likely to be one of the key pieces of advice they want from the consultants. However, the new system could compromise the consultants' ability to give this advice impartially.

Under the current system, it appears that the consultants have no incentive to recommend one software supplier over another. However, under the proposed new system, consultants may be tempted to advise clients to buy the system that will earn them the highest amount of commission rather than the system which is best for the client.

Such practices could be damaging to SBC's reputation and future revenues. If clients install software systems on SBC's advice which do not meet their requirements effectively, then they are unlikely to use SBC in future.

Alternative bonus/reward scheme – It appears that the commission scheme is the only option which the directors have looked at so far. However, rather than only looking at one scheme, they should also consider whether there are any alternative schemes which may be more appropriate. For example, it is not clear whether SBC currently has any kind of performance related pay scheme, or bonus scheme; a scheme which rewards consultants for their performance in relation to a range of targets, linked to SBC's overall objectives, may be more appropriate than the current proposal.

Answers to Self-test

Answer to Self-test question 1

Part (a)

The Senior Partner and Connie emphasise the aspects of appraisal schemes that **support their own favoured policies**. Such schemes should support the organisation's overall objectives without incurring excessive administrative and management costs.

In an organisation such as an accounting practice, the professional staff should indeed be highly **self-motivated**, able to judge the effectiveness of their own performance and bring to their work a commitment to high professional standards. On the other hand, it is inevitable that their **talents and performance will vary** and they will need **guidance and help with their future development**. Dealing with these issues would be the role of an appraisal scheme.

The overall aim of such a scheme would be to **support progress toward the achievement of corporate objectives** and it would do this in three ways: performance review, potential review and training needs review.

Performance review. Performance review should provide employees with an **impartial and authoritative assessment of the quality and effect of their work**. Individuals should have personal objectives that support corporate goals via intermediate objectives relevant to the roles of their work groups. A reasoned assessment of performance can have a **positive motivating effect** simply as a kind of positive, reinforcing feedback. It can also provide an opportunity for analysing and addressing the **reasons for sub-optimal performance.**

Potential review. Any organisation needs to make the best use it can of its people. An accountancy practice is typical of many modern organisations in that its people are its greatest asset and future success depends on managing them in a way that makes the best use of their skills and aptitudes. An important aspect of this is **assessing potential for promotion and movement into positions of greater challenge and responsibility.**

Training needs review. A further aspect of the desirable practice of enabling staff to achieve their potential is the provision of training and development activities. The appraisal system is one means by which **training needs can be assessed** and training provision initiated.

In this context, the reviews within the appraisal system would seem to be a supportive developmental process.

However, there is a tension at the heart of an appraisal system between appraisal as a **judgement process** and a **developmental process**. Whereas development will help motivate, the judgemental aspect of appraisal may **demotivate** and this will hinder the firm in trying to achieve its goals.

The appraisal system

An appraisal system must be properly administered and operated if it is to make a proper contribution to the organisation's progress.

The appraisal cycle. Formal appraisal, with interviews and written assessments, is typically undertaken on an **annual cycle**. This interval is commonly regarded as too long to be effective because of the speed with which individual roles can evolve and their holders can develop, so the annual appraisal is often supplemented with a less detailed review after six months. Sometimes the procedure is sufficiently simplified that the whole cycle can be done at intervals of six months. Much modern thinking on this topic is now suggesting that any frequency of periodic appraisal is unsatisfactory and that it should be replaced by a **continuous process of coaching and assessment**.

This aspect of 'continuous improvement' will be more likely to help the firm achieve its goals.

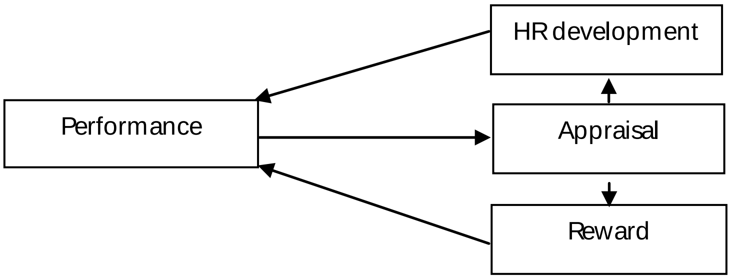
Objectivity and reliability. Appraisal involves an element of direct personal criticism that can be stressful for all parties involved. If the system is to be credible, its outputs must be seen as objective and reliable. These outputs should be used to motivate individuals to achieve their goals.

Setting targets. Past performance should be reviewed against **objective standards** and the performance against these targets should form the basis of the employee's reward.

If the approval system acts to motivate the staff by rewarding them for achieving their **individual goals** and these individual goals are properly **aligned to the firm's goals**, then the appraisal can be effective in helping the firm achieve its goals.

However, the goals in themselves must be **realistic and achievable**. If they are not, then staff will become de-motivated and the appraisals will be counter-productive.

However, overall an effective appraisal system can help manage the workforce in a rational way, as through the feedback look illustrated below, thereby helping the firm to achieve its goals.



Part (b)

Performance management involves the establishment of clear, agreed individual **goals and performance standards**; continuous leadership action to both **motivate and appraise subordinates**; and a **periodic review** of performance at which the goals and performance standards for the next cycle are set.

Performance management is an application of the **rational model** of strategic management, in that individual goals are intended to form the lowest echelon of a **hierarchy of objectives** that builds up to support the **overall mission** of the organisation. It is an essential aspect of the system that individual goals should be **agreed and internalised** so that true **goal congruence** is achieved.

This overall approach was first described by Peter Drucker, and is seen most clearly in the system of **management by objectives** (Mb0). Mb0 as a management system has fallen somewhat from favour with the rise of quality management methods that emphasise processual and procedural conformance rather than the attainment of overall performance goals. Nevertheless, it has much to offer.

MbO and strategic analysis

Under a formal Mb0 system, the process of setting goals is part of the **implementation phase** of strategic management and follows consideration of resources, overall objectives and SWOT analysis. In this way, MbO resembles the strategic analysis stage of the rational planning model.

Strategic choice

Top level subordinate goals are agreed for heads of departments, divisions or functions: these goals should be specific, measurable, attainable, relevant and time-bound (SMART). It is particularly important that the achievement of a goal can be established by objective **measurement**. There may be different timescales for different objectives, with short-term goals supporting longer-term ones. Again there is a parallel here to the notions of suitability, acceptability, and feasibility of the rational planning model.

Strategic implementation

Departmental heads then agree SMART goals for their subordinates in discussion with them, that support their own personal goals, and so on down the hierarchy to the level of the individual employee. All members of the organisation thus know what they are expected to achieve and how it fits into the wider fabric of the organisation's mission.

Periodic **performance review** is based on the objective appraisal of success against agreed goals, the agreement of goals for the next period and an assessment of the resources, including training, that the reviewee may require to reach those goals. The MbO system thus closes the **feedback loop** in the corporate control system.

Answer to Self-test question 2

Part (a)

Impact of the reward management scheme on staff turnover

The engineers at Elegard are very important workers to the company. Their motivation, their commitment and their proficiency in undertaking repair work are all critical success factors for Elegard because they will influence how customers perceive the company and, therefore, whether customers will renew their warranties rather than moving to a competitor.

Elegard's high labour turnover suggests its engineers are not as motivated and committed to the company as they could be, and this is a significant problem.

High labour turnover is also a problem because of the costs incurred in training newly recruited engineers – about CU7,000 each – in addition to the costs of advertising jobs and arranging interviews.

Consequently, the extent to which the current reward management scheme contributes to this high labour turnover among Elegard's engineers suggests there are a number of problems with the scheme.

Too much focus on base pay – Elegard's rewards scheme focuses on base pay with little attention given to performance pay or indirect pay. The focus on basic pay is unlikely to encourage motivation among skilled staff, like the engineers. Although Elegard's basic pay is higher than its competitors, it has a higher staff turnover rate than its competitors. This suggests that base pay alone is not an effective reward.

Lack of performance related pay – Safequip and Guarantor both offer their engineers performance related pay. This is likely to act as a motivating factor for their engineers, knowing they can gain extra pay by virtue of doing their jobs well. By contrast, Elegard's engineers have no such incentive. An exit interview with one of the engineers reinforces this point: 'The real problem is that the pay structure does not differentiate between good, average and poor performers. This is really de-motivating.'

The HR director has recognised this weakness in the current reward management scheme, which is why he has suggested two new performance related pay measures.

Current scheme does not promote organisational goals – The lack of performance related pay means there is little incentive for the engineers to do a good job. Given the key role the engineers play in the success of the company, this is a major business risk. If customers do not feel they are getting a good service from Elegard, they are unlikely to renew their warranties. Again, one of the exit interviews stresses the problem here: 'There is no point in doing a good job, because you get paid no more than [for] doing an ordinary one. Average work is tolerated here.'

Absence of profit share scheme – Overall organisational performance can be supported through profit sharing schemes, provided individual's goals are properly aligned to corporate objectives.

If employees benefit from the profitability of their company, then they have an incentive to try to maximise that profitability. Both Safequip and Guarantor offer a profit sharing scheme for their engineers, but Elegard does not. This is likely to reinforce the attitude among Elegard staff that there is no point trying to do a good job, because they will get no benefit from doing so.

Levels of indirect pay – Indirect pay (or benefits) such as pension plans or private health care can form a valuable part of an organisation's total rewards package.

Two measures which could indicate Elegard's approach to indirect pay are the number of days of holiday staff are offered per year, and the average amount of training they are given. In both of these measures, Elegard performs worse than its competitors.

Low average training spend – The relatively low amount which Elegard spends on training is a particular concern. It suggests that Elegard views training as a cost rather than as an investment in human capital.

One of the exit interviews highlights the impression this view is giving to the staff: 'This is the first place I have worked where learning new skills is not encouraged.' Elegard seems to view training as a risk, thinking that once staff gain new skills they will inevitably leave. Ironically, however, the lack of opportunities for training and development seems to be one of the reasons prompting staff to leave.

Part (b)

General problems

Ability of employees to influence performance measures – The key logic behind performance related pay is that the incentive of an increased income will motivate employees to improve their performance. However, if the employees cannot influence the performance targets they are being measured against then performance related pay will not be a motivating factor for them. Unfortunately, it seems that the performance targets the HR director is proposing are largely outside the scope of the employees' influence.

Goal congruence – Performance measures should be designed so that individuals' goals are aligned with organisational goals. If a scheme encourages employees to work in a way that maximises their individual income, but in doing so reduces the performance or profitability of their organisation as a whole, this will be a problem for the organisation. The HR director's focus on speed may create problems in this respect.

Limitations of proposed team-based bonus scheme

Response time measures outside employees' control – The HR director has proposed that the bonus should be based on the **time between a customer logging a repair request and the date the engineer arrives** to fix the problem. This correctly reflects that customers value quick response times, but it overlooks that the measure is influenced by factors outside the team's control.

The date an engineer can attend to fix the problem **depends on the availability of an engineer**. This could be influenced by the **number of engineers Elegard chooses to employ** rather than necessarily the efficiency of the engineers.

Customers can dictate visit dates – Also, Elegard's policy is to schedule visits 'at the earliest possible time **convenient to the customer**.' However, if domestic customers are out at work and cannot immediately take time off to be at home for a service visit, this 'convenient time' may be quite a long way in the future. The team cannot control this timescale, making it an unsuitable basis for a performance measure.

Limitations of proposed individual bonus scheme

The individual bonus will be based on the average time taken for an engineer to fix a fault once they have arrived at the customer's premises. The HR director's logic for this is that quick response time increases business efficiency.

To an extent, the engineer can control the time taken to fix a fault, but there are still some significant problems with this measure.

Repair time depends on the complexity of the problem – An engineer called out to fix a complex problem will inevitability take longer than an engineer who has to fix a simple problem. This measure would therefore penalise engineers working on complicated problems, which ironically could be the most important jobs for Elegard to do well.

Trade-off between speed and quality – The performance measure might encourage engineers to perform a **quick fix** (to get the job signed off) rather than to sort the underlying problem properly.

Consequently, the **measure could actually increase the volume of repairs** Elegard has to undertake, whereas the business model is based on the need to minimise calls and repairs.

In respect, the HR Director's proposal would create a **problem with goal congruence**. By performing low-quality quick fixes individual engineers can boost their own incomes, but their doing so will damage the profitability of the company as a whole.

Inaccurate job reporting – The measure could also encourage engineers to misrepresent the time they actually spent on a job. The bonuses are based on the time taken to **fix a fault once the engineer has arrived at the customer's premises**, so if an engineer claims it took longer to get to a client than it did the engineer can **artificially reduce the time reported against the job**. Again, the measure is promoting behaviour which is unhelpful for the company as a whole. For example, if customers' warranty fees are calculated according to the time taken to fix faults, an understated time could result in Elegard charging a warranty that is too low, which in turn could cause of restriction of Elegard's profits.

Focus only on time – As well as these specific issues around goal congruence, the HR Director's proposals suffer through focusing exclusively on time. While speed is important to the customer (and so is an important performance measure), the proposals would benefit by including other measures which address quality, skills, or training. The lack of focus on quality and training are key issues behind the current high staff turnover, yet these proposals do nothing to address this.

Answer to Self-test question 3

MEMORANDUM

To: The Board of Grateley Ltd

From: HR Director

Date: [today's date]

Subject: HRM implications of strategic options

In broad terms, approaches to human resource management can be classified into 'hard' and 'soft' approaches, and these represent opposite ends of the spectrum.

Hard approach. Emphasises **resources** element of HRM. Human resources are planned and developed to meet the wider strategic objectives of the organisation, as with any other resource. This involves managing the functions set out below to maximise employee effectiveness and control staff costs.

Soft approach. Emphasises **human** element of HRM. This is concerned with employee relations, the development of individual skills and the welfare of staff.

Grateley currently adopts the hard view of HRM but this needs consideration given the magniture of change elsewhere in the organisation. The implications of this approach and of the proposed changes themselves can be seen in all the HRM functions within the company.

Personnel planning and control. This is the analysis of the organisation's future need for employee resources, with respect to quantity and skills, given the nature of the labour market.

The most obvious feature in the current circumstances is to allow for the loss of business from Bloomsdale. The reduction in future employee levels will need to correspond with future demand for Grateley's output. If Bloomsdale is halving the volume of its purchases from Grateley and these currently account for 60% of revenue, then total revenue in future will be around 70% of its current level (ie 60% x ½ from Bloomsdale, and 40% from other customers). This would indicate that at least one factory will need to be closed unless Grateley is able to attract any significant new customers, and even this is dependent on Bloomsdale not cutting its purchase further in future.

If there is to be a new factory in Congo then appropriate planning is necessary to determine the optimal quantity of new labour. This may not be the same as for a Bangladeshi factory because of differences in labour productivity, different levels of capital investment, different procedures and employee agreements, different motivation and incentives, and different labour costs.

Recruitment and selection. Choosing the right person for the posts specified in the job design.

There is unlikely to be recruitment in Bangladesh, but under strategic option 2 there will be significant recruitment in Congo and this would be a major HRM exercise in an unfamiliar labour market.

Remuneration. Preparing remuneration packages for employees to provide appropriate incentives while controlling costs in the circumstances of the organisation and the labour market. This may involve participation in collective bargaining with trades unions.

It would appear that labour rates are relatively low for Bangladesh but are likely to be much lower in Congo.

The two issues here are the amount of remuneration and the form it takes in terms of incentives or conditions.

In terms of total remuneration per employee, the company is restricted by the need to control costs and to meet Bloomsdale's demands on price. This in turn is determined by competitors' prices in the clothing market. The other constraint, however, is Bangladeshi labour market whereby it might not be possible to attract the appropriate quality and quantity of labour in the long term if pay is too low. Other conditions, such as the minimum wage and union agreements, also constrain the ability to reduce the remuneration per employee.

However, while there are a number of constraints on remuneration per employee, labour cost savings can be made by labour efficiency gains. There has been strong union resistance to this in the past but, given the external threat from Bloomsdale, there is an improved prospect of managing redundancies at those Bangladesh plants remaining open as part of a reorganisation package.

In Congo, labour costs would be much lower but the workforce are likely to be, initially at least, unskilled and there would be a need to develop the right corporate culture in order to maintain quality of output. Transportation costs (inward and outward), set-up costs and inventory holding costs would partially off-set any labour cost advantange.

Incentives. The incentives schemes presently in operation in Bangladesh do not appear to be working, given the failure to meet targets in two months out of three. Low motivation and morale also seem to be apparent. Studies argue, however, that financial reward can only have a limited effect on motivation (eg Maslow, McGregor Theory X, and Herzberg). Thus, while the form of remuneration should be reconsidered, other aspects of HRM should also be examined to try to improve morale and motivation at existing Bangladeshi factories and to develop them at the Congo factory if option 2 is selected.

Employee communication and counselling. Developing communication channels to and from individuals, groups and all employees collectively, but also participation in operation such communication procedures.

The top-down management approach may be partly responsible for the lack of motivation. The nature of the work, culture of instruction/imposition and the lack of opportunity to advance would all appear to reduce motivation for employees. There might therefore be a key role for HRM both in changing management style in existing plants and also in developing a new management style for the potential new plant. This could lead to increased motivation and improved output and efficiency.

A study by Blake and Mouton analysed management style within a two-dimensional matrix (or managerial grid). The two factors identified were: (i) concern for people; (ii) concern for production or task.

In the context of this matrix, the management style at Grateley could be regarded as high in terms of (ii) and low in terms of (i). A new style of participation might be regarded as more balanced between the two factors. Indeed, to the extent that participation may lead to greater motivation and increased production, it could be viewed as high in respect of both of Blake and Mouton's factors.

Studies (eg the Hawthorne Experiments) have also indicated the potential for motivation through consultation. In the Hawthorne Experiments, the work carried out by staff was repetitive and boring. A series of changes were introduced after consultation with employees. After the changes, productivity rose in almost every case. The rise in productivity was as much due to the fact that employees had been consulted and so felt appreciated, rather to the nature of the changes themselves.

A particular issue in Grateley's case will the likely cultural differences between Bangladesh and Congo. This many result in different types of motivation, different work methods and different managerial styles being appropriate.

Job design. Producing a job description and job specification in terms of experience, skills and education. In setting up a new workforce in Congo, a major exercise in job design and specification will be necessary.

Training and development. Involves the analysis of training needs and the organisation of the provision of training and staff development to meet those needs. Includes new and existing staff, and all levels of management.

In terms of the new jobs in Congo, training all new employees simultaneously is a major undertaking.

Even in Bangladesh, however, the scale of the labour reductions under either option is likely to involve reorganisation of the workforce, which could have implications for training needs.

Compliance with legal and other standards. Involves informing and advising managers of employment, contract and other relevant law with respect to employees, and setting up procedures to comply with such legislation and other codes of conduct, agreements and ethical standards.

In Congo, the law and codes of conduct are likely to be different to Bangladesh and a learning process will be needed. Local expertise will be necessary in employment law.

Moreover, even if employment laws in Congo are less strict than in Bangladesh, in terms of being seen as a socially responsible company, Grateley will need to consider whether its own policies are more stringent than required by local law.

Other HRM issues are likely to include performance appraisal, disciplining employees, grievances and disputes, and workforce diversity.

The closure of one or more of Bangladeshi factories will also lead to specific HRM issues around redundancies. Grateley will need to be seen to act fairly and ethically in terms of any redundancies in order to protect the company's reputation and to avoid any legal claims being brought against it, particularly given the unionisation of the workforce.

Notes

Notes

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