Contents

Chapter-1

Introduction to the strategic business leader exam

Chapter learning objectives

Upon completion of this chapter you will be able to:

- understand the aims and structure of the Strategic Business Leader (SBL) exam and how it is marked
- understand what it means to be a "strategic leader"
- understand the professional skills required in the SBL exam and how they are examined.

1 Introduction

The aim of the exam

The aim of the Strategic Business Leader (SBL) exam is to demonstrate organisational leadership and senior consultancy or advisory capabilities and relevant professional skills, through the context of an integrated case study.

The examination requires candidates to demonstrate a range of professional skills demanded by effective leaders or in advising or supporting senior management in directing organisations.

Role play

The basic structure of each exam will require the candidate to take the **role** of an organizational leader or as a consultant or adviser to senior management.

For example, in sample assessment 1, candidates were asked to adopt the role of an external management consultant throughout the case, whereas in sample assessment 2 roles included being chairman of the nominations and corporate governance (NCG) committee in task 1, an assistant auditor in task 2 and a project manager in task 5. In each scenario candidates were expected to "get into character" and be very careful to consider who they were working for and who the report was for and what they required.

2 The strategic leader

Being a leader

Increasingly the role of accountants is that of professional advisors and leaders within business.

A leader is expected to be able to

- analyse a business situation and
- provide and implement appropriate, effective and sustainable solutions

This means that they can

- be clear and focused, identifying the key issues in any situation analyse and address ethical concerns
- use technical models and quantitative analysis to draw out key issues, establish causality and integrate a wide range of factors into a coherent argument
- make clear recommendations that meet and exceed the needs of users and are 'fit for purpose'.

The SBL exam will test the extent to which you can fulfill this role and demonstrate this skill set.

Thinking strategically

- Taking a **long term perspective.**
- Looking at the **whole organisation** as well as individual products/ divisions / strategic business units (SBUs).
- Setting the **direction** of the whole organisation and integrating its activities.
- Considering the views of **all stakeholders.**

- Analysing the organisations **resources** and defining resource requirements.
- Relating the organization to its **environments.**
- Looking at gaining a sustainable **competitive advantage.**

3. Professional skills

Employability and professional skills

These form the basis of the professional skills listed in the syllabus:

- Communication
- Commercial acumen
- Analysis
- Scepticism
- Evaluation

Chapter 2

Concepts of Strategy

1 The nature of strategic decisions

Strategic planning

'Strategic planning' can also be known as 'long-term planning' or 'corporate planning'. Those alternative names give some insight into nature of strategic planning it:

- considers the longer term (think of a time-horizon of about five years or beyond)
- considers the whole organization.

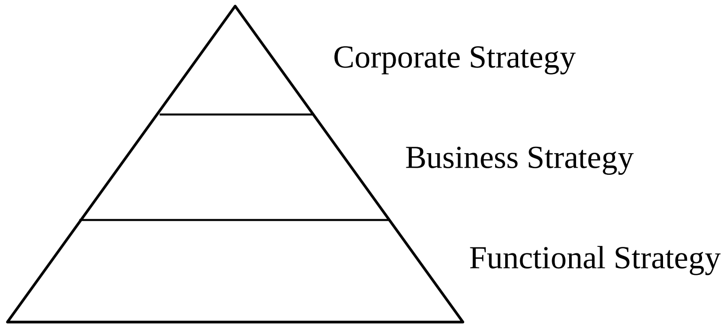
Other characteristics of strategic planning are that:

- it gives direction to the whole organisation, and integrates its activities
- it considers all stakeholders
- it looks at how to gain a sustainable competitive advantage
- it relates the organisation, its resources and competences to its environments.

Advantages	Disadvantages
• forces organisations to look ahead	• can be time consuming and expensive
• improved fit with the environment	• may be difficult in rapidly changing markets
• better use of resources	• can become a straightjacket
• provides a direction/vision	• some unplanned for opportunities may be missed
• helps monitor progress	• can become bureaucratic
• ensures goal congruence	• is less relevant in a crisis

Level of strategic planning

There are three levels of strategic planning:



Corporate Strategy

- this looks at the organisation as a whole and considers:
- the firm's orientation toward growth (also known as its directional strategy)
- the level of diversification in the company's products and markets (also known as its portfolio strategy)
- the manner in which management coordinates activities and transfers strategic capabilities between business units (also known as its parenting strategy).

Business Strategy

This examines each individual business unit and focuses on:

- actions taken to provide value to customers and gain a competitive advantage by exploiting core competencies in specific, individual product or service markets.
- the firm's position in an industry, relative to competitors and to the five forces of competition.

Functional or Operational Strategy

Functional strategy relates to a single functional operation (such as purchasing, marketing, human resource management etc.) and the activities involved therein. Decisions at this level within the organization are often described as tactical.

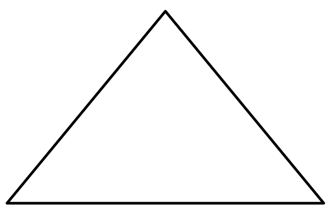
They are much more detailed and specific than corporate and business level strategies and deal with areas such as:

- allocation of resources among for optimal contribution to the achievement of the SBU and corporate-level objectives
- coordination between functions for optimal contribution to the achievement of the SBU and corporate-level objectives
- gaining, retaining and developing resources and capabilities into ones which can give strategic advantages and support the business level strategy.

2 An approach to strategic planning

The Johnson, Scholes and Whittington (JSW) model of strategic planning consists of three elements:

The strategic position / analysis



Strategic choices Strategy into action (implementation)

The strategic position/analysis

Assessing the strategic position consists of analyzing:

- the environment (competitors, markets, regulations, discoveries, etc), helping identify opportunities and threats

- the strategic capability of the organisaction (resources and competences), helping identify strengths and weaknesses
- the culture, beliefs and assumptions of the organization
- the expectation and power of stakeholders (what do the shareholders want? Will employees co-operate?

Strategic choice

Strategic choice follows strategic analysis and is based upon the following three elements.

- Generation of strategic options, e.g. growth, acquisition, diversification or concentration.
- Evaluation of the options to assess their relative merits and feasibility.
- Selection of the strategy or option that the organization will pursue. There could be more than one strategy chosen but there is a change of an inherent danger or disadvantage to any choice made. Although there are techniques for evaluating specific options, the selection is often subjective and likely to be influenced by the values of manager and other groups with an interest in the organization.

Strategy into action/implementation

Implementing a strategy has three elements.

- Organising / structuring. For example, should the organisation be split into European, US and Sian divisions? How autonomous should divisions be?
- Enabling an organisation's resources should support the chosen strategy. For example, appropriate human resources and non-current assets need to be acquired.
- Managing change. Most strategic planning and implementation will involve change, so managing change, in particular employee' fears and resistance, is crucial.

The implementation process

Structure

It is likely that changes in organizational structure will be needed to carry through the strategy and there is also likely to be a need to adapt the systems used to manage the organisation.

Resource planning

Resource planning covers finance, human resource management and physical resources such as land and buildings. It involves assessing the key tasks to satisfy the critical success factors, and the resources to be allocated to the key tasks. It is concerned with the following questions.

Managing change

Successful implementation will rely on the successful management of the change to the new strategy. This will involve not only the management of the systems and structures of the organisation, but also the management of its people and routines. This will involve two elements:

The JSW model of strategic planning

Johnson, Scholes and Whittington model of strategic planning

A full-price airline is considering setting up a 'no frills', low-fare subsidiary. The strategic planning process would include the following elements.

Strategic position: An analysis will need to be made of areas such as expected competitor actions, oil price forecasts, passenger volume forecasts, availability of cheap landing rights, public concern for environmental damage, the strength of the airlines main brand.

Strategic choices: A number of options will need to be considered such as which routes to launch? Whether to set up a service from scratch or buy an existing cheap airline? Which planes to use, what on-board services to offer?

Strategic implementation: Once a decision has been made the best way to put that decision into practice will have to be considered and this will involve an assessment of areas such as how autonomous should the new airline be? How to recruit and train staff? Implementation of the internet booking system. Acquisition of aircraft. Obtaining landing slots.

3 Strategic drift

When planned strategies are not realised it is often because events develop in unexpected ways:

- the organisation's underlying assumptions turn out to be invalid
- the pace of development overtakes it
- changes in the organisation's external environment, e.g. changes in the market for the goods and services that the firm produces and in the nature of the competition facing the company
- the organisation's internal environment changes.

If an organisation fails to keep up with the changes in its external environment it can lead to what is known as strategic drift.

Explanation of the stages in strategic drift

- Phase 1: The organisation takes a series of logical, incremental steps that were part of its plan to change ahead of the market and develop a competitive advantage.
- Phase 2: The rate of change in the market place speeds up, and the firm's incrementalist approach is not enough to maintain its advantage, and it is left behind.
- Phase 3: Faced with a stimulus for action, managers may seek to extend the market for their business, but may assume that it will be similar to their existing market, and therefore set about managing the new venture in much the same way as they have been used to.

Causes of strategic drift

- cultural influences in maintaining strategic stability and sometimes resisting strategic change
- the power structure within the organisation
- the effect of politics and the relative influences on the decision-making of different individuals and groups.

Avoiding strategic drift

- regularly assesses its environment (both in its current state and its expected future state) for changes
- has flexible systems for reacting to changes in its environment
- breaks down barriers to change by having and organisational culture that successfully copes with change
- has a clear idea of its mission and objectives order to understand where it wants to be in the future and to guide strategic changes to organisational direction and strategy.

Chapter-3

Strategic analysis

2 The PESTEL model

The **PESTEL** model looks at the macroenvironment, using the following headings:

- **Political.** The political environment includes taxation policy, government stability and foreign trade regulations.
- **Economic.** The economic environment includes interest rates, inflation, business cycles, unemployment, disposable income and energy availability and cost.
- **Social.** The social/cultural environment includes population demographics, social mobility, income distribution, lifestyle changes, attitudes to works and leisure, levels of education and consumerism.
- **Technological.** The technological environment is influenced by government spending on research, new discoveries and development, technological and industry focus of technological effort, speed of technological transfer and rates of obsolescence.
- **Ecological/ environmental.** The ecological environment, sometimes just referred to as 'the environment', considers ways in which the organisation can produce its goods or services with the minimum environmental damage.
- **Legal.** The legal environment covers influences such as taxation, employment law, monopoly legislation and environmental protection laws.

Overall, the model should allow a business to assess the **growth prospects** for the industry within which the organisation operates.

3 Porter's five forces model

Porter looked at the structure of industries. In particular, he was interested in assessing industry attractiveness, by which he meant how easy it would be to make above average **profits** (for shareholders and to fund adequate investment). He concluded that industry attractiveness depends on five factors or forces:

Force	**Potential impact on attractiveness**
Buyer power	Powerful buyers can demand discounted prices
	And extra services (which and costs to the organisation)
Supplier power	Powerful suppliers can lead to price wars and higher prices for
	their product(s)

Competitive rivalry	High levels of competition can lead to price wars and high expenditure on marketing and innovation
New entrants	New entrants can increase the cost of resources as well as increasing the power of other force
Substitutes	If an organisation has a lot of substitutes it will have to keep its prices low to deter customers from moving to these substitutes

Porter's five forces

Bargaining power of buyers

Powerful customers can force price cuts and/or quality improvements. Either way, margins are eroded. Bargaining power is high when a combination of factors arises.

Such factors could include where:

- a buyer's purchases are a high proportion of the supplier's total business or represent a high proportion of total trade in that market
- a buyer makes a low profit
- the quality of purchases is unimportant or delivery timing is irrelevant, and prices will be forced down
- there are similar alternative products available from other suppliers.

Bargaining power of suppliers

The power of suppliers to charge higher prices will be influenced by the following:

- the degree to which switching costs apply and substitutes are available
- the presence of one or two dominant suppliers controlling prices
- the extent to which products offered have a uniqueness of brand, technical performance or design not available elsewhere.

Competition/rivalry

Intensity of existing competition will depend on the following factors:

- Number and relative strength of competitors. The competition in a market can range from perfect competition through to monopoly.
- Rate of growth. Where the market is expanding, competition is low key.
- Where high fixed costs are involved companies will cut prices to marginal cost levels to protect volume, and drive weaker competitors out of the market.

- If buyers can switch easily between suppliers the competition is keen.
- If the exit barrier (i.e. the cost incurred in leaving the market) is high, companies will hang on until forced out, thereby increasing competition and depressing profit.

Threat of new entrants

New entrants into a market will bring extra capacity and intensify competition. The threat from new entrants will depend upon the strength of the barriers to entry and the likely response of existing competitors to a new entrant. Barriers to entry are factors that make it difficult for a new entrant to gain an initial foothold in a market. Major sources of barriers to entry are:

- **Economies of scale,** where the industry is one where unit costs decline significantly as volume increases, such that a new entrant will be unable to start on a comparable cost basis.
- **Product differentiation,** where established firms have good brand image and customer loyalty. The costs of overcoming this can be prohibitive.
- **Capital requirements,** where the industry requires a heavy initial investment (e.g. steel industry, rail transport).
- **Switching costs,** i.e. one-off costs in moving from one supplier to another (e.g. a garage chain switching car dealership).
- **Access to distribution channels** may be restricted (e.g. for some major toiletry brands in the UK 90% of sales go through 12 buying points, i.e. chemist multiples and major retailers). It is therefore difficult for a new toiletry product or manufacturer to gain shelf space.
- **Cost advantages of existing producers,** independent of economies of scale, e.g. patents, special knowledge, favourable access to suppliers, government subsidies.
- **Know-how.** It is much more difficult to penetrate a business where considerable know-how and skills are needed than to enter a simple, basic market.
- **Regulation.** Governments or professional bodies might supervise and limit new entrants.

Threat of substitute products

This threat is across industries (e.g. rail travel versus bus travel versus private car) or within an industry (e.g. long life milk as a substitute for delivered fresh milk). **Porter** explains that 'substitutes limit the potential returns… by placing a ceiling on the price which firms in the industry can profitably charge'. The better the price-performance alternative offered by substitutes, the more readily will customers switch.

4 Scenario planning

The number of scenarios to plan for

The most common approach to scenario planning is to create three potential future scenarios:

- The most likely scenario – this reflects the majority of managements' expectations of the future possibilities for the market.
- The best case scenario – this reflects a position where the key environment factors move in a favourable direction for the organization (for example, if the product becomes fashionable, the economy improves, competitors fail to react to changing technology etc.).
- The worst case scenario – this reflects a position where the environment turns against the organization (for example, if there were more entrants into the market or if the economy where to suffer a period of recession).

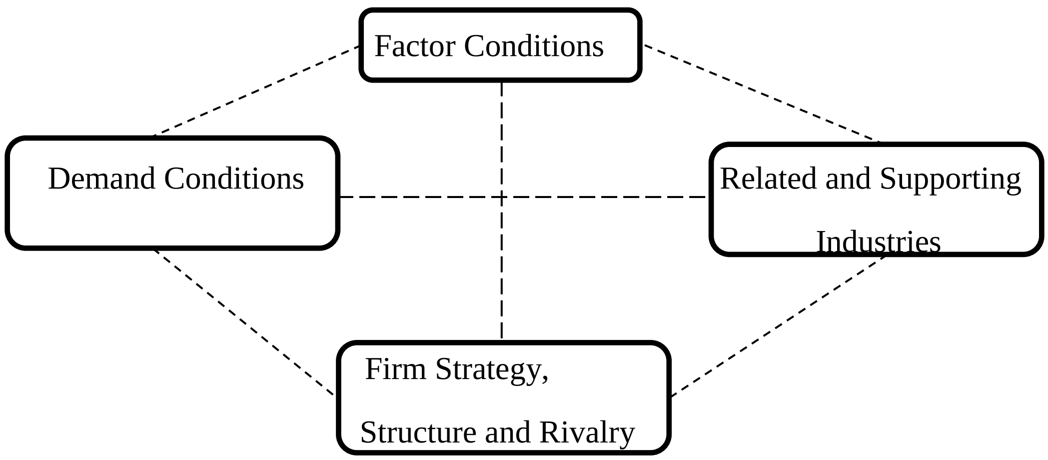
Benefits and problems of scenario planning

Manager aware of what key environmental factors for the organization are

Warning signs in place for potential scenarios created contingency plans for coping with different scenarios more flexible at adapting to its environment. Lead to a strategic competitive advantage

5 Porter's diamond

Porter called the answer to these questions the determinants of national competitive advantage. He suggested that there are four main factors which determine national competitive advantage and expressed them in the form of a diamond.



Further detail on Porter's diamond

(a) Favourable factor conditions:

(i) physical resources such as land, minerals and weather

(ii) capital

(iii) human resources such as skills, motivation, price and industrial relations

(iv) knowledge that can be used effectively

(v) infrastructure.

Porter also found that countries with factor disadvantages were forced to innovate to overcome these problems, e.g. Japanese firms experienced high energy costs and were forced to develop energy efficient products and processes that were subsequently demanded worldwide.

(b) Demand conditions: there must be a strong home market demand for the product or service. This determines how industries perceive and respond to buyer needs and creates the pressure to innovate. A compliant domestic market is a disadvantage because it does not force the industry to become innovative and able to excel.

(c) Relating and supporting industries: the success of an industry can be due to its suppliers and related industries. Sweden's global superiority in its pulp and paper industries is supported by a network of related industries including packaging, chemicals wood-processing, conveyor systems and truck manufacture. Many of these supporting industries have also achieved leading global positions.

(d) Firm strategy, structure and rivalry: organizational goals can be determined by ownership structure. Unquoted companies may have slightly longer time horizons to operate in because their financial performance is subject to much less scrutiny than quoted companies. They may also have different 'return on capital' requirements.

6 Environmental opportunities and threats

- the organization has to decide how to:
- grab the best opportunities
- defend against the most serious threats.

7 Strategic capabilities, resources and competences

Strategic capability is the adequacy and suitability of the resources and competences an organisation needs if it is to survive and prosper.

Another way to look at CSFs is to examine an organisation's strategic capabilities. If a business can obtain unique resources and core competences this should lead to its success. This can be explained in the following table:

	Resources	**Competences**
Threshold capabilities • these are necessary for any organisation to exist and compete in an industry • they are likely to be common to most rivals and easily copied • they will not lead to success or competitive advantage.	Threshold resources Example: any daily newspaper has reporters, editors, printing staff etc.	Threshold competences Example: every consumer electronics firm will have capabilities in electrical engineering
Strategic Capabilities • these are particular to an individual business • they will be hard to copy • they will be valued by the customer **(CSF)** • they will lead to competitive advantage.	Unique resources Example: A particular newspaper may be able to stand out from its rivals if it has an exclusive deal with the country's top sportstar who will write a daily column on his/ her sport.	Core Competences Example: Sorry believe they have core competences in design and user-friendliness that their rivals can't match.

More on strategic capabilities

Note that capability refers to resources and competences and their relationship can be shown as:

Strategic capability

Resource

Competences: the activities, process and methods through which an organization uses its resources effectively

Tangible: physical asset such as Machinery, labour, finance

Intangible: non-physical assets such as knowledge, knowhow, brand, reputation

Strategic capability can also be divided into threshold capabilities and capabilities for competitive advantage.

- Threshold capabilities. These are the **minimum** capabilities needed for the organisation to be able to compete in a given market. They consist of threshold resources and threshold competences - the resources and competences needed to meet customers' minimum requirements.
- Capabilities for competitive advantage. The capabilities that allow an organization to beat its competitors. These capabilities must meet the needs and expectations of its customers. Unique capabilities are not enough – they must be valued by the customers.

Threshold capabilities
Threshold resources
Threshold competences

→

Capabilities for competitive advantage
Unique resources
Core competences

- Unique resources are those resources that create competitive advantage and that others **cannot imitate or obtain.** Examples of unique resources are:
  - brand
  - situation, for example, near a source of raw material or a source of cheap labour

- sunk – competitors have to cover depreciation costs
- right to use a patented process.

Note that if the unique resource is people-based, the people can move to competitors or start their own business.

- Core competences are the activities, processes and methods through which an organisation uses its resources effectively, in ways that others cannot imitate or obtain. Examples of core competences are:
  - sophisticated IT that, for example, enables complex and accurate demand forecasting
  - a corporate culture that fosters innovation
  - the ability to share and lever knowledge throughout the orgainsation.

Critical success factors

What are critical success factors?

Critical success factors (CSFs) are the essential areas of the business that must be performed well if the mission, objectives and goals of the business are to be achieved.

Critical success factors (CSFs) are performance requirements that are fundamental to an organisation's success. In this context CSFs should thus be viewed as those product features that are particularly valued by customers. This is where the organisation must outperform competition

Examples of CSFs for major industries include:

- in the automobile industry – styling, an efficient dealer network, organisation, performance
- in the food processing industry – new product development, good distribution channels, health aspects (e.g. low fat)
- in the life insurance industry – reputation, innovative new policies
- in the supermarket industry - the right product mix available in each store having it actually available on the shelves, pricing it correctly.

Organisational knowledge as a strategic capability

Knowledge is a strategic capability. An organisation's knowledge of its environment (such as expected technological changes, changes in substitute availability etc.) can make it stand out from rivals. It can be more proactive towards its environment and also be in a position to react quicker to environmental changes when necessary.

Johnson, Scholes and Whittington define organizational knowledge as:

'the collective experience accumulated through systems, routines and activities of sharing across the organization.'

Resources (such as staff, assets etc.) can be purchased but capabilities must be developed and grown. Organisations therefore need to work on this. It is not automatic and problems that are discovered too late can be difficult to rectify.

Organisational knowledge is cumulative in nature. It will be built up over time from past experience and actions. But it does not simply follow a learning curve effect (otherwise organisations of a similar ‘mass’ or history would have similar organizational knowledge – which is not often the case). Organisational knowledge can also be added to and improved. Environmental analysis, staff development, process improvement, organisational structure etc. (many of these areas covered later in the syllabus) can all impact on and improve organizational knowledge.

Organisations must recognise that successful development of organizational knowledge can be a critical success factor. A key part of this can be knowledge management.

Knowledge management involves the processes of:

- uncovering, or discovering, knowledge
- capturing knowledge
- sharing knowledge
- distributing knowledge
- maintaining knowledge.

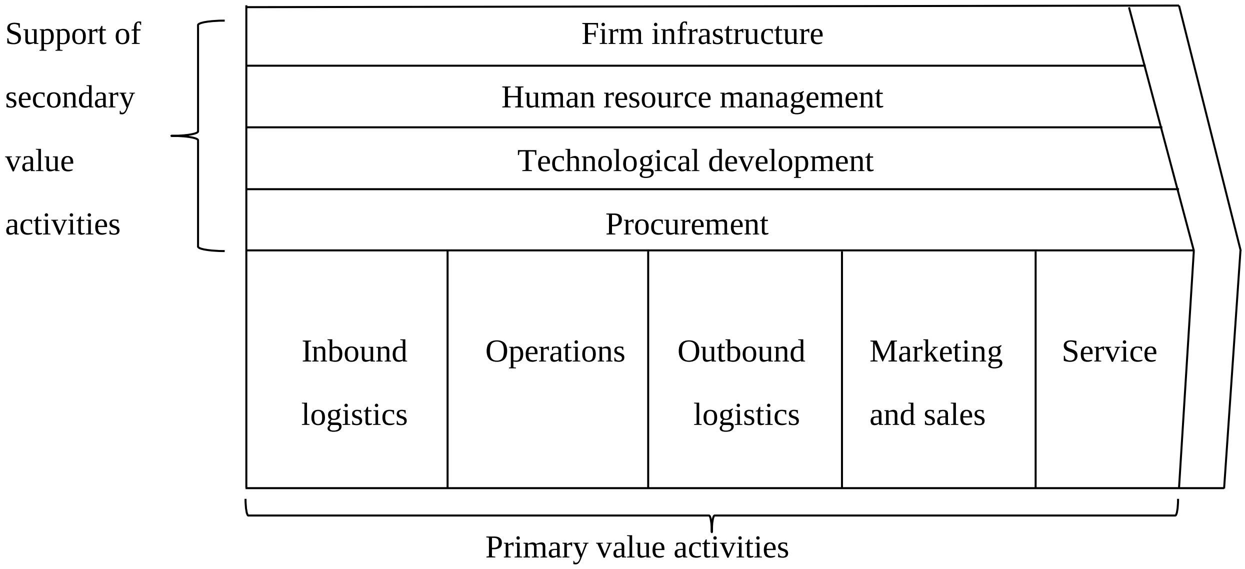
8 Value chain analysis

The value chain

Porter developed the value chain to help identify which activities within the firm were contributing to a competitive advantage and which were not.

‘The approach involves breaking down the firm into five ‘primary’ and four ‘support’ activities, and then looking at each to see if they give a cost advantage or quality advantage.

Porter’s value chain



Explanation of the value chain activities

Primary activities:

- Inbound logistics – receiving, storing and handling raw material inputs. For example, a just-in-time stock system could give a cost advantage.
- Operations – transformation of the raw materials into finished goods and services. For example, using skilled craftsmen could give a quality advantage.
- Outbound logistics – storing, distributing and delivering finished goods to customers. For example, outsourcing delivering could give a cost advantage.
- Marketing and sales – for example, sponsorship of a sports celebrity could enhance the image of the product.
- Service – all activities that occur after the point of sale, such as installation, training and repair, e.g. Marks & Spencer's friendly approach to returns gives it a perceived quality advantage.

Secondary activities:

- Firm infrastructure – how the firm is organised. For example, centralized buying could result in cost savings due to bulk discounts.
- Technology development – how the firm uses technology. For example, the latest computer-controlled machinery gives greater flexibility to tailor products to individual customer specifications.
- Human resources development – how people contribute to competitive advantage. For example, employing expert buyers could enable a supermarket to purchase better wines than competitors.
- Procurement – purchasing, but not just limited to materials. For example, buying a building out of town could give a cost advantage over high street competitors.

Apply the value chain in a scenario

To gain a competitive advantage over its rivals a company must either:

- perform value creation functions at a lower cost than its rivals, or
- perform them in a way that leads to differentiation and a premium price.

The competitive advantage will permeate all elements of the value chain:

Nature of competitive strategy:	**Low cost, low selling price**	**High end (differentiator)**

Primary activities

Inbound logistics	Standardised components and materials with little customisation	Premium materials Selective sourcing
Operations	Bulk production Focus on efficiency High levels of standardisation	Flexible production Focus on quality Facilitation of customisation
Outbound logistics	Few outlets used Bulk delivery and careful management of delivery loads Minimal packaging	Use of premium distributors and retailers Flexible (possibly free) delivery Premium packaging
Marketing and sales	Minimal levels of marketing Sales focus is on quantity Standardised	High levels of promotion Lots of market research High levels of customer management and personalisation
Service	Very little	Extensive

Support activities

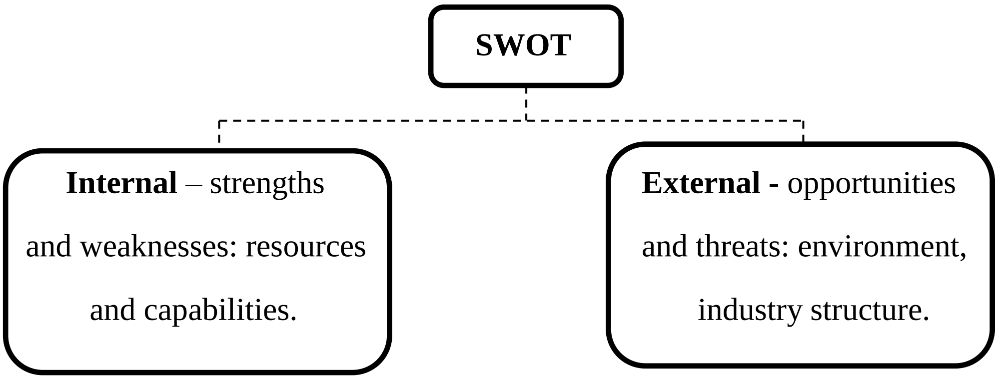
HRM	Use low skilled staff Reduced training and staff development	Use higher skilled staff Encourage staff development See staff as a key resource
TD	Use e-procurement to reduce costs of procurement High use of technological to improve efficiencies and cut costs	Less use of technology in operations Greater use of technology in marketing in sales to facilitate high promotion levels High R & D Regular process redesign
Procurement	Seek out cheapest and most efficient supplies Use outsourcing when it reduces costs	Seek premium suppliers
Infrastructure	Functional structure Many centralized services A more global approach Produce in cheapest locations	Flexible structures Small span of authority Tall structures National independence

Note: These are simply examples to illustrate how companies with different competitive strategies will have different value chains. It does not mean that all low cost manufacturers of differentiators will have the characteristics illustrated above.

9 SWOT analysis

Strengths, weaknesses, opportunities and threats

A SWOT analysis can be used as an analysis tool in its own right or can be used as a summary sheet on which other results can be placed.



Using a SWOT analysis

The first step is to rank in order of importance the finding of the SWOT anslysis.

- Strength that match no opportunity are of little use without an opportunity.
- A distinctive competence is a strength that can be exploited.

Strategies can be developed which:

- neutralize weaknesses or convert them into strengths
- convert threats into opportunities
- match strength with opportunities.

These are discussed in later chapters.

Consider the following SWOT for a small advertising agency:

Strengths	Weaknesses
• well diversified client portfolio • strong management team • profitable • listed on a stock exchange • low gearing • award winners • differentiated, personal service • established 60 years ago	• high work-in-progress levels • high levels of receivables • poor control of time allocation to clients • limited access to debt finance • reached overdraft limit • lacks ability to service very large clients • 40% of turnover from two clients • Recent complaint about tone of an advert

Opportunities	Threats
• tender for a major contract • expand overseas • launch an internet marketing advisory service • buy a rival • move into firm production	• recession putting downward pressure on volume and prices • loss of bank support • loss of a major client • customers moving to e-marketing • loss of key staff • takeover by a rival

An organisation's SWOT anslysis is likely to drive the need for change within the organization. A lack of fit between the current strategic position and the organisation's environment will mean, for example, that new strategies will be required in order to avoid any further strategic drift.

Other key drivers of change

- The change may come as a reaction to competitor actions or as a new deliberate change of competitive strategy.
- The change may be driven by changes in the organisation's environment (such as from the availability of new technology, changes in regulation or changes in taste and fashion that were covered in the PESTEL model). Often change is customer-led through changes in demographics or definitions of value.
- There may be internal drivers of change from a change in culture changes in organizational missions and goals, from redesigned and improved processes etc. Many of these topics are covered elsewhere in this text.
- The change may be market-led. Markets are becoming more global and organisations are having to create global strategies which are themselves driving changes within organisations. Declining barriers to international trade mean that many orgnisations are producing and selling in many more countries than they have in the past.

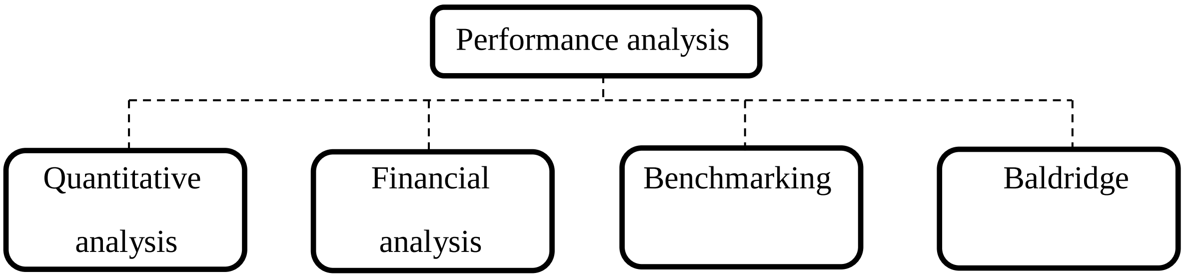
These changes may have a number of impacts on the organisation:

- The market sector is likely to change as rivals change and some rivals leave the sector and new rivals enter the sector.
  Collaborations between organisations may be necessary and the sector may even split into smaller strategic groups.
- Organisational structure will need to change as part of an overall change in the culture of the organisation.
- A new orgnisational mission and set of objectives may need to be considered.
- New monitoring and control tools will be needed to ensure strategic fit with the changing environment as well as fit with the organizational mission.
- Organisations may have to become more flexible and adaptable in order to be better prepared for further changes in the future.

These changes will also be explored across the syllabus/text.

Chapter 4

Performance analysis



1 Quantitative analysis

It is very likely in the exam that the examiner will provide tables and data in order to provide some of the information that is needed in order to properly perform the strategic analysis (both external and internal). It will be vital that students can both interpret and use this information in their answers.

Test your understanding 1

The following data is given for sales of cinema tickets in a large country over the last two years.

Company	**2007 Sales ($bn)**	**2008 Sales ($bn)**
A	2.0	2.0
B	1.8	2.0
C	2.2	2.1
D	2.1	1.9
Others	1.6	1.7
Total industry sales	9.7	9.7

Required:

Analysis the competitive nature of the cinema industry in this country.

Answer:

Test your understanding 1

The table shows two things:

- the market overall is not growing
- no one company dominates the market.

Professional skill;
Simply identifying the issues is not enough. You need to investigate why the industry is competitive and what this might mean for the attractiveness of the industry.

The data provided on the industry would suggest that this is likely to be a competitive industry. No company has significantly better economies of scale in order to achieve cost leadership and marketing budgets and techniques are likely to be very similar which will make differentiation strategies harder. The companies will know that, in order to grow, there is unlikely to be new sales coming into the market and therefore they will have to tempt customers away from rivals – which will increase the competitive activities in the industry. This is likely to adversely impact on margins and make the industry less attractive for those organisations operating in it.

Note: The table might also provide information on the difficulty that new entrants into the market might have in overcoming the position of the four established peoviders.

Financial statements

The examiner might provide sets of financial statements and a student must use these to pull out the key messages and issues. There will be some important technique points to this:

- choose three or four key ratios
- there is no need to illustrate the formula or the calculation
- only one comparator should be needed
- focus on the cause of any changes and what this might tell us about the organisation's position

Revision of financial ratios

Ratios

The mechanics of ratio analysis are repeated here for revision purposes.

Profitability ratios

- ROCE = Operating Profit (PBIT)/Capital Employed x100
- Gross margin = Gross profit / Sales x100
- Net margin = Net profit/Sales x100
- ROE = Profit after tax and preference dividend/Shareholders' funds x100 x100

Efficiency ratios

- Asset turnover = Sales/Capital Employed
- ROCE = Net margin x asset turnover
- Receivables days = Receivables balance/Credit sales x365
- Payables days = Payables balance/Credit purchases x365
- Inventory = Inventory/Cost of sales x365
- Revenue per employee = Sales/Number of employees

Liquidity ratios

- Current Ratio = Current Assets/Current Liabilities
- Quick Ratio (acid test) = Current Assets – inventory/Current liabilities

Gearing ratios

- Financial Gearing = Debt/Equity
- Financial Gearing = Debt/Debt + Equity

Investor ratios

- Dividend Cover = PAT/Total Dividend
- Interest Cover = PBIT/Interest
- EPS = Profit after tax and preference dividends/Number of shares x100
- PE ratio = Share price/EPS

Non-financial performance measures

Although profit cannot be ignored as it is the main objective of commercial organisations, performance analysis should not focus on profit alone. A range of performance indicators should be used and these should be a mix of financial and non-financial measures.

Examples of Non-financial CSFs and KPIs

The table below shows a number of non-financial performance indicators grouped against CSFs. The organisation will formulate its own, specific KPIs which best suit its business.

CSFs	KPIs
Competitiveness	• sales growth by product or service
	• measure of customer base
	• relative market share and position
Resource utilization	• efficiency measurements of resources planned against consume
	• measurements of resources available against those used
Quality of service	• productivity measurements
	• quality measures in every unit
	• evaluate suppliers on the basis of quality
	• number of customer complaints received
Customer satisfaction	• number of new accounts lost or gained
	• speed of response to customer needs
	• information listening by calling a certain number of customers each week
Quality of working life	• number of factory and non-factory manager visits to customers
	• days absence
	• labour turnover
Innovation	• overtime
	• measures of job satisfaction
Responsiveness (lead time)	• proportion of new products and services to old one
	• new product or service sales levels
	• order entry delays and errors
	• wrong blueprints or specifications
	• long set-up times and large lots
Quality of output	• high defect count
	• machines that break down
	• returns from customers
	• reject rates
Flexibility (ability to react to changing demand and a	• reworking costs
	• warranty costs
	• product/service introduction flexibility

changing environment)	• product/service mix flexibility • volume flexibility • delivery flexibility • time to respond to customer demands

2 Benchmarking

Why benchmark?

Benchmarking is the process of systematic comparison of a service, practice or process. Its use is to provide a target for action in order to improve competitive position.

Types of benchmarking

There are various types of benchmarking such as:

- internal
- competitive/industry
- activity
- generic

Types of benchmarks explained

Internal benchmarking

This method examines past performance over a period of time to determine trends and best performance. Alternatively, a range of processes might be assessed in order to determine internal best practice, which can then be used as the benchmark for other processes. There is a danger however that this will result in the continuance of poor bad habits and that competitors are ignored.

Competitive benchmarking

This method compares performance of the process against other firms in the same industry or sector. Major automakers, for example, will buy cars made by their competitors then reverse engineer those cars to see how to improve their own product. However, there is a danger that, if this is only carried out on a local level, it may not promote performance that is good enough to match wider (e.g. international) rivals.

Activity benchmarking

This method looks at other organisations, not necessarily competitors, who are performing similar activities. For example, if a firm wanted to improve its delivery times to customers it might benchmark this activity against the delivery times of specialist delivery companies such as DHL. In this way, commercial best practice is identified.

Generic benchmarking

For some activities, the process might be so unique that there may not be competitive or activity benchmarks available. In these cases, a conceptually similar process is sought as a benchmark.

For example, when building a rail tunnel connecting Aomori Prefecture on the Japanese island of Honshu and the island of Hokkaido which travels under sea, the construction company would have had no similar activities against which to benchmark (the under-sea tunnel between England and France was yet to be built). However, the tunneling was conceptually similar to explorations into volcanic crusts and this process was used as the benchmark.

The main benefits include:

- improved performance and added value – benchmarking identifies methods of improving operational efficiency and product design and helps companies focus on capabilities critical to building strategic advantage
- improved understanding of environmental pressures
- improved competitive position – benchmarking reveals a company's relative cost position and identifies opportunities for improvement
- a creative process of change
- a target to motivate and improve operations
- increased rate of organisational learning – benchmarking brings new ideas into the company and facilitates experience sharing.

Dangers of benchmarking

- 'you get what you measure' – managers may learn to direct attention at what gets benchmarked rather than at what is important strategically
- Benchmarking does not always reveal the reasons for good/poor performance
- Managers need to be aware that a benchmarking exercise can appear to threaten staff where it appears that benchmarking is designed to identify weaknesses in individual performance rather than how the process itself can be improved. To alleviate this fear, managers need to be involved in the benchmarking exercise and provide reassurance to staff regarding the aims and objectives of benchmarking.
- In today's environment, the more innovative companies are less concerned with benchmarking numbers (for example, costs or productivity) than they are with focusing on the processes. If a company focuses on the **processes,** the numbers will eventually self correct.

3 Multi variable performance analysis

The balanced scorecard

- a financial perspective – this considers whether an organisation is achieving its financial targets and meeting the needs of shareholders
- a customer perspective – this considers the organisation from a customer point of view to determine whether the organisation is meeting customer needs
- an innovation perspective – this considers whether the organisation is continuing to improve and develop
- an internal business process perspective – this considers whether the organisation's processes are efficient as well as whether employees are satisfied and motivated

Baldrige performance excellence

This was developed by Malcom Baldrige as a way of measuring and rewarding those organisations that have performed better than their contemporaries. Baldrige developed criteria for performance excellence in the belief that organisations that incorporate them into their organisational prctives can expect performance superior to their competitors.

The Baldrige model assesses and organisation across seven categories:

- Leadership – how the organisation's leadership guides, governs and sustains the organisation's performance.
- Strategy – the ability to successfully plan, develop and implement strategies.
- Customers – the success in building and sustaining strong, lasting relationships with customers.
- Workforce – how the organisation enables and empowers its workforce to achieve organisational goals
- Operations – the design and effectiveness of organisational processes and whether these are improving and meeting strategic needs.
- Results – the performance and improvement of the organisation, relative to competitors, in the key categories of the model.
- Measurement, analysis, and knowledge management – how data is stored, managed, analysed and used within the organisation.

Further details

Leadership will consider an organisation in areas such as whether:

- Its leaders provide clear, well communicated goals and lead by example
- Its corporate governance – for example, in whether best practice is being applied and all stakeholder views are considered
- It has considered its wider social responsibilities

Strategy will consider an organisation in areas such as:

- whether it has clear objectives
- its ability to create strategic plans
- whether strategic plans fit with the strategic objectives
- how strategies are developed and implemented
- whether suitable and sufficient resources are provided for strategic implementation
- whether it measure success or failure of strategic objectives

Customers will consider an organisation in areas such as:

- the level of customer support
- customer complaint management
- the level of customer interaction and engagement
- whether customers are segmented and products/services personalised to segments

Workforce will consider an organisation in areas such as:

- recruitment and retention
- workforce career progression
- workforce training and development
- reward schemes and controls
- appraisal
- workforce engagement

Operations will consider an organisation in areas such as:

- whether processes are reviewed and assessed
- whether processes are improved
- how effective processes are in delivering customer value and strategic value

Results will consider organisational improvement in all key areas such as:

- product and process results
- customer results
- workforce results
- leadership and governance results
- financial and market results

The category asks about performance levels relative to those of competitors and other organisations with similar product offerings.

Measurement, analysis and knowledge management will consider an organisation in areas such as:

- whether organisational knowledge is managed and shared
- whether benchmarking is used
- which performance measures are used and how data is collected
- whether action is taken as a result of performance measurement

From this it can be seen that the Baldrige Values include:

- Vvisionary leadership
- customer-driven excellence
- organisational and personal learning
- valuing employees and partners
- agility
- focus on the future
- managing for innovation
- management by fact

- social responsibility
- focus on results and creating value
- systems perspective

An organization that scores well in the areas of the model should be better at

- achieving its strategic goals
- competing
- improving its results
- improving and learning
- meeting customer needs and retaining customers

Chapter 5

Strategic choice

This chapter examines three key elements of strategic choice:

- competitive strategies – how best to beat competitive rivals
- growth strategies – how to achieve growth in new areas
- strategy evaluation – choosing the best available option

2 Competitive strategy options

Generic strategies: cost leadership, differentiation and focus

Professor Michael Porter identified three generic strategies through which an organisation can achieve competitive advantage.

	Cost leadership	**Differentiation**	**Focus**
Aim	To cut costs of production/ purchasing/ service and in turn cut selling prices	To offer a product that can't be matched by rivals and charge a premium for this "difference"	Position the business in one particular niche in the market
How	• economies of sales • use of learning effects • large production runs • using cheaper labour and materials • moving to cheaper premises	• branding • quality & design • innovation • knowledge management • control over suppliers • support	1 find a segment where the cost leader or differentiators have little or no presence and build business here 2 reduction in product range

	Cost leadership	Differentiation	Focus
Benefits	• high volumes • creates a barrier to entry • can operate in unattractive segments • win price wars • reduced power of substitutes	• builds brand loyalty and repeat purchases • higher margins • reduction in power of customers	• develops brand loyalty • little competiotion • often a first step towards the other generic strategies
Threats	• no fallback position if leadership is lost • larger rivals (possibly from overseas) may enter the market • strong currency makes imports cheaper	• perform badly in a recession • often easily copied in the long run need to constantly innovate • needs much higher marketing than cost leadership • fewer barriers to entry • smaller volumes	• low volumes • if successful, it attracts cost leaders and differentiators • few barriers to entry
Suitability	Large organisations with economies of scale	Innovative companies with large marking budgets	Small business with entrepreneurial flair, strong market knowledge and a risk taking attitude (often new starts)

A business that fails to achieve one of these generic position will be **Stuck in the middle** – it will lose some customers who will move downmarket to the cost leader, other customers who will move upmarket to differentiators, and others will move to rivals who focus on their specialist needs.

Porter's generic strategies

Cost leadership

Advantages

- Better margins through lower costs.
- Ability to undercut competitors on price, thus reducing competitive rivalry.
- Low costs act as a barrier to entry deterring new entrants.
- Low prices make substitutes less attractive.
- Better margins give more scope to absorb pressure from powerful buyers/suppliers.
- Low costs give a platform for expansion – both gaining market share and moving into new markets.

Drawbacks of such a strategy

- In industries that only require a low critical mass of production output to achieve economies of scale, cost leadership would be difficult to achieve, because many other firms would be able to match the costs. It is only when the critical mass of production is high that a cost leadership strategy is likely to be effective.

Other drawbacks

- Only room for one cost leader – no fallback position if the cost advantage is eroded.
- Cost advantage may be lost because of inflation, movements in exchange rates, competitors using more modern manufacturing technology or cheap overseas labour, etc.
- Customers may prefer to pay extra for a better product.

Differentiation

Here the firm creates a product that is perceived to be unique in the market.

Ways of achieving differentiation

Quality differentiation

This has to do with the features of the product that make it better – not fundamentally different but just better.

Design differentiation

Differentiation on the basis of design and offer the customer something that is truly different as it breaks away from the dominant design if there is one.

Image differentiation

Marketing is used to feign differentiation where it otherwise does not exist, i.e. an image is created for the product. This can also include cosmetic differences to a product that do not enhance its performance in any serious way (e.g. packaging).

Support differentiation

More substantial, but still no effect on the product itself, is to differentiate on the basis of something that goes alongside the product, some basis of support, such as after-sales service.

Rewards of a differentiation strategy:

- better margins through being able to charge higher prices
- higher quality offsets competitive rivalry
- product uniqueness reduces customer power
- quality acts as a barrier to entry
- quality reduces the attractiveness of substitutes.

Risks of such a strategy:

- cheap copies
- being out-differentiated
- customers unwilling to pay the extra (e.g. in a recession)
- differentiating factors no longer valued by customers (e.g. due to changes in fashion).

Focus

Position oneself to uniquely serve one particular niche in the market. A focus strategy is based on fragmenting the market and focusing on particular market segments. The firm will not market its products industry-wide but will concentrate on a particular type of buyer or geographical area.

Cost focus

This involves selecting a particular niche in the market and focusing on providing products for that niche. By concentrating on a limited range of products or a small geographical area the costs can be kept low.

Differentiation focus

Select a particular niche and concentrate on competing in that niche on the basis of differentiation.

Reward

You become an expert in your field and understand the marketplace more.

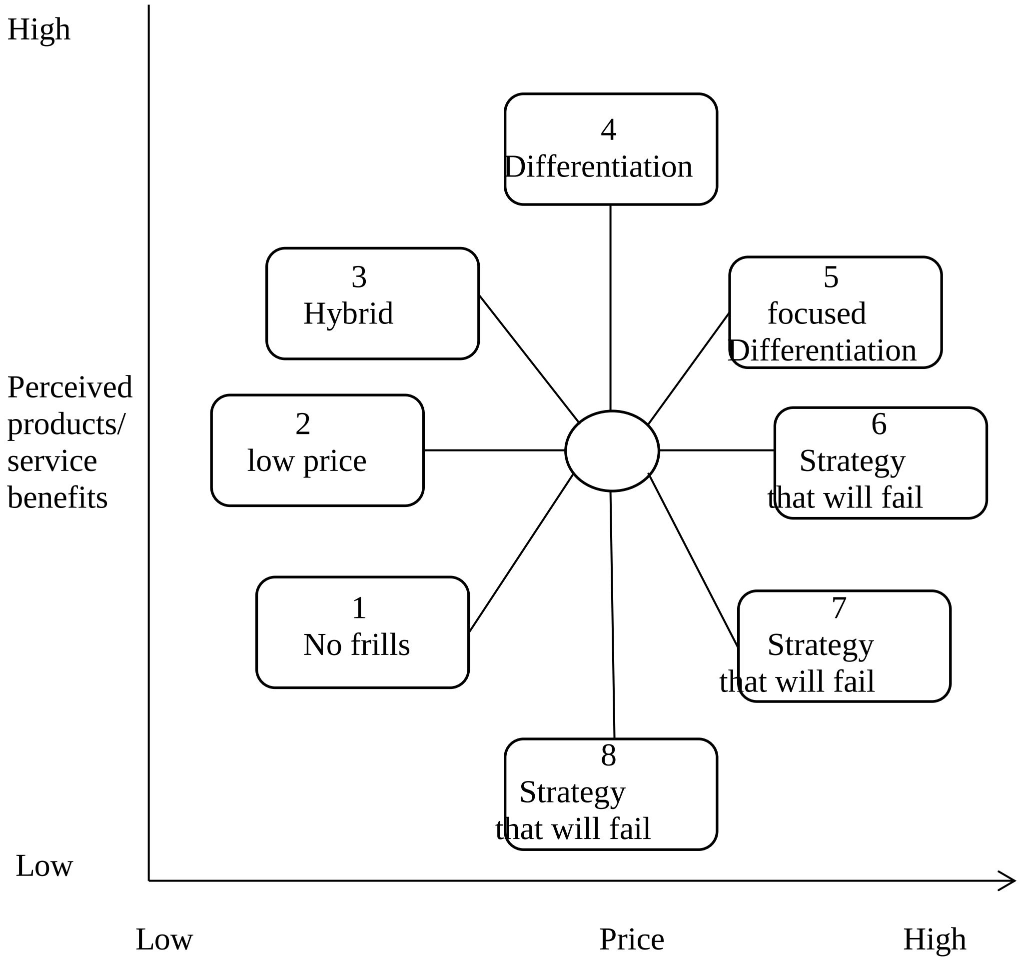
Risks

The segment is not sustainable enough to provide the firm with a profitable basis for its operations.

The strategy clock

An alternative way of identifying strategies that might lead to competitive advantage is to look at 'market facing' generic strategies.

- This approach is based on the assumption that competitive advantage is achieved if a firm supplies what customers want better or more effectively than its competitors.
- Better could mean a more suitable product or service, or could mean a cheaper one of adequate quality.
- In effect, customers are looking for what they perceive as best 'value for money'.



Explanation of the strategy clock strategies

(Adapted from the work of **C. Bowman and D. Faulkner** 'Competitive and Corporate Strategy – lrwin – 1996)

Routes 1 and 2 are **price-based** strategies.

- 1 = no frills
  Commodity-like products and services. Very price-sensitive customers. Simple products and services where innovation is quickly imitated – price is a key competitive weapon. Costs are kept low because the product/service is very basic.
- 2 = low price
  Aim for a low price without sacrificing perceived quality or benefits. In the long-run, the low price strategy must be supported by a low cost base.
- 3 = hybrid strategy
  Achieves differentiation, but also keeps prices down. This implies high volumes or some other way costs can be kept low despite the inherent costs of differentiation.

Routes 4 and 5 are **differentiation** strategies.

- 4 = differentiation
- Offering better products and services at higher selling prices. Products and services need to be targeted carefully if customers are going to be willing to pay a premium price.
- 5 = focused differentiation
- Offering high perceived benefits at high prices. Often this approach relies on powerful branding. New ventures often start with focused strategies, but then become less focused as they grow and need to address new markets.
- 6, 7, 8 = failure strategies
- Ordinary products and services being sold at high prices. Can only work if there is a protected monopoly. Some organisations try option 8 by sneakily reducing benefits while maintaining prices.

A strategic business unit (SBU) is a part of an organisation for which there is a distinct external market. Different strategies can be adopted for different SBUs. For example, Toyota and Lexus (part of Toyota) operate as separate SBUs with different strategies. Some fashion businesses successfully separate their exclusive ranges of clothing from their diffusion lines.

3 Sustaining competitive advantage

Once a competitive advantage is achieved it will be important that it is sustained. Competitive advantage can best be sustained by strategic capabilities which are:

- valued,
- rare, and
- robust.

Further details

- **Value of strategic capabilities.** The strategic capability must be one that is of value to the customer. A distinctive capability is not enough: the strategic capability must be able to generate what customers value in terms of products or services.
- **Rarity of strategic capabilities.** Competitive advantage will not be attained if competitors have identical strategic capabilities. Unique or rare resources or competences are needed to allow the organisation to outperform its rivals.
- **Robustness of strategic capabilities.** Capabilities for competitive advantage should be robust, meaning that they are hard to imitate. Therefore, competitive advantage is not so often sustained through physical/tangible resources as these can be copied/acquired over time. More important is the way in which the resources are organised and deployed as these competences are, in general, more difficult to identify and imitate.

However, organisations can also take strategic steps to protect their competitive position through:

- price based strategies,
- further differentiation , or
- lock-in.

Price based strategies

An organization that is pursuing a price-based strategy (such as a no-frils position on the strategy clock) may be able to sustain this position as follows:

- further cost efficiencies,
- winning price war, or
- accepting lower margins.

Differentiation based strategies

These can be sustained through:

- creating difficulties in imitation,
- achieving imperfect mobility of resources, and
- re-investing margins.

Further details

- creating difficulties in imitation about ensuring that strategic capabilities cannot be copied by rivals.
- achieving imperfect mobility of resources ensuring that the capabilities that create the difference cannot be traded to rivals.
- re-investing margins investing profits in areas such as innovation and knowledge management can sustain a competitive advantage.

Differentiation through innovation

Innovation is increasingly seen as important for strategic success. The reasons are:

- increased rate of technical advances
- increased competition
- increased customer expectations.

In all functions that serve to produce goods and services, achieving superior innovativeness, relative to competitors, can help the firm to acquire new customers.

Innovation can apply to:

- the nature of the product or service being supplied
- how the product or service is produced and delivered
- operating the firm in a new or novel way.

Research and development

Research and development (R & D) can be defined as 'the organisation of innovation at the level of the firm'. R & D aims to satisfy a market need by developing new products and by improved methods of production. It must also find applications for scientific and technical developments. However, an R & D (innovation) strategy cannot sensibly be pursued in isolation from the rest of the organisation. The business strategy will concentrate on the broad range of products that the organisation wishes to have and the broad markets in which it wishes to compete. This strategy will be supported by the organisation's competence strategy, focused on the technologies the organisation needs if it is to pursue its business strategy successfully.

Richard Lynch identifies three distinctive roles for innovation within a business level strategy:

- achieving new growth through entry into new products and markets
- retaining competitive advantage by strengthening the product offering
- achieving competitive advantage through jumping ahead of existing rivals.

Acquiring new technologies

New technologies often emerge in one of two ways. Technology-push is based upon an understanding of the technology, but a less well-developed idea of market-pull has important applications.

New ideas frequently emerge through market-pull. In this case, new technologies are developed based upon a good understanding of customer requirements, or close collaboration with a customer.

These two approaches are mutually exclusive, and frequently support each other.

The impact of new product, process, and service development and innovation in supporting organisation strategy

- They will help close the gap between the organisation's current strategic position and its desired position as defined by its mission and objectives.
- New launches can be a differentiator and innovative organisations can be more attractive to customers and investors.
- Many new developments fail and therefore launching more than one new development can diversify away some of this risk.
- As products and services age, new developments need to be found to replace them. This should happen before older products and services start to experience declining sales.
- New developments are often copied by rivals so that any competitive advantage is short-lived. Organisations therefore need to be thinking about their next development whilst revals are busy catching up with existing developments.
- Developments encourage an organisation to be to be flexible and to learn. These can be critical success factors for future success (especially in changing environments).
- Organisations with a focus on quality see continuous improvement as a core competency and organisational mission.

  New developments make the achievement of competitive strategies easier – either by cutting costs or by differentiating the business.

Lock-in

This approach can work for both price-based and differentiation-based strategies. It happens where a business' products become the industry standards. Examples are:

- Microsoft Windows
- Dolby
- Internet Explorer

These are not necessarily the best or cheapest products but have such market-dominance that competitors find it very difficult to break into the market because users are often locked in to the product and would find it expensive or inconvenient to switch to rivals. The major threat to such businesses is likely to be attention from anti-monopoly regulators.

4 Growth strategies

Introduction

Growth strategies are explored through the use of the **Ansoff matrix.** Ansoff suggested that growth strategies can fall into 4 categories.

The matrix

	Existing Products	**New Products**
Existing Mardets	**Market penetration/growth.** • This typically involves the use of a new/improved competitive stategy. Key risks: • competitor reaction • can lead to stagnation	**Product development** • New products could arise from R&D, join ventures, buying in other people's products, copying innovations of rivals or licensing. • It might also come from product augmentation (for example, by upgrading software capabilities) Key risks: • market size and demand are unknown

		• can lead to cannibalisation of existing products
New Markets	**Market development** • This involves finding new market for existing products. • These could be new segments in current market (e.g. new age groups) or oversea market. Key risks: • needs a new external analysis • puts a strain on existing strategic capabilities	**Diversification** • This involves moving away from existing core activities and offer a new product to a new customer. • More details are available elsewhere in this chapter. Key risks: • combines the risks of product and market development • need good corporate parenting skills (covered in detail in the next chapter)

Market penetration – existing markets and products

- market penetration involves some of the following:
- increasing the average spend per visit for existing customers
- increasing the frequency of visits for existing customers winning customers away from rivals encouraging non-users to buy.

Strategies used to penetrate a market include:

- Changes to the marketing mix.
- Pursuing a new competitive strategy.
- Increasing the sales force.

A market penetration strategy would be contemplated for the following reasons.

- When the overall market is growing, or can be induced to grow, it may be relatively easy for companies entering the market,

- Unwilling to permit a decline in sales, even though the overall market is declining.
- If other companies are leaving the market for whatever reasons, penetration could prove easy
- An organisation that holds a strong market position, relatively easy to penetrate the market.
- Requires a relatively lower level of investment with a corresponding reduction in risk and senior management involvement.

Ansoff suggests that, if penetration through an improved competitive strategy cannot be achieved, the organisaion could instead consider:

- consolidation – acquire or merge with rivals in order to increase market share or obtain economies of scale
- efficiency gains – it will be important to reduce costs as much as possible and to improve processes to market them quicker, more effective and more attractive to customers
- withdrawl – if no obvious route for improvement is available it may be best to withdraw from the market entirely (for example, by selling out to rivals).

Product development – existing markets and new product

- develop new product features through attempting to adapt, modify, magnify, substitute, rearrange, reverse or combine existing features
- create different quality versions of the product
- develop additional models and sizes.

(a) It holds a high relative share of the market, has a strong brand presence
(b) There is growth potential in the market
(c) The changing needs of its customers demand new products
(d) It needs to react to technological developments
(e) The company is particularly strong in R & D
(f) The company has a strong organisation structure based on product divisions
(g) For offensive or defensive motives, for example responding to competitive innovations in the market.

There are reasons why new-product development is becoming increasingly difficult to achieve:

(a) in some industries there is a shortage of new product ideas
(b) increasing market differentiation causes market segments to narrow with the effect that low volumes
(c) new product development very costly
(d) it might still suffer a short-life cycle with rivals quick to 'copycat' in market
(e) there is a high chance of product failure.

Market development – existing products and new markets

Market development strategy has the aim of increasing sales by repositioning present products to new markets. (Note: this strategy is also referred to as (**market creation'.)**

Kotler suggests that there are two possibilities:

(a) the company can open additional geographical market through regional, national or international expansion
(b) the company can try to attract other market segments through developing product versions that appeal to these segments, entering new channels of distribution, or advertising in other media.

Market development strategy would be contemplated for the following reasons:

(a) the company identifies potential opportunities for market development
(b) the company's resources are structured to produce a particular product or product line and it would be very costly to switch technologies
(c) the company's distinctive competence lies with the product and it also has strong marketing competence

- **Growth by diversification – new products and new markets**

The term 'diversification' actually covers a range of different techniques.

Conglomerate diversification – a firm moves into markets that are unrelated to its existing technologies and products to build up a portfolio of businesses.

- **Horizontal diversification** – synergy is highest in the case of horizontal diversification, especially if the technology is related, but the disadvantage is that little additional flexibility is provided. This type of strategy affects all parts of the value chain since fixed costs can be spread over an increased number of units. Most diversification strategies are of this type.
- **Vertical integration** – this can take the form of forward or backward integration
    - **Forward integration** – moving towards the consumer – control of distribution, e.g. drinks manufacturers buying public houses.
    - **Backward integration** – moving away from the consumer – control of supplier, e.g. beer brewers buying hop growers.

Unrelated/conglomerate diversification

- Diversifying into completely unrelated businesses.
- Not clear where added value comes from – except if an ailing business is turned round.
- Often leads to loss of shareholder value.

Advantages	Disadvantages
• Increased flexibility • Increased profitability • Ability to grow quickly • Better access to capital markets • Avoidance of anti-monopoly legislation • Diversification of risk	• No synergies • No additional benefit for shareholders • No advantage over small firms • Lacks of management focus

Vertical integration

Advantages	**Disadvantages**
Cost • Economies of combined operations • Economies of internal control. • Economies of avoiding the market. **Quality** • Tap into technology – enhanced ability to differentiate. **Barriers** • Assured supply/demand. • Defence against locks-out. • Create barriers by controlling supplies/distribution/retail outlets.	**Cost** • It may not be cheaper to do it oneself – especially if suppliers have economies of scale. • Increased operating gearing. • Dulled incentives. • Capital investment. • Reduced flexibility to switch to cheaper suppliers. **Quality** • Cut off from suppliers/customers. • Reduced flexibility to switch to better suppliers. • Differing managerial requirements. **Barrieres** • Much more difficult to exit the industry.

Horizontal diversification

Advantages	Disadvantages
• Likely to be more synergies. For example, when Coca Cola moved into the production of other type of drinks such as bottled water and bottled tea, they could share bottling plants, staff and distribution networks. • This can offer a defence against substitutes. • This can widen the company's peoduct portfolio and reduce reliance on one product or on powerful cutomers. • There is likely to be less risk than with vertical integration or conglomeratisation as some existing strategic capabilities can still be used.	• Selling to different customers against different rivals will require an understanding of the market. • Some new strategic capabilities will be needed. • Synergies are not automatic and will need to be worked on. • It can be more difficult to manage a diversified business. Many of these problems can be overcome by the use of strategic alliances and good corporate parenting and these ideas are explored in more detail in the next chapter.

Achieving international growth

Reasons why companies pursue a strategy of international diversification

- There are increasing opportunities from global markets,
- If local markets are saturated or limited,
- Risks may be spread as poor results in one market due to local economic conditions
- It may be possible to take advantage of particular aspects of different locations and markets such as low labour costs.

Driving and restraining forces for international expansion

Driving forces:

- Technology
- Culture
- Market needs
- Cost
- Free markets
- Economic intergration
- Peace/political stability
- Management vision
- Strategic intent
- Global strategy and action.

Restraining factors:

- Culture
- Market differences
- Cost
- National controls
- Nationalism
- War
- Management myopia/short-sightedness
- Organisation history
- Domestic focus.

Possible strategies for geographical diversification

- A multi-domestic strategy where products and services are tailored to individual countries and market, with many activities specific to particular countries.
- A global strategy, where standard products are sold in different countries.
- A balance between the two above strategies, where products are largely global but have minor modifications to suit the requirements of individual countries. There will generally be a trade-off between scale economies and the need to tailor products to services to local markets.

5 Strategy evaluation

Johnson, Schole and Whittington (JSW) argue that for a strategy to be successful it must satisfy three criteria:

- **Suitability –** whether the options are adequate responses to the firm's assessment of its strategic position.
- **Acceptability** – considers whether the options meet and are consistent with the firm's objectives and are acceptable to the stakeholders.
- **Feasibility –** assesses whether the organisation has the resources it needs to carry out the strategy.

This criteria can be applied to any strategy choice such as the competitive strategies and the growth strategies assessed in this chapter, or even the methods of development considered in a later chapter.

Further explanation on each test

Suitability

Suitability considers whether the new strategy fits in with the organisation's environment and addresses its key issues. Suitability would therefore consider whether the strategy takes account of

- changes in technology
- the threat from substitutes
- the reaction of competitors
- whether the business is its life cycle
- support for overseas expansion
- the timing of the strategy

Feasibility

Assesses whether the organisation has the resources it needs to carry out the strategy. It could be linked back to the resource audit and strategic capabilities covered in chapter 3. This would involve ensuring that

- the organisation has the right number of staff
- staff have the right skills
- adequate finance is available
- technology is suitable

- the organisation has appropriate skills in areas such as marketing and design
- the organisation has experience with this market and/or product.

Feasibility may also consider barriers to entry to ensure that the market can be accessed.

Acceptability

Acceptability concerns assessing risk, return and stakeholders' expectations.

Risk

Risk can be assessed through using:

- Financial ratios to identify any problems.
- Sensitivity analysis.

A strategy that is deemed to be too risky may be rejected regardless of whether it is suitable and feasible.

Risk (and how to evaluate it) is covered in more detail in chapter 14 when we revise areas such as expected value and decision tree techniques.

Return

A project will only be acceptable if meets the returns expected by key stakeholders. These returns may be both financial and non-financial.

Stakeholder expectations

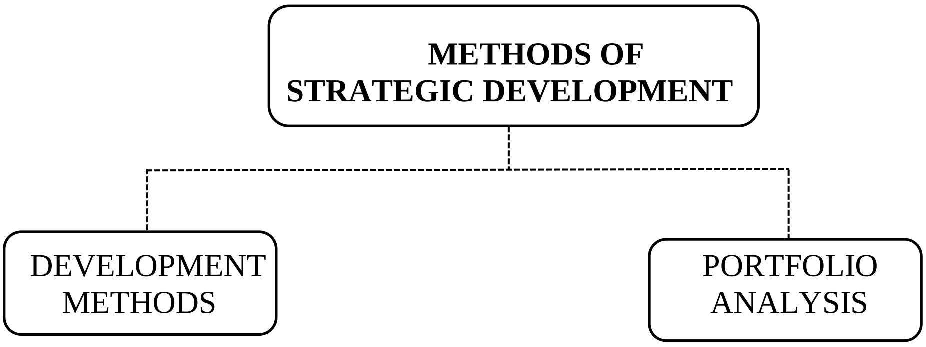
It will be important to consider the reactions to strategy of all stakeholders

- Stakeholder attitudes to risk
- How customers will react
- Whether there will be any resistance from staff
- Whether the policy is ethical and how the wider community will react
- Whether the strategy fits in with the overall vision, mission and objectives of the organization
- Whether the strategy meets any known goals set out by stakeholders

Stakeholder mapping and analysis (covered in chapter 7) can be of great value here.

Chapter 6

Methods of strategic development



1 Introduction

Types of business combinations. Method is to develop a strategy through acquisition, then an organisation must consider corporate parenting and portfolio analysis.

2 Alternative development options

Acquisition

Technically, a merger is in essence the pooling of interests by two business entities which results in common ownership. An acquisition normally involves a larger company (a predator) acquiring a smaller company (a target).

Acquisitions typically have the following issues:

Advantages	Disadvantages
• it is a quick way to grow	• can be very expensive
• there can be synergistic gains	• synergies are not automatic
• acquire the necessary strategic capabilities	• can lead to cultural clashes
• overcomes barriers to entry	• there may be legal barriers to overcome (e.g. competition law)
• can choose a target that fits best (see portfolio analysis later)	• all parts of the target are acquired (including its problems)
• enhances reputation with finance providers	• requires good change management skills

"Potential sources of synergy"

Improved profitability

Combined profits can be higher due to:

- Sales synergies.
- Cost synergies.

Improved financial position

The financial position of the combined company may be better due to:

- sharing assets (and selling off excess assets)
- using assets better
- shared working capital management
- finding cheaper financing
- stabilizing cash flows (e.g. removing seasonality).

Improved market position

This can come from:

- sharing skills or knowledge
- risk reduction from a portfolio effect
- improved management/better corporate parenting
- better focus.

Organic growth

Advantages	Disadvantages
• can spread the cost	• lack of experience in new areas
• no cultural clashes or control issues	• less attractive to finance providers
• can be set up in many ways – for example, through a new division	• there may be barriers to organic entry
• may get access to government grants	• it may be too slow
• easier to terminate	• no access to skills, reputation etc. or other strategic capabilities required for success
• can be developed slowly (less risk)	• managers may be spread too thinly

Joint venture

Advantages	Disadvantages
• can share the set-up and running costs	• can often lead to disputes
• can learn from each other	• may give access to strategic capabilities and eventually allow the partner to compete in core areas
• can focus on relative strengths	• there may be a lack of commitment from each party
• may reduce political or cultural risks	• requires strong central support which may not be provided
• it is better than going it alone and then competing	• transfer pricing issues may arise and performance appraisal can be complicated

Characteristics of a well structured strategic alliance

A strategic alliance can be defined as a co-operative business activity, formed by two or more separate organisations for strategic purposes, that allocates ownership, operational responsibilities, financial risks, and rewards to each member, while preserving their separate identity/autonomy.

Seven characteristics of a well-structured alliance have been identified.

- **Strategic synergy** – more strength when combined than they have independently.
- **Positioning opportunity** – at least one of the companies should be able to gain a leadership position (i.e. to sell a new product or service; to secure access to raw material or technology).
- **Limited resource availability** – a potentially good partner will have strengths that complement weaknesses of the other partner. One of the partners could not do this alone.
- **Less risk** – forming the alliance reduces the risk of the venture.
- **Co-operative spirit** – both companies must want to do this and be willing to co-operate fully.
- **Clarity of purpose** – results, milestones, methods and resource commitments must be clearly understood.
- **Win-win** – the structure, risks, operations and rewards must be fairly apportioned among members.

Franchising

Advantages	Disadvantages
• receive an initial capital injection	• share profits
• can spread brand quickly	• may give access to strategic capabilities and eventually allow the partner to compete in core areas
• easy to terminate	• there may be a lack of goal congruence
• a good way to test the market before full investment	• there is a loss of control over quality, recruitment etc.
• franchisee may provide better local knowledge	• there may be a lack of consistency across franchises
• franchisor management can focus on strategic rather than operational issues	• it may be difficult to attract franchisees

Franchising

The mechanism

- The franchiser grants a licence to the franchisee allowing the franchisee to use the franchiser's name, goodwill and systems.
- The franchisee pays the franchiser for these rights and also for subsequent support services the franchiser may supply.
- The franchisee is responsible for the day to day running of the franchise. The franchiser may impose quality control measures on the franchisee to ensure the goodwill of the franchiser is not damaged.
- Capital for setting up the franchise is normally supplied by both parties.
- The franchiser will typically provide support services including: national advertising, market research and development, technical expertise, management support.

The advantages for the franchiser are as follows:

- Rapid expansion and increasing market share with relatively little equity capital.
- The franchisee provides local knowledge and unit supervision. The franchiser specialises in providing a central marketing and control function, limiting the range of management skills needed.
- The franchiser has limited capital in any one unit and therefore has low financial risk.
- Economies of scale are quickly available to the franchiser as the network increases. For example, with the supply of branded goods, an extensive advertising spend is justifiable.

The advantages for the franchisee are as follows.

These are mainly in the set-up stages where many new businesses often fail.

- The franchisee will adopt a brand name, trading format and product specification that has been tested and practiced.
- The learning curve and attendant risks are minimized.
- The franchisee usually undertakes training, origanised by the franchiser, which should provide a running start, further reducing risk.

Disadvantages

Note: most of these relate to clashes between the franchiser and franchisee

- A franchisee is largely independent and makes personal decisions about how to run his operation. Quality and service will be deviating from the standards which the franchiser has established.
- There can be a clash between local needs or opportunities and the strategy of the franchiser
- The franchiser may seek to update/amend the products/services on offer whilst some franchisees may be slow to accept change
- The most successful franchisees may break away and set up as independents, thereby becoming competitors.

3 Portfolio analysis tools

The use of portfolio analysis

An organisation may have to make investment decisions such as whether to add a company to its existing portfolio or whether to divest of an existing subsidiary. One technique that can be used to perform this task is portfolio analysis, which determines the fit between the business unit and other business units held by organisation.

The Boston Consulting Group (BCG) growth share matrix

- This two-by-two matrix classifies businesses, divisions or products according to the present market share and the future growth of that market.
- Growth is seen as the best measure of market attractiveness.
- Market share is seen to be a good indicator of competitive strength.

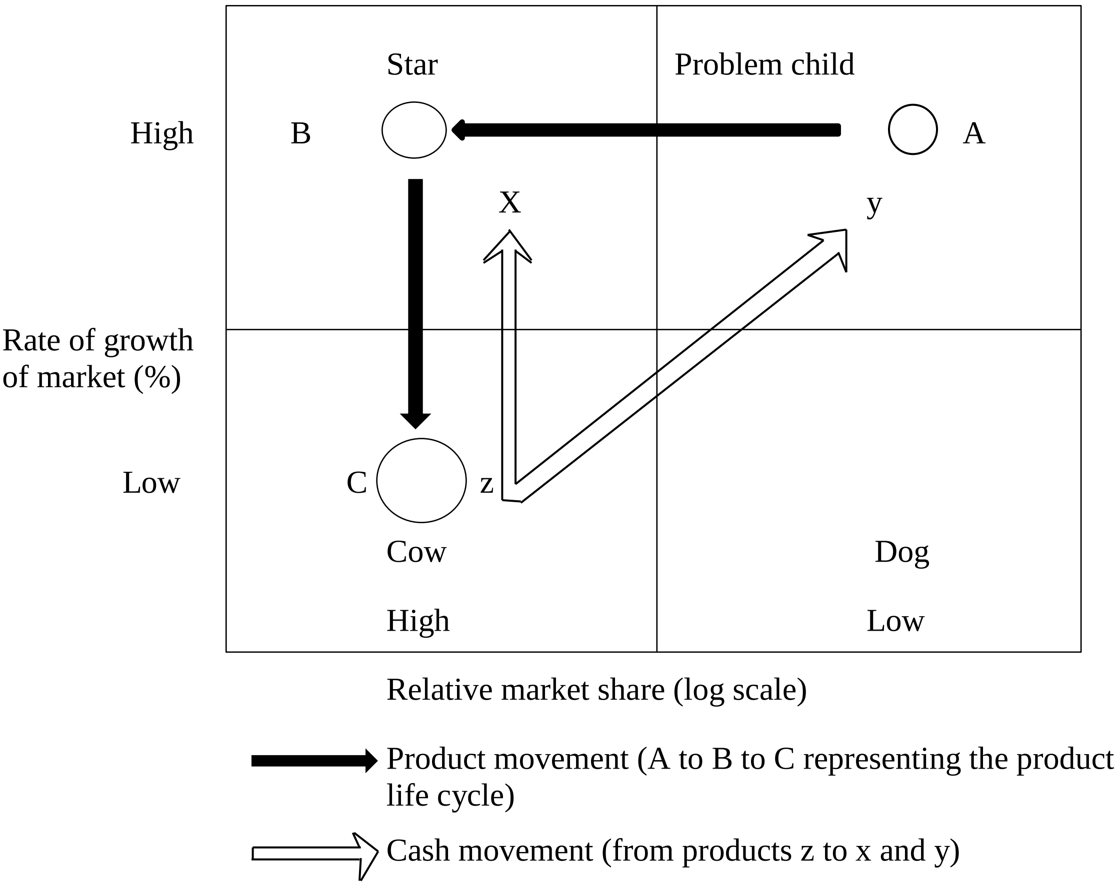
Rate of growth in the market		
High	**Star**	**Problem child**
Low	**Cash cow**	**Dog**
	High	Low

Relative market share

An organisation would want to have the following in a balanced portfolio:

- cash cows of sufficient size and/or number that can support other products in the portfolio
- stars of sufficient size and/or number that will provide sufficient cash generation when the current cash cows can no longer do so
- problem children that have reasonable prospects of becoming future stars
- no dogs or – if there are any – there would need to be good reasons for retaining them.

The ideal progression is illustrated below:



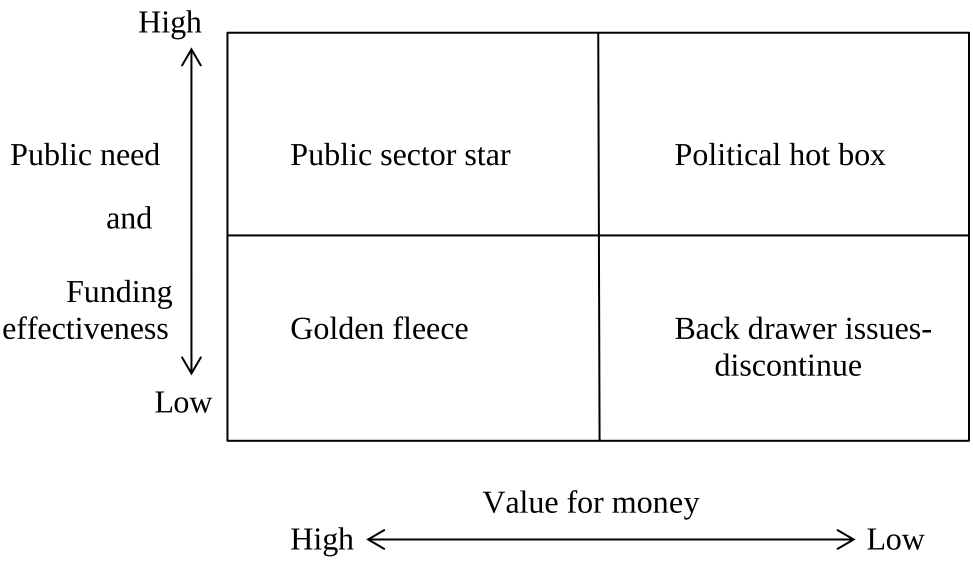
The public sector portfolio matrix

The BCG is aimed primarily at commercial, private sector organisations. The public sector portfolio adapts the BCG idea to public sector organisations and the axes are “public need and funding effectiveness” and “value for money”.

Public sector portfolio matrix

The dimensions of the matrix are:

- value for money – this considers whether the service can be provided effectively
- the desirability of the service – public support and funding attractiveness.



The four potential positions for services can lead to the following strategies for each service;

Position	**Characteristics**	**Strategy**
Public sector star	Attractive to the public and well funded. Funds are used well and the service goals are achieved.	Continue at current funding levels.
Golden fleece	Very effective, but the public believe that it is over-funded	Move funds to other services, aim to reduce the service or cut staff numbers.
Back drawer issue	Not effective and not desired by the public.	Remove this service.
Political hot box	Very popular but not very effective. Putting a drain on funding that could be used elsewhere	Either aim to change the public's perceptions and change it into a back drawer issue, or try to improve effectiveness (for example, by providing extra resources) and turn it into a star. Lobby for more funding.

The Ashridge portfolio display

The Ashridge portfolio display, or parenting matrix, developed by Campbell, Goold and Alexander, focuses on the benefits that corporate parents can bring discussed earlier in this chapter).

Ability to add value	Low	High
High	**Ballast**	**Heartland**
Low	**Alien territory**	**Value trap**

Opportunities to add value

Explain of the matrix

Heartland business units

- These are where there is a high degree of match and the parent company has the capabilities and experience to add value by providing the support required by the business unit.
- These businesses should be central to future strategy.

Ballast businesses

- These are those where the parent understands the business well but there are limited opportunities to offer help, sometimes because the business has been owned for a long time and has no further support needs.
- These businesses would do better if left alone or indeed divested.

Value trap businesses

- These are those where there appear to be many parenting opportunities but there is a poor fit with the critical success factors of the business.
- There appears to be good potential but in practice because of the lack of fit with the strategy there is a high possibility of destruction of value.

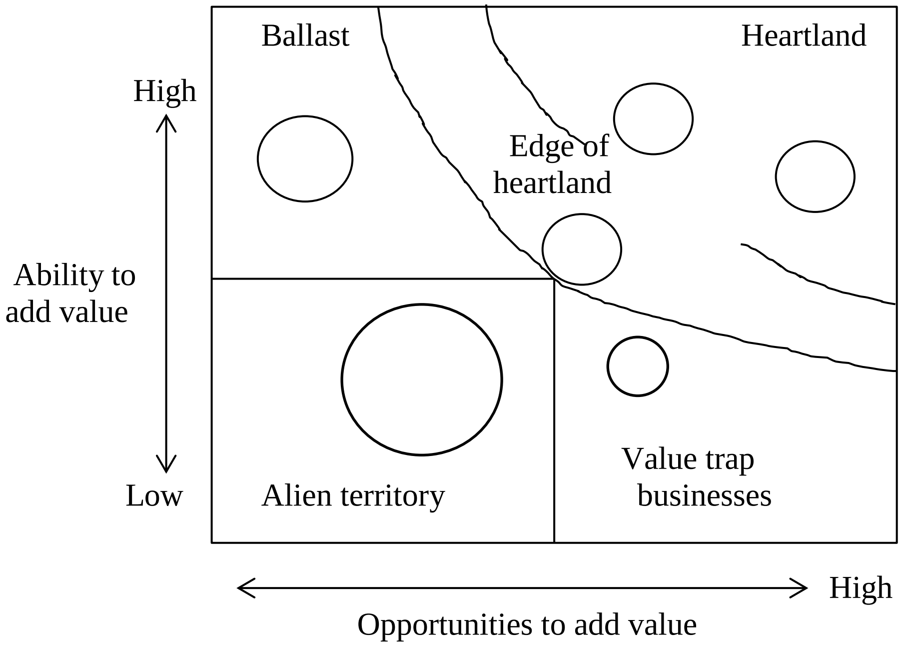
Alien businesses

- These are those where there is a complete mismatch.
- These should not remain part of the corporate portfolio.

Using the Ashridge portfolio display indicates which types of companies should be divested and why. Businesses that may be candidates for disinvestment are:

- alien businesses – the parent cannot do good to these organisations and they would achieve more in another group
- value trap businesses – despite potential, a lack of fit leads to a high possibility of a loss of value
- ballast businesses – may do better as the parent has littler to offer.

The matrix can be expanded to introduce what are called 'edge of heartland' business units:



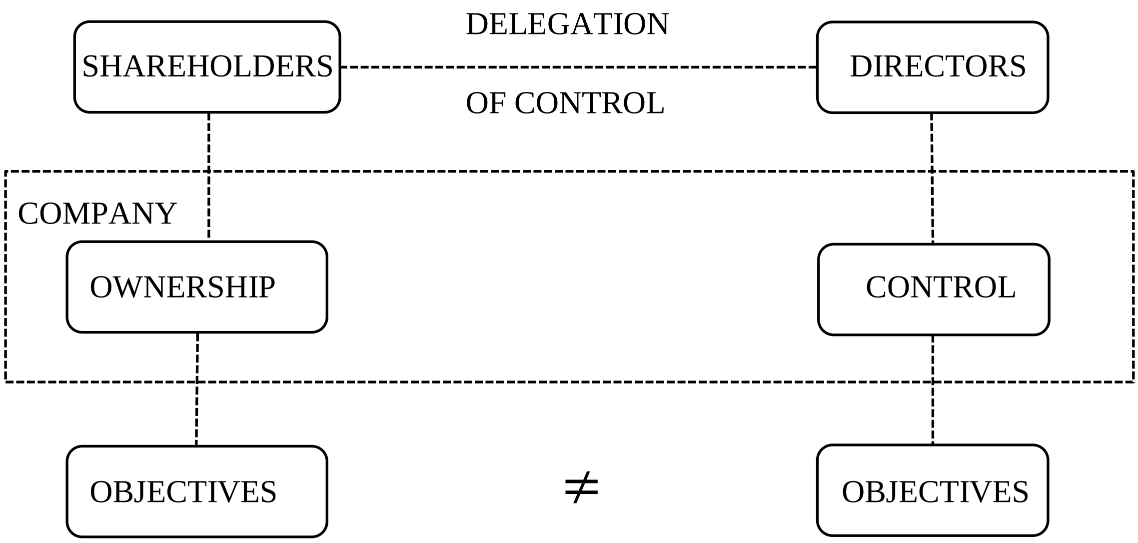
Edge of heartland business units

- These are those where there is a good fit in in some areas where the parent can bring particular skills that add value to the business unit, but not in others, where the parent may destroy value.
- However, if the parent develops sufficient understanding of the business to avoid this, then the business may move into the heartland.

Chapter 7

Governance general priciples

1 Company ownership and control



2 What is ‘corporate governance’?

The **Cadbury Report 1992** provides a useful definition:

- ‘the system by which companies are directed and controlled’.

An expansion might include:

- ‘in the interests of shareholders’ highlighting the agency issue involved
- ‘and in relation to those beyond the company boundaries’ or
- ‘and stakeholders’ suggesting a much broader definition that brings in concerns over social responsibility.

To include these final elements is to recognise the need for organisations to be accountable to someone or something.

Governance could therefore be described as:

- **‘the system by which companies are directed and controlled in the interests of shareholders and other stakeholders’.**

Coverage of governance

Companies are directed and controlled from inside and outside the company. Good governance requires the following to be considered:

Direction from within:

- the nature and structure of those who set direction, the board of directions
- the need to monitor major forces through risk analysis
- the need to control operations: internal control.

Control from outside:

- the need to be knowledgeable about the regulatory framework that defines codes of best practice, compliance and legal statute
- the wider view of corporate position in the world through social responsibility and ethical decisions.

3 The business case for governance

Providing a business case for governance is important in order to enlist management support. Corporate governance is claimed to bring the following benefits:

- It is suggested that strengthening the control structure of a business increases accountability of management and maximizes sustainable wealth creation.
- Institutional investors believe that better financial performance is achieved through better management, and better managers pay attention to governance, hence the company is more attractive to such investors.
- The above points may cause the share price to rise – which can be referred to as the "governance dividend" (i.e. the benefit that shareholders receive from good corporate governance).
- Additionally, a socially responsible company may be more attractive to customers and investors hence revenues and share price may rise (a "social responsibility dividend").

The hard point to prove is how far this business case extends and what the returns actually are.

CORPORATE GOVERNANCE

PURPOSES

Primary:

Monitor those parties within a company who control the resources owned by investors.

Suppose

- Ensure there is a suitable balace of power on the board of directions.
- Ensure executive directors are remunerated fairly.
- Make the board of directors responsible for monitoring and managing risk.
- Ensure the external auditors remain independent and free from the influence of the company.
- Address other issues, e.g. business ethics, corporate social responsibility (CSR), and protection of 'whistleblowers'.

OBJECTIVES

Primary:

Contributes to improved corporate performance and accountability in creating long-term shareholder value

Supporting:

- Control the controllers by increasing the amount of reporting and disclosure to all stakeholders.
- Increase level of confidence and transparency in company activities for all investors (existing and potential) and thus promote growth.
- Ensure that the company is run in a legal and ethical manner.
- Build in control at the top that will 'cascade' down the organisation.

5 Key concepts

The foundation to governance is the action of the individual. These actions are guided by a person's moral stance.

Important in governance

An appropriate level of morality or ethical behaviour is important for a number of reasons:

- Codes provide the principle to behaviour; it is the individual's ethical stance that translates this into action in a given business situation.
- The existence of given levels of ethical behaviour improves vital public perception and support for the accountancy profession and actions of individuals within that profession.

- Such moral virtue operates as a guide to individual, personal behaviour as well as in a business context.
- The existence of such moral virtue provides trust in the agency relationship between the accountant and others such as auditors. This trust is an essential ingredient for successful relationships.

Fairness

- A sense of equality in dealing with internal stakeholders.
- A sense of even-handedness in dealing with external stakeholders.
- An ability to reach an equitable judgement in a given ethical situation.

Openness/transparency

- Transparency is required in the agency relationship. In terms of definition, transparency means openness (say, of discussions), clarity, lack of withholding of relevant information unless necessary.
- It has a default position of information provision rather than concealment.

Innovation

- Innovation occurs when a firm "transforms knowledge and ideas into new products, processes and systems for the benefit of the firm and its stakeholders."
- In the context of corporate government, this covers innovation and experimentation in reporting, allowing the business to move away from rigid compliance, and towards the better communication of its individual value creation story for its providers of financial capital.
- Ultimately, innovation improves a firm's reporting performance to the benefit of investors and consumers.
- Much of the knowledge from which innovation stems is tacit and "local," meaning that such knowledge is unique to the company and the environment in which the knowledge arises.
- In addition, the capacity of a firm to integrate external knowledge is crucial for successful innovation.

Scepticism

- Scepticism (often referred to as professional skepticism) is an attitude which includes a questioning mind, being alert to conditions which may indicate possible misstatement due to error or fraud. This is to provide a critical assessment of evidence.

- For example, The UK Corporate Governance Code provisions advocate for non-executives to apply scepticism in order to challenge and scrutinise management effectively.

Independence

- Independence from personal influence of senior management for non-executive directors (NEDs).
- Independence of the board from operational involvement.
- Independence of directorships from overt personal motivation since the organization should be run for the benefit of its owners.
- A quality possessed by individuals and refers to the avoidance of being unduly influenced by a vested interest.
- This freedom enables a more objective position to be taken on issues compared to those who consider vested interests or other loyalties.

Probity/honesty

- Honesty in financial/positional reporting.
- Perception of honesty of the finance team from internal and external stakeholders.
- A foundation ethical stance in both principles – and rules-based systems.

Responsibility

- Willingness to accept liability for the outcome of governance decisions.
- Clarity in the definition of roles and responsibilities for action.
- Conscientious business and personal behavior.

Accountability

- The obligation of an individual or organisation to account for its actions and activities.
- Accounting for business position as a result of acceptance of responsibility.
- Providing clarity in communication channels with internal and external stakeholders.
- Development and maintenance of risk management and control systems.

Reputation

- Developing and sustaining personal reputation through other moral virtues.
- Developing and sustaining the moral stance of the organisation.
- Developing and sustaining the moral stance of the accounting profession.

Judgement

- The ability to reach and communicate meaningful conclusions.
- The ability to weigh up numerous issues and give each due consideration.
- The development of a balanced and evaluated approach to making business decisions and personal relationships covering intellectual and moral aspects.
- To make decisions in the best interests of the organisation.

Integrity

- A steadfast adherence to strict ethical standards despite any other pressures to act otherwise.
- Integrity describes the personal ethical position of the highest standards of professionalism and probity.
- It is an underlying and underpinning principle of corporate governance and it is required that all those representing shareholder interests in agency relationships both possess and exercise absolute integrity at all times.

Is governance relevant to all companies?

Issues in corporate governance relate to companies, and in particular listed companies whose shares are traded on major stock markets. However, similar issues might apply to smaller companies, and certainly to many large not-for-profit organisations.

	Large listed company	**Private company**	**Not-for-profit organisation**
Primary accountability	Shareholders and regulators	Shareholders	Fund providers, regulators, general public, members (whether applicable).
Pricipal stakeholders	Shareholders	Shareholders	Donors, grant providers, regulars, general public, service users, members (if applicable).
Main methods of monitoring performance	Financial statements	Financial statements	Financial statements, other financial and non-financial measures.
Governance/board structure	Executive and NEDs.	Executive directors.	Volunteer trustees, paid and unpaid

	Appointment through formal process in line with governance requirements	Appointment may be the result of shareholding or other recruitment processes.	management team. Appointments through recruitment, recommendation or word of mouth, or election process.
Openness and transparency	In line with corporate governance requirements.	Limited disclosure requirements	Limited requirements but large demand due to methods of funding.

7 Public Sector Governance

Public Sector Governance

- A range of organisations exists in most economies with three types predominant.
- Private sector – exist to make a profit
- Charities – which are charitable or benevolent
- Public sector – delivering goods or services not provided by "for profit" entities

The problem of agency in the Public sector

Those that manage a business (the agents) do not own that business but manage the business on behalf of those who do own it (the principals), hence the concept of agency. This is key concept in the context of corporate governance

In the public sector, the principals are different and rather than being for example shareholders are often those that fund and/or use the activity.

Therefore whilst private and public companies have shareholders, public sector organisations carry out their important roles on behalf of those who fund the service, mainly taxpayers, and the users of the services e.g. patients in a hospital. Funders and service users are therefore sometimes the same people (i.e. taxpayers placing their children in state school) but often they are not, giving rise to disagreements on how much is spent and on what service provision – the fundamental nature of political debate is about how much state funding should be allocated.

Public sector organisations emphasise different types of objectives to the private sector. Whereas private companies tend to seek to optimize their competitive strategy and advantages, public sector organisations tend to be concerned with social purposes and delivering their services efficiently, effectively and with good value for money.

Their objectives can therefore be more complex to develop.

This is often depicted as the three E's.

- Economy – to deliver the service on time and within budget and to obtain service at the lowest cost thus delivering value to the taxpayers, as well as those working in them and those using the service. This will achieve consistency with policy objectives.
- Effectiveness – to deliver the service the organisation was created to provide.
- Efficiency – to deliver the service with the best use of resources, an efficcient organisation delivers more for a given level of resource input than an inefficient one.

Governance arrangements in the Public Sector

With no one single mechanism being appropriate to control and monitor the achievement of objectives, accountability is achieved, at least in part, by having a system of reporting and oversight.

This entails those in charge of the service delivery to report to an external body if oversight which may be e.g. a board of governors or trustees.

The roles of the oversight bodies include:

- To ensure the service complies with government rules
- To ensure that performance targets are met
- To set and monitor performance against budgets
- To oversee senior appointments
- To monitor management performance
- To remove underperforming senior managers
- To report to higher authorities on the organisations being monitored

Changing policy objectives

There is constant debate about the extent, operation and often the need for public sector organisations.

The debate continues as to these ventures, arguments for and against raging depending on your political bias.

Those in favour argue:

- More efficiency in delivery via profit driven performance measures
- Increased competition driving better value for money to the consumer
- Better quality management
- Improved governance.

Those against argue:

- Profit is not the motive for improved strategic services e.g. health
- Increased competition will lead to detrimental change
- Key services e.g. transport should always remain under state control to ensure effective delivery.

Agency in not-for-profit organisations

In a not-for-profit organisation, such as a charity, there are no residual claims to be paid out and no owners expecting to earn a profit. Therefore, within these organisations, any agency relationship between owners and managers is clouded.

Furthermore, without residual claims or stock, there is no need or management to worry about the organisation being bought or sold in the marketplace. These conditions may suggest that managers in a not-for-profit organisation have increased opportunity to pursue self-interest.

The decision control role of not-for-profit boards is the same as for profits boards. In general, not-for-profit boards also have a special responsibility for generating and managing financial resources. They are often called on to personally contribute to the institution, lead campaigns to encourage others to contribute, and manage the financial resources held by the institution. Together, these two responsibilities, decision control and financial management, are among the most important duties of the boards of not for profit organisations.

8 Internal corporate governance stakeholders

Stakeholder theory will be covered in more detail in chapter 9. A useful definition of a stakeholder, for use at this point, is **'any person or group that can affect or be affected by the policies or activities of an organisation'.**

Each internal stakeholder has:

- An operational role within the company
- A role in the corporate governance of the company
- A number of interests in the company (referred to as the **stakeholder 'claim').**

<table>
<tr><th>Stakeholder</th><th>Operational role</th><th>Corporate governance role</th><th>Main interests in company</th></tr>
<tr><td>Directors</td><td>Responsible for the actions of the corporation.</td><td>Control company in best interest of stakeholders.</td><td rowspan="2">• pay
• performance-linked bonuses
• share options
• status
• reputation
• power.</td></tr>
<tr><td>Company secretary</td><td>Ensure compliance with company legislation and regulations and keep board members informed of their legal responsibilities.</td><td>Advise board on corporate governance matters.</td></tr>
<tr><td>Sub-board management</td><td>Run business operations. Implement board policies.</td><td>• Identify and evaluate risks faced by company
• Enforce controls
• Monitor success
• Report concerns.</td><td rowspan="2">• Pay
• performance-linked bonuses
• job stability
• career progression
• status
• working conditions.</td></tr>
<tr><td>Employees</td><td>Carry out orders of management.</td><td>• Comply with internal controls
• Report breaches.</td></tr>
<tr><td>Employee representatives, e.g. trade unions</td><td>Protect employee interests.</td><td>Highlight and take action against breaches in governance requirements, e.g. protection of whistle-blowers.</td><td>• power
• status</td></tr>
</table>

The board of directions

- Has the responsibility for giving direction to the company.
- Delegates most executive powers to the executive management, but reserves some decision-making powers to itself.
- Non-executive directions (NEDs) perform the functions of director only, without any executive responsibilities.
- Executive directions combine their stake in the company as a director with their stake as fully paid employees, and their interests are, therefore, likely to differ from those of the NEDs.

The company secretary

- Often responsible for advising the board on corporate governance matters and ensuring board procedures are followed.
- Duties vary with the size of the company, but are likely to include:
  - arranging meetings of the board
  - drafting and circulating minutes of board meetings
  - ensuring that board decisions are communicated to staff and outsiders
  - completing and signing of various returns
  - filing accounts with statutory authorities
  - maintaining statutory documents and registers required by the authorities.
- Company secretary may act as the general administrator and head office manager.
- Does not have the same legal responsibilities as directors.
- Should always act in the interests of the company in any event of conflict or dispute with directors.
- Is responsible to the board and accountable through the chairman and Chief Executive Officer (CEO) for duties carried out.
- Has the same interests and claims in the company as other employees.
- Remuneration package should be settled by the board or remuneration committee.

Management

- Responsible for running business operations.
- Accountable to the board of directors (and more particularly to the CEO).

Employees

- Have a stake in their company because it provides them with a job and an income.

Trade unions

- Primary interest will be in the pay and working conditions of their members.
- Will be concerned by poor corporate governance, for example lack of protection for whistleblowers or poor management of health and safety risks, and hence assist in the checks and balance of power within a company.
- Can optimize industrial relations, easing workforce negotiations, and hence ensure an efficient and supportive relationship.
- Power of trade unions will vary between countries, with it being much stronger in countries such as France where union rights are extended to all employees.

9 External corporate governance stakeholders

A company has many external stakeholders involved in corporate governance.

Each stakeholder has:

- a role to play in influencing the operation of the company
- its own interests and claims in the company
- a stakeholder claim is where a stakeholder wants something from an organisation. These claims can be concerned with the way a stakeholder may want to influence the activities of an organisation or by the way they are affected by the organisation.

There are:

- Direct claims – made by stakeholders directly with the organisation and are unambiguous e.g. trade unions. Effectively they have their own voice
- Indirect claims – where stakeholder is "voiceless", e.g. an individual customer of a large retail organisation or the environment with the inevitable problem of interpretation.

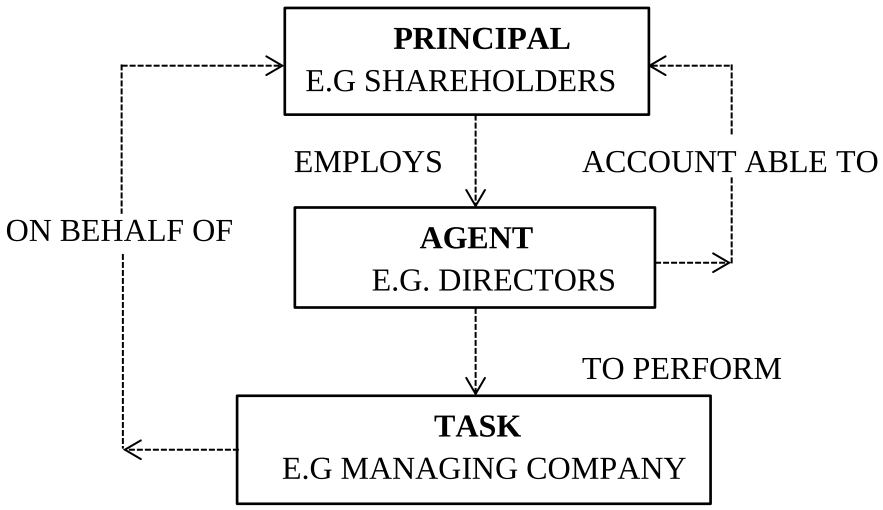
External party	Main role	Interest and claims in comapny
Auditors	Independent review of company's reported financial position	• fees • reputation • quality of relationship • compliance with audit requirements.
Regulators	Implementing and monitoring regulations.	• compliance with regulations • effectiveness of regulations.
Government	Implementing and maintaining laws with which all companies must comply.	• compliance with laws • payment of taxes • level of employment • levels of imports / exports.
Stock exchange	Implementing and maintaining rules and regulations for companies listed on the exchange	• compliance with rules and regulations • fees.
Small investors	Limited power with use of vote	• maximization of shareholder value
Institutional investors	Through considered use of their votes can (and should) beneficially influence corporate policy	• value of shares and dividend payments • security of funds invested • timeliness of information received form company • shareholder rights are observed.

Institutional investors and corporate governance

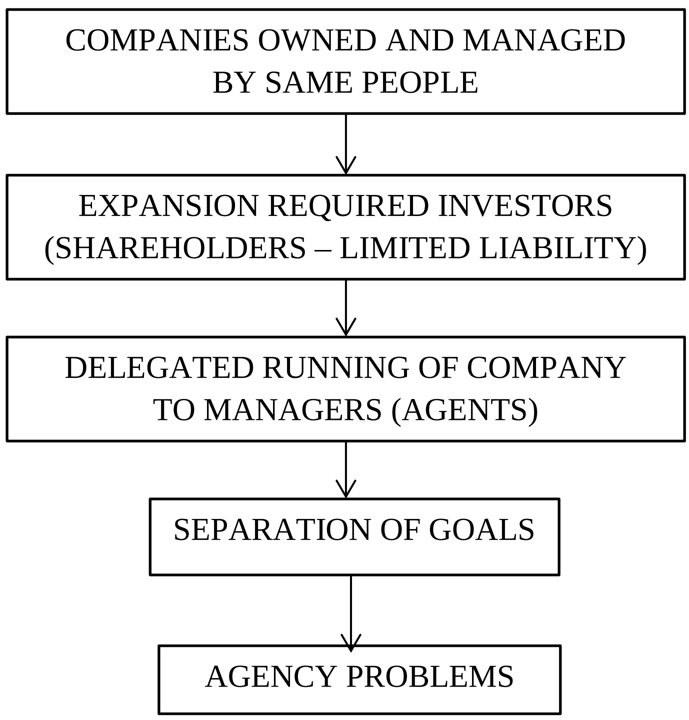
- Due to the size of their shareholdings, institutional investors can exert significant influence on corporate policy and take an active role in bringing under-performing companies to task.
- The main kind of institutional investors are:
  - Pension funs
  - Insurance companies
  - Mutual funds
  - Sovereign funds

10 What is agency theory?

Agency theory is a group of concepts describing the nature of the agency relationship deriving from the separation between ownership and control.



Agency theory and corporate governance



11 Key concepts of agency theory

A number of key terms and concepts are essential to understanding agency theory.

- An **agent** is employed by a **principal** to carry out a task on their behalf.
- **Agency** refers to the relationship between a principal and their agent.
- **Agency costs** are incurred by principals in monitoring agency behavior because of a lack of trusts in the good faith of agents.
- By accepting to undertake a task on their behalf, an agent becomes **accountable** to the principal by whom they are employed. The agent is accountable to that principal.
- Directors (agents) have a **fiduciary responsibility** to the shareholders (principal) of their organisation (usually described through company law as 'operating in the best interests of the shareholders').
- **Stakeholders** are any person or group that can affect or be affected by the policies or activities of an organisation.
- Agent **objectives** (such as a desire for high salary, large bonus and status for a director) will differ from the principal's objectives (wealth maximization for shareholders)
- The most important agency costs are the external audit fee, attending meeting and reading both annual reports and analyst's reports.

The cost of agency relationships

Agency cost

Agency costs arise largely from principals monitoring activities of agents, and may be viewed in monetary terms, resources consumed or time taken in monitoring. Costs are borne by the principal, but may be indirectly incurred as the agent spends time resources on certain activities. Examples of costs include:

- incentive schemes and remuneration packages for directors
- costs of management providing annual report data such as committee activity and risk management analysis, and cost of principal reviewing this data
- cost of meetings with financial analysts and principal shareholders
- the cost of accepting higher risks than shareholders would like in the way in which the company operates
- cost of monitoring behavior, such as by establishing management audit procedures.

Residual loss

This is an additional type of agency cost and relates to directors furnishing themselves with expensive cars and planes etc. these costs are above and beyond the remuneration package for the director, and are a direct loss to shareholders.

Agency problem resolution measures

- Meetings between the directors and key institutional investors.
- Voting rights at the AGM in support of, or against, resolutions.
- Proposing resolutions for vote by shareholders at AGMs.

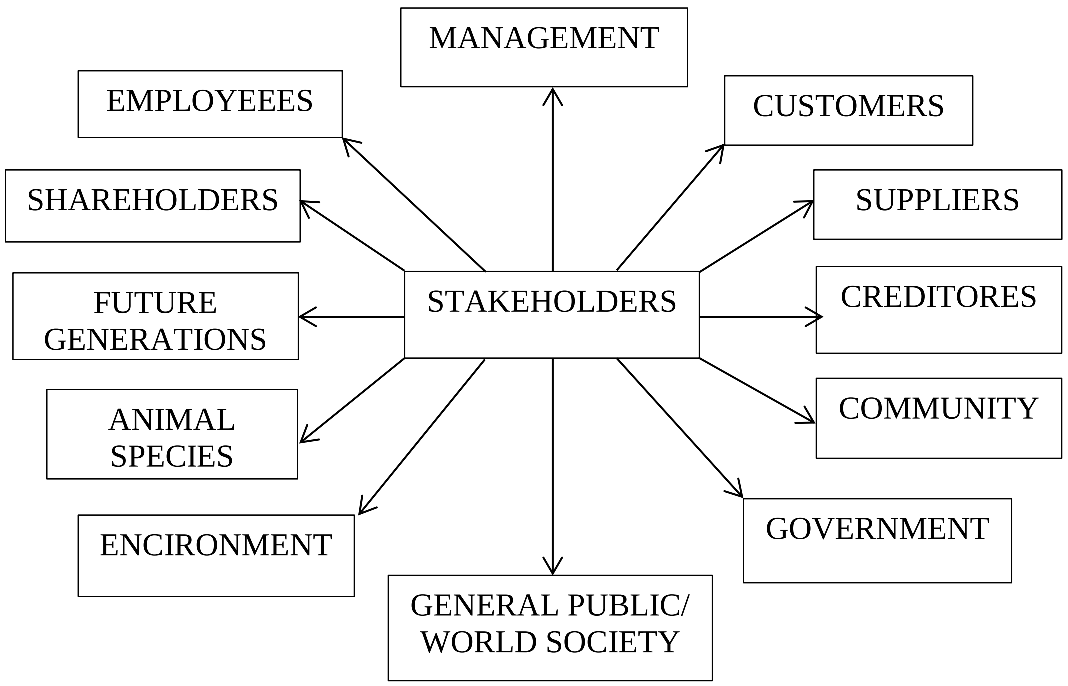
- Accepting takeovers.
- Divestment of shares is the ultimate threat.

Agent accountability

- The need to act in shareholders' interests
- The need to provide good information such as audited accounts and annual reports
- The need to operate within a defined legal structure.
- Directors are accountable to shareholders.
- Directors must prove that they are discharging their responsibilities in line with shareholder expectations in the form of financial results, a clean audit report and reported compliance with codes of corporate governance.
- If the shareholders do not like what they see, they ultimately (although not necessarily practically) have the power to remove the directors and replace them.)

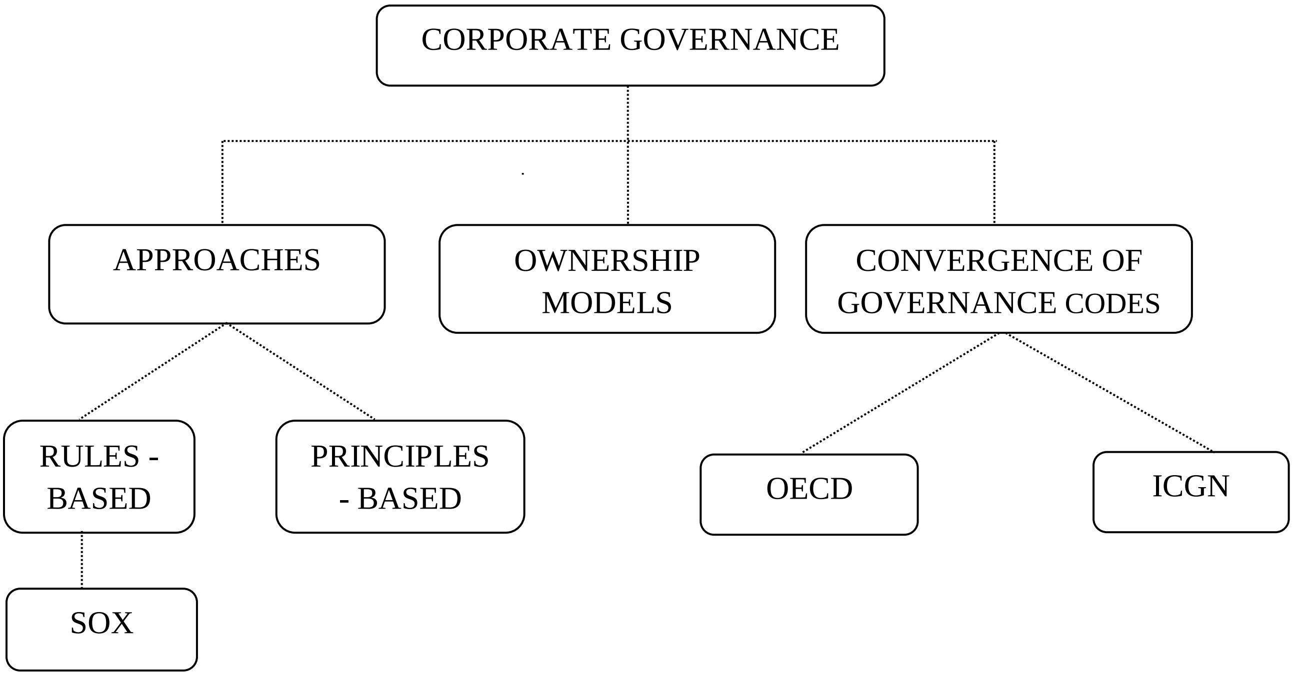
12 Stakeholder theory

Stakeholders are not only are affected by the organisation but they also affect the organisation.

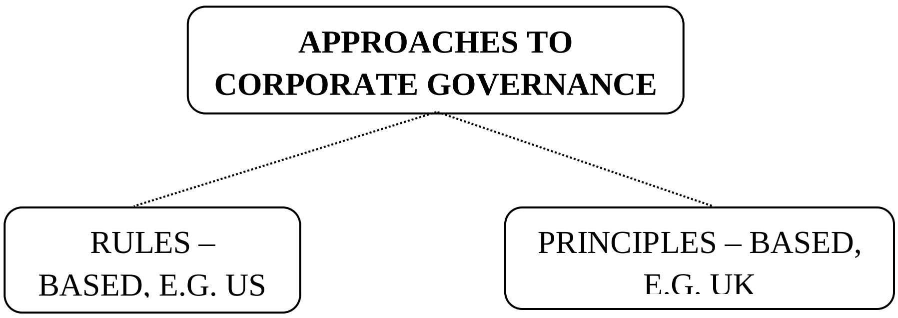


Chapter - 8

Approaches to governance



(1)Rules and principles based approaches to corporate governance



- A rules-based approach instills the code into law with appropriate penalties for transgression.
- A principles-based approach requires the company to adhere to the spirit rather than the letter of the code. The company must either comply with the code or explain why it has not through reports to the appropriate body and its shareholders.

The US model is enshrined into law by virtue of virtue of SOX. It is, therefore, a rules-based approach.

Choice of governance regime

The decision as to which approach to use for a country can be governed by many factors:

- Dominant ownership structure (bank, family or multiple shareholder)
- Legal system and its power/ ability
- Government structure and policies
- State of the economy
- Culture and history
- Levels of capital inflow or investment coming into the country
- Global economic and political climate

UK Corporate Governance Code (2016)

The "comply or explain" approach is the trademark of corporate governance in the UK.

Illustration 1 – Marks & Spencer

On 10 March 2008, Marks & Spencer announced Board and senior management changes.

The announcement stated that "Lord Burns will stand down as Chairman with effect from 1 June 2008" and that "Sir Stuart Rose is appointed Executive Chairman from the same date".

This action meant that Sir Stuart Rose would become CEO and chairman and, in allowing one individual to hold both positions, Marks & Spencer would not be in compliance with the UK Corporate Governance Code.

Furthermore (and also in contravention of the code), the directors had not fully consulted major shareholders in advance of this announcement.

In their corporate governance statement for the year ended 29 March 2008, Marks & Spencer stated that they had complied with all the provisions of the code with the exception of the two noted above and went on to explain the non compliance. A letter was also written to the shareholders (dated 3 April 2008) explaining in full the reasons for the departure.

Arguments in favour of a rules-based approach (and against a principles-based approach)

Organization's perspective:

- Clarity in terms of what the company must do – the rules are a legal requirement, clarity should exist and hence no interpretation is required.
- Standardization for all companies – there is no choice as to complying or explaining and this creates a standardized and possibly fairer approach for all businesses.
- Binding requirements – the criminal nature makes it very clear that the rules must be complied with.

Wider stakeholder perspective:

- Standardization across all companies – a level playing field is created.
- Sanction – the sanction is criminal and therefore a greater deterrent to transgression.
- Greater confidence in regulatory compliance.

Arguments against a rules-based approach (and in favour of a principles-based approach)

Organization's perspective:

- Exploitation of loopholes – the exacting nature of the law lends itself to the seeking of loopholes.
- Underlying belief – the belief is that you must only play by the rules set. There is no suggestion that you should **want** to play by the rules (i.e. no 'buy-in' is required).
- Flexibility is lost – there is no choice in compliance to reflect the nature of the organization, its size or stage of development.
- Checklist approach – this can arise as companies seek to comply with all aspects of the rules and start 'box-ticking'.

Wider stakeholder perspective:

- 'Regulation overload' – the volume of rules and amount of legislation may give rise to increasing costs for businesses and for the regulators.
- Legal costs – to enact new legislation to close loopholes.
- Limits – there is no room to improve, or go beyond the minimum level set.

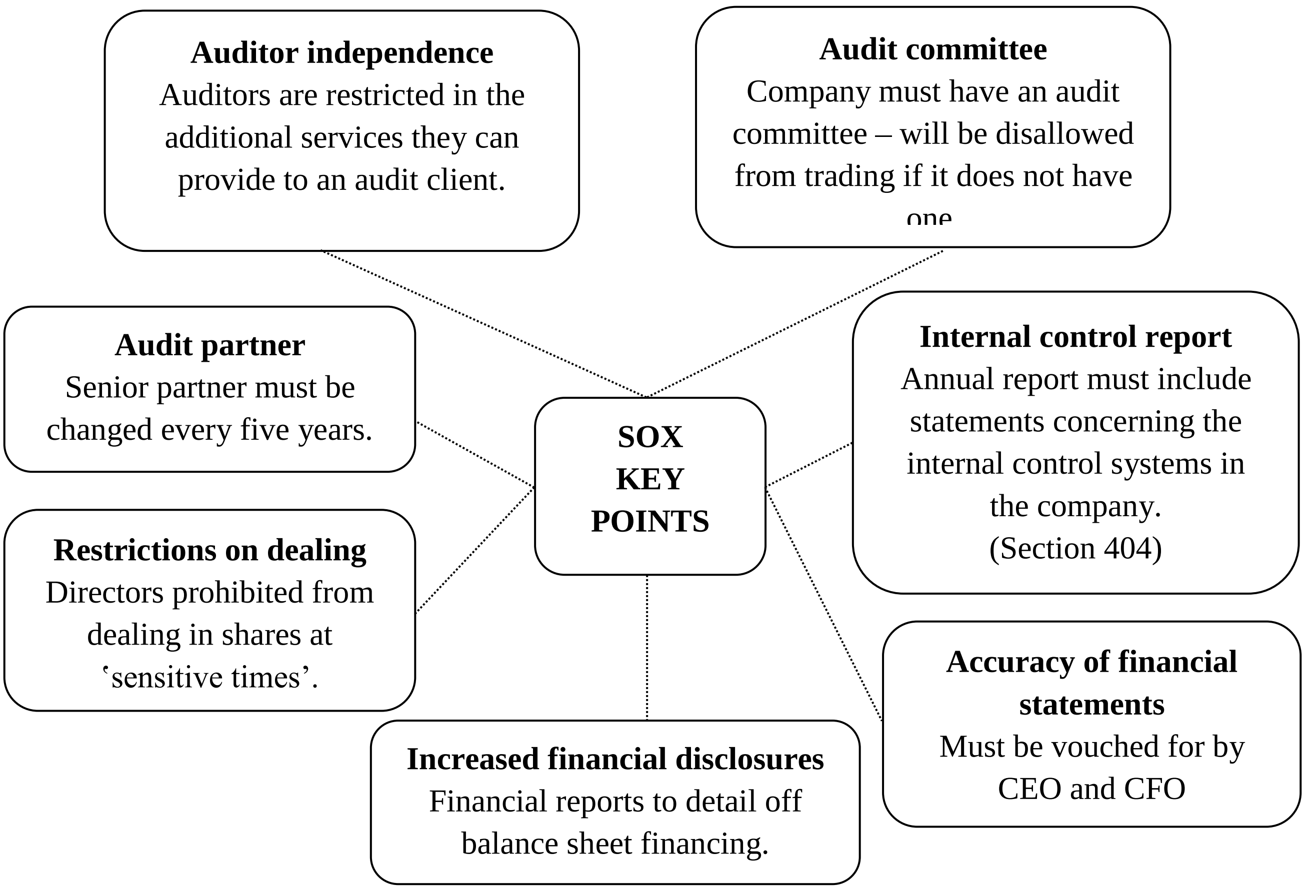
- 'Box-ticking' rather than compliance – this does not lead to well governed organizations.

(2) Sarbanes – Oxley (SOX)

In 2002, following a number of corporate governance scandals such as Enron and World Com, tough new corporate governance regulations were introduced in the US by SOX.

It is named after Senator Paul Sarbanes and Representative Michael Oxley, who were its main architects, and it set a number of non-negotiable rules and deadlines for compliance.

- SOX-is a rules-based approach to governance.
- SOX-is extremely detailed and carries the full force of the law.
- SOX-includes requirements for the Securities and Exchange Commission (SEC) to issue certain rules on corporate governance.
- It is relevant to US companies, directors of subsidiaries of US-listed businesses and auditors who are working on US-listed businesses.



Measures introduced by SOX

Measures introduced by SOX include:

- All companies with a listing for their shares in the US must provide a signed certificate to the SEC vouching for the accuracy of their financial statements (signed by CEO and chairman).
- If a company's financial statements are restated due to material non-compliance with accounting rules and standards, the CEO and chief finance officer (CFO) must forfeit bonuses awarded in the previous 12 months.
- Restrictions are placed on the type of non-audit work that can be performed for a company by its firm of auditors.
- The senior audit partner working on a client's audit must be changed at least every five years (i.e. audit partner rotation is compulsory).
- An independent five-man board called the Public Company Oversight Board has been established, with responsibilities for enforcing professional standards in accounting and auditing.
- Regulations on the disclosure of off-balance sheet transactions have been tightened up.
- Directors are prohibited from dealing in the shares of their company at 'sensitive times'.

Internal control statement (s404)

Sarbanes-Oxley Act section 404 requires management and the external auditor to publish a statement for external usage that reports on the adequacy of the company's internal control over financial reporting.

The cost of complying with s404 impacts smaller companies disproportionately, as there is a significant fixed cost involved in completing the assessment.

The requirement is that a company's published annual report should include an internal control report of management that contains:

(1) A statement of management's responsibility for establishing and maintaining adequate internal control over financial reporting for the company.
(2) A statement identifying the framework used by management to conduct the required evaluation of the effectiveness of the company's internal control over financial reporting.
(3) Management's assessment of the effectiveness of the company's internal control over financial reporting as of the end of the company's most recent fiscal year. Management is not permitted to conclude that the company's internal control over financial reporting is effective if there are one or more material weaknesses in the company's internal control over financial reporting.

(4) A statement that the audit firm that audited the financial statements included in the annual report has issued an attestation report on management's assessment of the company's internal control over financial reporting.

Key effects of SOX

- Personal liability of directors for mismanagement and criminal punishment.
- Improved communication of material issues to shareholders.
- Improved investor and public confidence in corporate US.
- Improved internal control and external audit of companies.
- Greater arm's length relationships between companies and audit firms.
- Improved governance through audit committees.

Negative reactions to SOX

- Doubling of audit fee costs to organizations.
- Onerous documentation and internal control costs.
- Reduced flexibility and responsiveness of companies.
- Reduced risk taking and competitiveness of organizations.
- Limited impact on the ability to stop corporate abuse.
- Legislation defines a legal minimum standard and little more.

(3) Governance structures

Wider world view o governance requires consideration of the nature of ownership, power and control.

Family structures (as opposed to joint stock)

A family structure exists where a family has a controlling number of shares in a company. This has potential benefits and problems for the company, and the other shareholders involved.

Benefits that arise include:

- Fewer agency costs – since the family is directly involved in the company there are fewer agency costs.
- Ethics – it could be said that threats to reputation are threats to family honour and this increases the likely level of ethical behavior.
- Fewer short-term decisions – the longevity of the company and the wealth already inherent in such families suggest long – term growth is a bigger issue.

Problems include:

- Gene pool – the gene pool of expertise in owner managers must be questionable over generations.
- Feuds – families fight, and this is an added element of cultural complexity in the business operation.
- Separation – families separate and this could be costly in terms of buying out shareholding and restructuring.

Insider-dominated structures (as opposed to outsider-dominated)

This is an extension of the same idea. Insider – dominated structures are where the listed companies are dominated by a small group of shareholders. These:

- May be family owned.
- May be banks, other companies or governments.
- Predominate in Japan and Germany.

The close relationship suggests benefits including:

- The agency problem is reduced i.e. easier to establish links between owners and managers.
- Greater access and potentially lower cost of capital i.e. smaller base of shareholders.
- Smaller base of shareholders willing to take a long term strategic view of investment.
- Improved communication and influence over management policy and dialogue.

Problems include:

- Lack of minority shareholder protection (unlike protection in law in outsider-dominated structures).
- Opaque operations and lack of transparency in reporting.
- Misuse of power i.e. reluctance to employ outsiders in influential positions and NED's.
- The market does not decided or govern (shareholders cannot exit easily to express discontent).
- Tend to be reluctant until forced to develop formal governance structures.
- Reluctance of large independent shareholders to invest.

National differences

The insider/outsider model deals with the issue of national differences.

- Insider orientation: Termed the French structure because of its origin.
- Outsider orientation: Anglo-American structure because of its origin.

Corporate governance in Japan

Some new corporate governance provisions were introduced into the Japanese Commercial Code in 2003, including provisions for US-Style board committees. However not many Japanese listed companies have yet decided to adopt this new system.

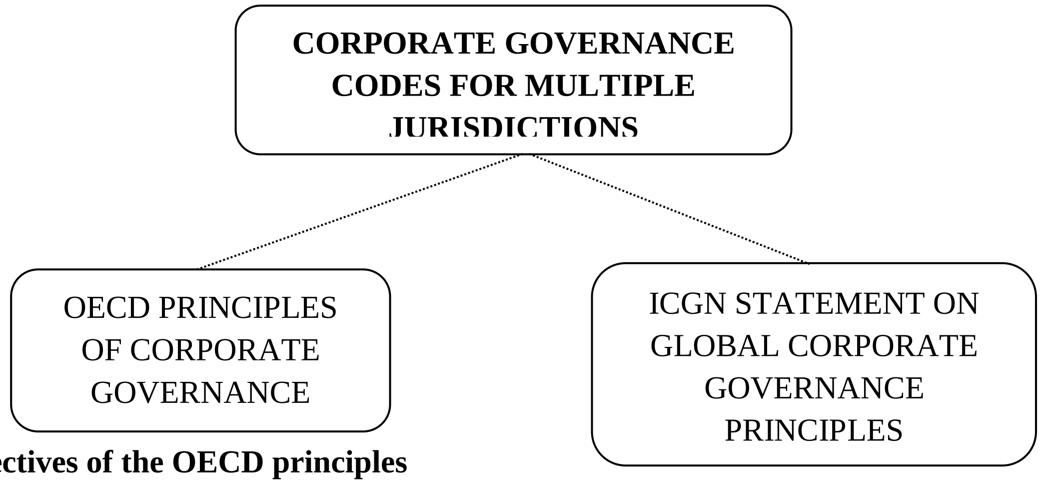
(4)International convergence

The competitiveness of nations is a preoccupation for all governments.

- Harmonization and liberalization of financial markets mean that foreign companies now find it easy to invest in any marketplace.
- This has led to a drive towards international standards in business practices to sit alongside the global shift in applying International Accounting Standards (IASs).

Two organizations have published corporate governance codes intended to apply to multiple national jurisdictions. These organizations are:

- The Organization for Economic Cooperation and Development (OECD) and
- The international Corporate Governance Network (ICGN).



Objectives of the OECD principles

- First initiative to develop the core elements of a good corporate governance regime.
- To assist OECD and non-OECD governments in their efforts to evaluate and improve the legal, institutional and regulatory framework for corporate governance in their countries.
- The principles focus on publicly- traded companies, both financial and non-financial. However, they might also be a useful tool for improving corporate governance in non-traded companies.

Content of the OECD principles:

- Ensuring the basis for an effective corporate governance framework.
- The rights of shareholders and key ownership functions.
- The equitable treatment of shareholders.
- The role of stakeholders in corporate governance.
- Disclosure and transparency.
- The responsibilities of the board.

Objectives of the ICGN principles

- Highlight corporate governance elements that when making asset allocations and investment decisions.
- The ICGN principles mainly focus on the governance of corporations whose securities are traded in the market.
- Encourage jurisdictions to address certain broader corporate and regulatory policies in areas which are beyond the authority of a corporation.

Content of the ICGN principles:

- Corporate objective – shareholder returns.
- Disclosure and transparency.
- Audit.
- Shareholders' ownership, responsibilities, voting rights and remedies.
- Corporate boards.
- Corporate remuneration policies.
- Corporate citizenship, stakeholder relations and the ethical conduct of business.
- Corporate governance implementation.

Limitations

- All codes are voluntary and are not legally enforceable unless enshrined in statute by individual countries.
- Local differences in company ownership models may mean parts of the codes are not applicable.

Chapter - 9

Stakeholders and corporate social responsibility

(1)Corporate social responsibility (CSR)

CSR is a concept with many definitions and practices. Whatever the definition is, the purpose of CSR is to drive change towards sustainability.

A corporation:

- Is an artificial person in law, It has the same rights and responsibilities as human beings.
- Is notionally owned by shareholders but exists independently of them. The shareholder has a right to vote and be paid a dividend but the company owns its assets.
- Managers have a fiduciary duty to protect shareholder investment.

Milton Friedman argued that, in relation to this definition, a corporation has no responsibility outside of making profit for shareholders:

- Only human beings have moral responsibility for their actions.
- It is the managers' duty to act solely in the interest of shareholders:
    - This is a point of law. Any other action is shareholder betrayal.
- Social issues are the province of the state and not corporations.

The argument against this viewpoint needs to provide the organization with an alternative view that leads to the same outcome of profit.

Enlightened self-interest

- Corporations perceived as ethically sound are rewarded with extra customers.
- Corporations which are ethically unsound are boycotted.
- Employees are more attracted to work for, and are more committed to, socially responsible companies.
- Voluntarily committing to social actions and programmers may forestall legislation and promote independence from government.
- Positive contribution to society may be a long-term investment in a safer, better educated and more equitable community creating a more stable context in which to do business.

(2) Stakeholders and their claims

As already stated in chapter 1 Freeman defines stakeholders as '**any person or group that can affect or be affected by the policies or activities of an organization'.**

- The definition is important since it shows the directionality of stakeholder claims in as much as they can impact on the corporation as well as being the recipient of the actions of the firm.

The traditional model of capitalism provides us with:

- Customers, suppliers, shareholders and employees.

The stakeholder model extends this to include:

- Government, civil society and competitors.

Stakeholder claims

These are the demands that the stakeholder makes of an organization.

- **Direct** stakeholder claims are usually unambiguous, and are often made directly between the stakeholders and the organization.
- **Indirect** claims are made by those stakeholders unable to express their claim directly to the organization. They have no 'voice'.

(3) Stakeholder classifications and relations

Classifications of stakeholders

There are a number of ways of classifying stakeholders according to criteria based on how stakeholders relate to organizational activities.

Internal and external stakeholders

This is the distinction between stakeholders inside the organization and those outside.

- Internal: includes employees and management, and possibly trade unions.
- External: includes customers, competitors and suppliers.

Narrow and wide stakeholders

This is the extent to which the stakeholder group is affected by organizational activity.

- Narrow: those most affected or who are dependent on corporation output, such as shareholders, employees, management, customers and suppliers.
- Wide: those less affected or dependent on company output such as government, the wider community and non-dependent customers.

Primary and secondary stakeholders

This focuses on the opposing view in Freeman's definition, that stakeholders affect organizations as well as being affected by organizations.

- Primary: those that have a direct affect on the company and without whom it would be difficult to operate, such as the government, shareholders and customers.
- Secondary: those that have a limited direct influence on the organization and without whom the company would survive, such as the community and management.

Active and passive stakeholders

This categorization distinguishes between those that seek to participate in organizational activity and those that do not.

- Active: those that wish to participate, so include management and employees, but may also include regulators, environmental pressure groups and suppliers.
- Passive: those that do not wish to participate and may include shareholders, local communities, government and customers.

Voluntary and involuntary stakeholders

This categorization removes the element of choice associated with active and passive participation, sub dividing the active group into two elements.

- Voluntary: those stakeholders that choose to be involved in organizational decision making such as management, employees, environmental groups and active shareholders. These stakeholders can withdraw their stake-holding in the short-term.
- Involuntary: those stakeholders that do not choose to be involved in organizational decisions but become involved for a variety of reasons. This could include regulators,

key customers, suppliers, government, natural environment and local communities. They cannot withdraw in the short-to medium-term.

Legitimate and illegitimate stakeholders

This is the extent to which the claim of the stakeholder is considered a valid claim. It can be a subjective classification with debate surrounding certain group's claims, and can lead into the concept of whether stakeholders are recognized by the organization or not.

- Legitimate: those with an active economic relationship with an organization, such as customers and suppliers.
- Illegitimate: those without such a link, such as terrorists, where there is no case for taking their views into account when making decisions.

Managing stakeholder relations

Stakeholder mapping: The Mendelow model

Interest			
Power		Low	High
	Low	Minimal Effort	Keep informed
	High	Keep Satisfied	Key Players

Power relates to the amount of influence (or power) that the stakeholder group can have over the organization. However, the fact that a group has power does not necessarily mean that their power will be used.

The **level of interest** indicates whether the stakeholder is actively interested in the performance of the organization. The amount of influence the group has depends on their level of power.

Assessing stakeholder importance

Three attributes may be assessed:

- Power: the perceived ability of the stakeholder to affect organizational action.
- Legitimacy: whether the company perceives the stakeholder action to be legitimate.
- Urgency: whether the stakeholder claim calls for immediate action.

Definitive stakeholders (possessing all three) require immediate action, the others are **latent** stakeholders.

Organizational motivations regarding stakeholders

Donaldson and Preston draw a distinction between two motivations as to why organizations act in relation to the concerns of stakeholders.

The **instrumental** view of stakeholders:

- This relates to motivation stemming from the possible impact of stakeholder action on the objectives of the organization.
- The organization reacts to stakeholder input because it believes that not to do so would have an impact on its primary objectives (which may be profit, but could be other objectives for organizations such as charities).
- Such a view o stakeholders is therefore devoid of any moral obligation.

The **normative** view of stakeholders:

- This relates to motivation stemming from a moral consciousness that accepts a moral duty towards others in order to sustain social cohesion (the good of society).
- Such an altruistic viewpoint appreciates the need to act in a general sense of what is right rather than in a narrow interpretation of what is right for the company to achieve its profit targets.

(4) Impact of stakeholders on corporate governance

There are various forms of social accounting produced for inclusion in the Business Review as part of annual accounting reports.

- Ethical accounting: tends to focus on internal management systems or codes of practice at an individual level and how the company audits and complies with this.
- Environmental accounting: tends to focus exclusively on the organization's impact on the natural environment.
- Social accounting: has a broader remit to incorporate employee conditions, health and safety, equal opportunities, human rights and charity work.
- Sustainability accounting: is a grand title that incorporates the triple bottom line of the first three with possible emphasis on environmentalism.

(5) The organization as a corporate citizen

Corporate citizenship

Corporate citizenship is that it goes beyond compliance, obeisance, obligations and that which is required by law.

The company embraces responsibility for its actions and encourages a positive impact on the stakeholders with whom it interfaces.

Corporate accountability

Corporate accountability refers to whether the organization is in some way answerable for the consequences of its actions beyond its relationship with shareholders.

Scope of corporate citizenship

There are three views as to the scope and nature of CC.

- Limited view of CC: this is a philanthropic view. The scope is limited to charitable donations to the local community in which the organization operates.
- Equivalent view: this is CC as being the equivalent to CSR. 'The extent to which business meets economic, legal, ethical and discretionary responsibilities'.
- Extended view: this is most appropriate viewpoint since here citizenship has rights and responsibilities. Rights include the right to freedom of speech and the right to own property. Responsibilities include the right to uphold civil liberties where governments may be failing in their duty.

Chapter 10

Effective Leadership

1 The nature and importance of leadership

Buchanan and Huczynski define a leader as ‘someone who exercise influence over other people’. Another definition is: Leadership is an interpersonal influence directed tow ard the achievement of a goal or goals. Three important parts of this definition are the terms interpersonal, influence, and goal:

- Interpersonal – means between persons. Thus, a leader has more than one person (group) to lead.
- Influence – is the power to affect others.
- Goal – is the end one strives to attain.

Basically, this traditional definition of leadership says that a leader influences more than one person towards a goal.

Leadership can be viewed from three standpoints:

- an attribute or a position, e.g. the managing director
- a characteristic of a person – a natural leader
- a category of behavior.

2 What makes an effective leader?

Trait theories

Early studies focused on the qualities required by effective leaders. Lists were compiled of required leadership qualities including:

- physical traits, such as drive, energy, appearance and height
- personality traits, such as adaptability, enthusiasm and self-confidence; and
- social traits, such as co-operation, tact, courtesy and administrative ability.

Certain other writers selected other personal qualities which were thought to be desirable in leaders, who are ‘born and not made’. Many great leaders were considered to have:

- above-average intelligence
- initiative – independence and inventiveness and the capacity to perceive a need for action
- motivation
- self-assurance and self-confidence
- the ‘helicopter factor’ – the ability to rise above the particulars of a situation and perceive it in relation to the surrounding context

- other 'essential' qualities included enthusiasm, sociability, integrity, courage, imagination, determination, energy, faith, even virility.

Behavioural/style theories

The research at Ashridge Management College distinguished four main management styles:

- Tells (autocratic) – the manager makes all the decisions and issues instructions which are to be obeyed without question.
- Sells (persuasive) – the manager still makes all the decisions, but believes that team members must be motivated to accept them in order to carry them out properly.
- Consults (participative) – the manager confers with the team and takes their views into account, although still retains the final say.
- Joins (democratic) – the leader and the team members make the decision together on the basis of consensus.

Contingency/contextual theories

The modern consensus is that there is no one best style of leadership that is equally effective for all circumstances.

One example studies in F1 is Adair's action-centred leadership approach. He argued that the leader needs to adapt to three competing needs:

- The needs of the group (communication, team building, motivation, discipline)
- The needs of individuals (coaching, counseling, motivating and developing)
- Task needs (setting objectives, planning tasks, allocating responsibilities and performance standards)

Such a balancing act is just as relevant to the CEO in the boardroom as it is to a supervisor on the shop floor.

A theory that is a mixture of both trait and contingency is the situational approach. The theory here is that leaders are products of particular situations.

3 Leadership and management

A leader can be a manager, but a manager is not necessarily a leader.

Management is the process of setting and achieving the goals of the organisation through the functions of management: planning, organising, directing (or leading), and controlling. A manager is hired by the organisation and is given formal authority to direct the activity of others in fulfilling organisational goals. Thus, leading is a major part of a manager's job. Yet a manager must also plan, organise, and control.

Leadership deals with the interpersonal aspects of a manager's job, whereas planning, organising, and controlling deal with the administrative aspects. Leadership deals with change, inspiration, motivation, and influence. Management deals more with carrying out the organisation's goals and maintaining equilibrium.

The key point in differentiating between leadership and management is the idea that employees willingly follow leaders because they want to, not because they have to. Leaders may not possess the formal power to reward or sanction performance because leadership does not necessarily take place within the hierarchical structure of the organisation. However, employees give the leader power by complying with what he or she requests. On the other hand, managers may have to rely on formal authority to get employees to accomplish goals.

The skills of a leader

- An understanding of the precise requirements needed from the group.
- The ability to make decisions, sometimes under pressure.
- An understanding of human nature to appreciate the attitude of the group.
- Confidence both in the group and themselves.
- The ability to create a sense of direction. Leaders should have a clear idea of what they are trying to achieve with their group, department, business unit or organisation.
- The ability to think strategically. Innovation and vision take a long while to see through from inception through to fruition or failure. The leader must be interested in the long-term view of the group
- Entrepreneurial abilities. Leaders should be able to identify opportunities and win the resources necessary to exploit them.
- The ability to lead from the front. Leaders must be able to inspire and motivate, to translate the vision into achievement.
- The possession of good communication skills.

The leader needs to use these skills to satisfy Adair's three principle requirements of leadership:

- Satisfy the task's needs. The leader ensures that the purpose – completion of the task – is fulfilled.
- Satisfy the group's needs. Until the task is completed, the group has to be held together; the leader must maintain team spirit and build morale.
- Satisfy the individual's needs. Each member of a group or team has individual needs and the leader should try as certain these needs and work towards satisfying them as far as is possible within the group's needs.

4 Leadership and culture

Bennis proposed that there were two types of leaders:

- Transactional leaders see the relationship with their followers in terms of a trade: they give followers the rewards they want in exchange for service, loyalty and compliance.
- Transformational leaders see their role as inspiring and motivating others to work at levels beyond mere compliance. Only transformational leadership is said to be able to change team/organisational cultures and move them in a new direction.

5 Entre and Intrapreneurship

Ways to encourage such intrapreneurship include the following:

- Set up a culture where employees are encouraged to explore new ideas.
- Managers should have open door policies making it easy for their staff to come and discuss new ideas.
- Removing administrative barriers and bureaucracy so that new ideas can be presented.
- Develop a culture where innovation is valued and failure is not the final work – calculated risk taking is essential to commercial success.
- Budget for resources to develop new ideas. Intrapreneurs should not be expected to finance development themselves.
- Give employees a degree of ownership of new ideas – for example, allowing them to present the concepts to senior management.
- Try to identify intrepreneurs and give them more time and resources to develop ideas further.

Differences between entrepreneurs and intrapreneurs

An entrepreneur is an individual that ‘starts-up’ a business and is the owner. Whereas, an intrapreneur is an employee of the company and does not usually have any ownership.

The intrapreneur may take ‘risks’ within the corporation where he works. There is no actual financial risk taken by the intrapreneur. In addition the difference between entrepreneurs and intrepreneurs is with regards to the “ultimate sacrifice”.

Chapter – 11

The board of directors

(1)Roles and responsibilities of directors

- Provide entrepreneurial leadership of the company.
- Represent company view and account to the public.
- Decide on a formal schedule of matters to be reserved for board decision.
- Determine the company's mission and purpose (strategic aims).
- Select and appoint the CEO, chairman and other board members.
- Set the company's values and standards.
- Ensure that the company's management is performing its job correctly.
- Establish appropriate internal controls that enable risk to be assessed and managed.
- Ensure that the necessary financial and human resources are in place for the company to meet its objectives.
- Ensure that its obligations to its shareholders and other stakeholders are understood and met.
- Meet regularly to discharge its duties effectively.
- For listed companies:
    - Appoint appropriate NEDs
    - Establish remuneration committee
    - Establish nominations committee
    - Establish audit committee
- Assess its own performance and report it annually to shareholders.
- Submit themselves for re-election at regular intervals. All directors in FTSE 350 companies should be put forward for re-election every year.

Effective board

An effective board demonstrates the following capabilities:

- Clear strategy aligned to capabilities.
- Vigorous implementation of strategy.
- Key performance drivers monitored.
- Sharp focus on the views of the City and other key stakeholders.
- Regular evaluation of board performance.

'Tone at the Top'

Management's "tone" has a trickle-down effect on employees. It top managers uphold ethics and integrity so will employees. But if senior management appears unconcerned with ethics and focuses solely on the bottom line, employees will perhaps be more prone to commit fraud and feel that ethical conduct isn't a priority.

Potential problems for boards

- Most boards largely rely on management to report information.
- A board that meets only occasionally may be unfamiliar with each other.
- CEOs often have forceful personalities.
- The current CEO's performance is judged by the same directors who appointed him/her making.

(2) What is diversity?

Diversity describes the range of visible and non-visible differences that exist between people.

Managing diversity harnesses these differences to create a productive environment in which everybody feels valued, where talents are fully utilized and in which organizational goals are met.

The concept of diversity encompasses acceptance and respect. It means understanding that each individual is unique, and recognizing our individual differences. These can be along the dimensions of:

- Race
- Ethnicity
- Gender
- Sexual orientation
- Socio-economic status
- Age
- Physical ability
- Religious beliefs
- Political beliefs or other ideologies

Diversifying the board is said broadly to have the following benefits:

- More effective decision making
- Better utilization of the talent pool.
- Enhancement of corporate reputation and ancestor relations by establishing the company as a responsible corporate citizen.

Women on the board

Evidence suggests that companies with a strong female representation at board and top management level perform better than those without and that gender-diverse boards have a positive impact on performance.

Board agenda items

A board agenda is likely to include the following:

Companies Act requirement

- Approval of interim and final financial statements.
- Approval of interim dividend and recommendation for final dividend.
- Approval of significant changes to accounting policies.
- Appointment or removal of key staff such as company secretary.
- Remuneration of auditors (where shareholders have delegated the power).
- Recommendation for the appointment or removal of auditors (where shareholders have delegated the power).

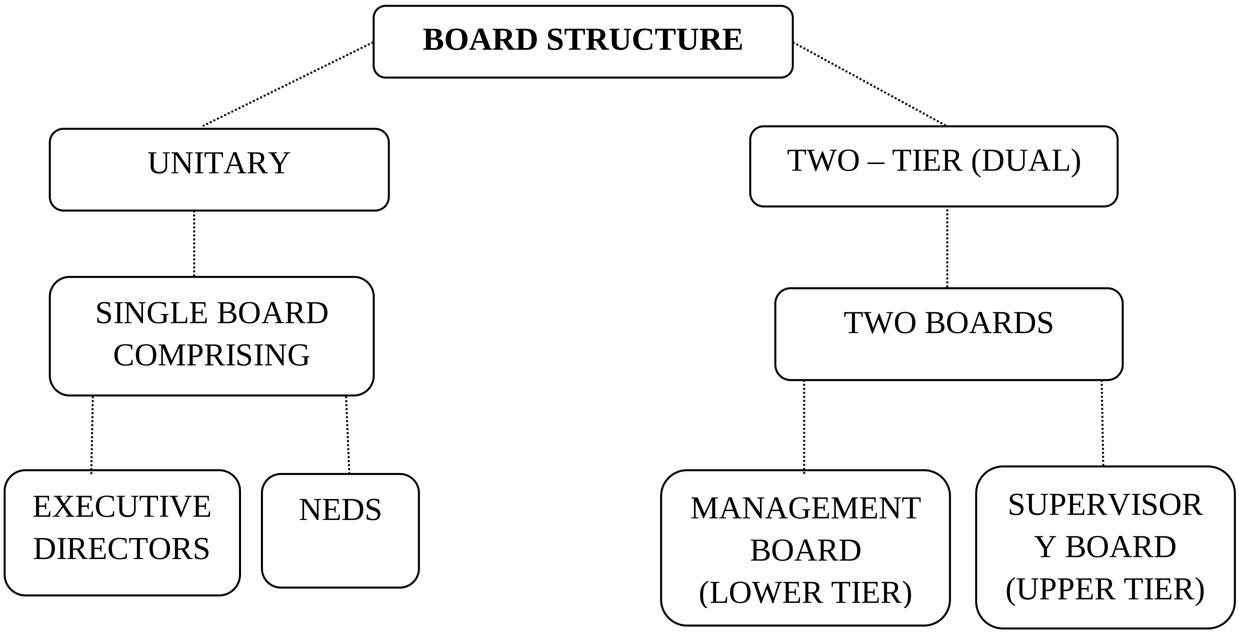
Stock exchange

- Approval of press releases concerning significant matters decided by the board.

Management

- Approval of group's commercial strategy.
- Approval of group's annual operating budget.
- Approval of group's annual capital expenditure plan.
- Changes relating to the group's capital structure.
- Terms and conditions/ service agreements of directors.
- Major changes to the group's management and control structure.

(3) Board structures



Two-tier boards

These are predominantly associated with France and Germany. Germany as an example, there are two main reasons for their existence:

- Codetermination: the right for workers to be informed and involved in decisions that affects them.
- Relationships: banks have a much closer relationship with German companies than in the UK.

Lower tier: management (Operating) board:

- Responsible for day-to-day running of the enterprise.
- Generally only includes executives.
- The CEO co-ordinates activity.

Upper tier: supervisory (corporate) board:

- Appoints, supervises and advises members of the management board
- Strategic oversight of the organization

- Includes employee representatives, environmental groups and other stakeholders" management representatives (these NEDs are not considered to be 'independent NEDs').
- The chairman co-ordinates the work
- Members are elected by shareholders at the annual general meeting (AGM).
- Receives information and reports from the management board.

Advantages of a two-tier board

- Clear separation between those that manage the company and those that own.
- Implicit shareholder involvement in most cases.
- Wider stakeholder involvement.
- Independence of thought, discussion and decision.
- Direct power over management.

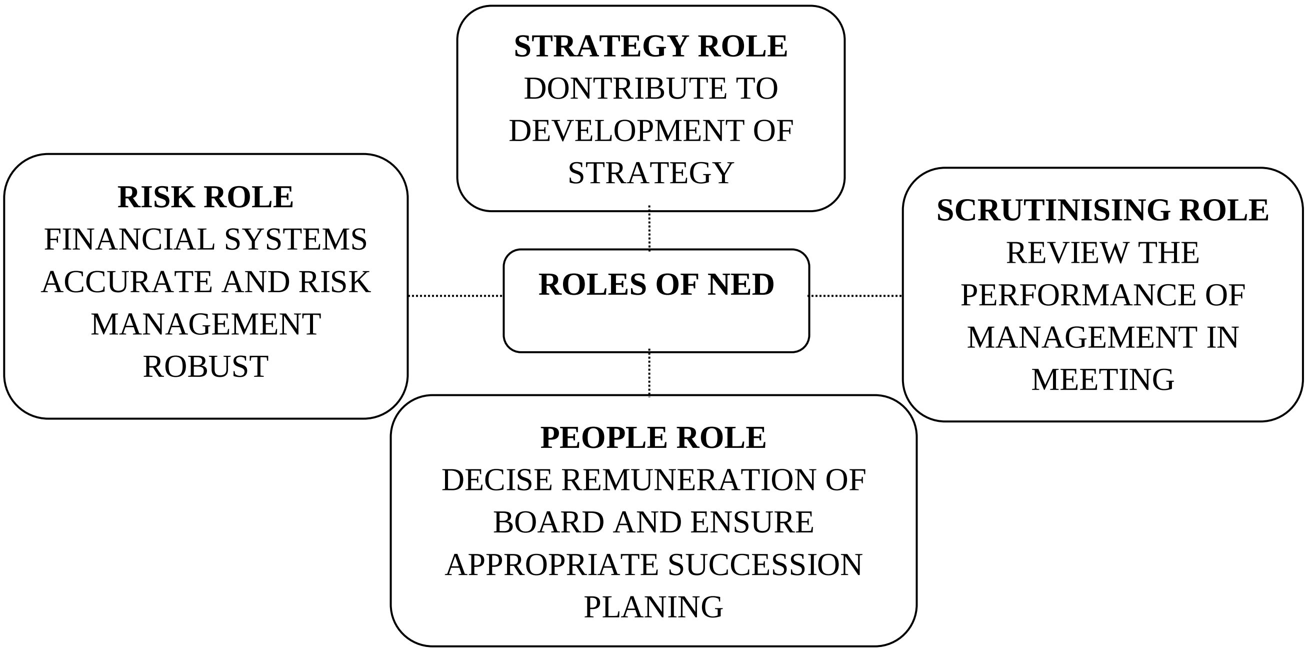
Problems with a two –tier board

- Dilution of power, confusion over authority and hence a perceived lack of accountability.
- Isolation of supervisory board through non-participation in management meetings.
- Agency problems between the boards where one will be acting on behalf of another.
- Increased bureaucracy which may result in slower decisions being made.
- Lack of transparency over appointment of supervisory board members.

Advantages of a unitary board

- NED expertise
- NED empowerment
- Compromise
- Responsibility
- Reduction of fraud, malpractice
- Improved investor confidence

(4)Non-executive directors (NEDs)



The key roles of NEDs

Strategy role: this recognizes that NEDs have the right and responsibility to contribute to strategic success, challenging strategy and offering advice on direction.

Scrutinizing role: NEDs are required to hold executive colleagues to account for decisions taken and results obtained.

Risk role: NEDs ensure the company has an adequate system of internal controls and systems of risk management in place.

People role: NEDs oversee a range of responsibilities with regard to the appointment and remuneration of executives and will be involved in contractual and disciplinary issues.

An effective NED

To be effective, a NED needs to:

- Build a-recognition by executives of their contribution.
- Be well-informed about the company and the external environment.
- Have a strong command of issues relevant to the business.
- Insist on a comprehensive, formal and tailored induction, continually develop and refresh their knowledge and skills.
- Information is provided sufficiently in advance of meetings.
- Insist that information is sufficient, accurate, clear and timely.

- Uphold the highest ethical standards of integrity and probity.
- Question intelligently, debate constructively, challenge rigorously and decide dispassionately.
- Promote the highest standards of corporate governance and seek compliance.

Independence

Board should include a balance of NEDs and executives. This is to reduce an unfavorable balance of power towards executives.

The board should consist of half independent NEDs excluding the chair.

One NED should be the senior independent director who is directly available to shareholders.

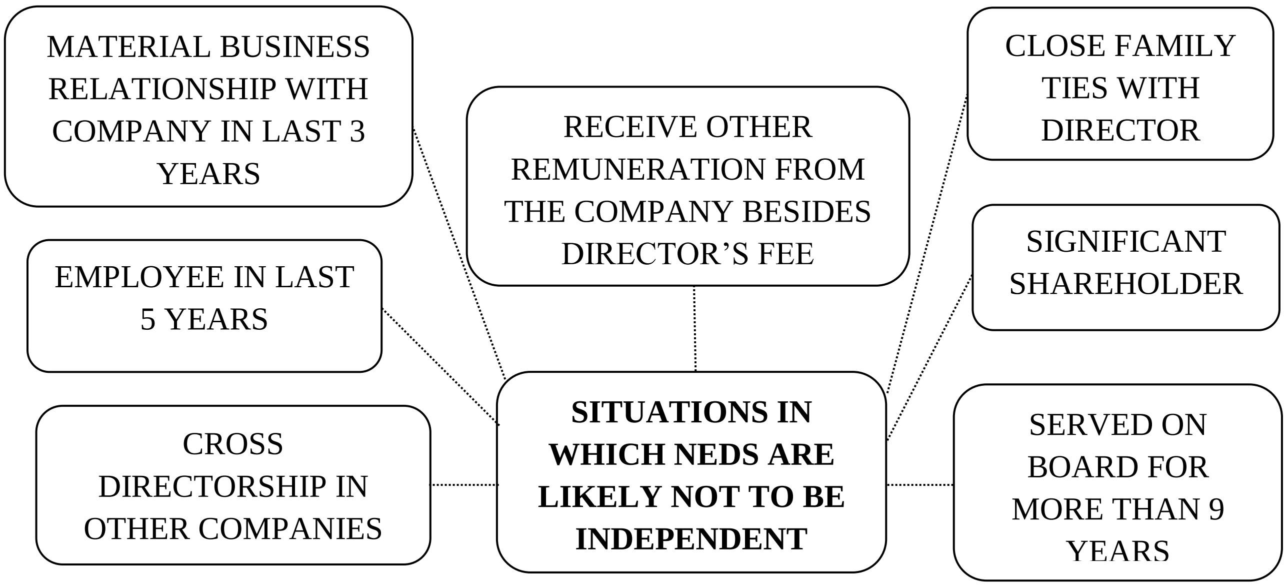
The primary fiduciary duty that NEDs owe is to the company's shareholders. They must not allow themselves to be captured or unduly influenced by the executive directors.

Recruiting those with previous industry involvement can result in a higher technical knowledge, benefit to a NED's contribution, less independent, to demonstrate independence when NEDs are appointed from outside the industry.

Reasons for NED independence

- To provide a detached and objective view of board decisions.
- To provide expertise and communicate effectively.
- To provide shareholders with an independent voice on the board.
- To provide confidence in corporate governance.
- To reduce accusations of self-interest in the behavior of executives.

Threats to independence



NEDs on the board

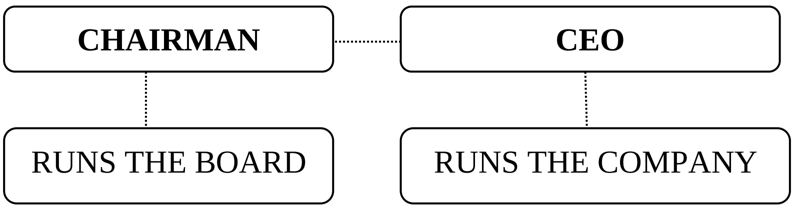
Advantages

- Monitoring: they offer a clear monitoring role, particularly on remuneration committees to dampen the excesses of executives.
- Expertise: to expand this resource available for management to use.
- Perception: institutional and watchdog perception is enhanced because of their presence.
- Communication: the implied improvement in communication between shareholders' interests and the company.
- Discipline: NEDs may have a positive influence on the success or otherwise of takeovers.

Disadvantages

- Unity: lack of trust and needless input can affect board operations.
- Quality: there may be a poor gene pool of NEDs willing to serve.
- Liability: the poor remuneration with the suggested (Higgs) removal of stock options from the package coupled with the equal liability in law for company operations might lead some to question whether they want the job or not.

(5) Chairman and CEO



Chairman's responsibilities

The overall responsibility of the chairman is to:

- Ensure that the board sets and implements the company's direction and strategy effectively, and
- Act as the company's lead representative, explaining aims and policies to the shareholders.

CEO's responsibilities

The overall responsibility of the CEO is to:

- Take responsibility for the performance of the company, as determined by the board's strategy
- Report to the chairman and/or board of directors.

Splitting the role

The UK Corporate Governance Code (2010) is unequivocal with regard to the separation of the chairman and CEO roles:

'A clear division of responsibilities must exist at the head of the company. No individual should have unfettered power of decision.'

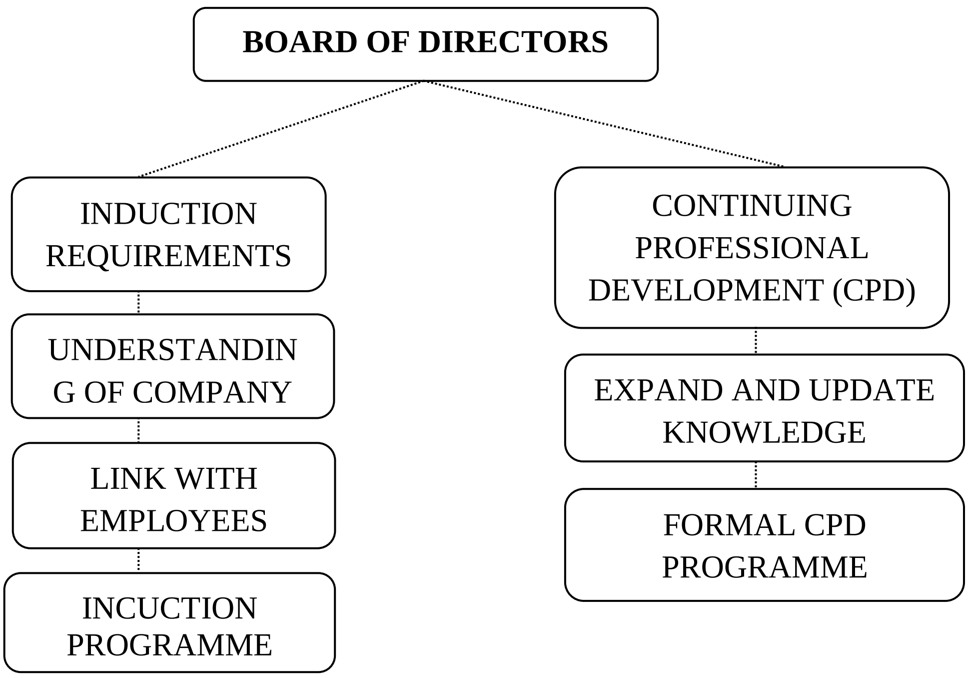
Reasons for splitting the role

- Representation: the chairman is clearly and solely a representative of shareholders with no conflict of interest having a role as a manager within the firm.
- Accountability: the existence of the separate chairman role provides a clear path of accountability for the CEO and the management team.
- Temptation: the removal of the joint role reduces the temptation to act more in self-interest rather than purely in the interest of shareholders.

Reasons against splitting the role

- Unity: the separation of the role creates two leaders rather than the unity provided by a single leader.
- Ability: both roles require an intricate knowledge of the company. It is far easier to have a single leader with this ability rather than search for two such individuals.
- Human nature: there will almost inevitably be conflict between two high-powered executive offices.

(6)Directors' induction and CPD



Induction

- Although aimed at NEDs, the principles of an induction program me will be the same for new executive directors coming to the company from another organization.
- For an internally-promoted director, it will depend on the person's background as to which aspects of the program me must be undertaken.
- It is important, for effective participation in board strategy development, not only for the board to get to know the new NED, but also for the NED to build relationships with the existing board and employees below board level.

Objectives of induction

- To communicate vision and culture.
- To communicate practical procedural duties.
- To reduce the time taken for an individual to become productive in their duties.
- To assimilate an individual as a welcome member of the board.
- To ensure retention of individuals for future periods.

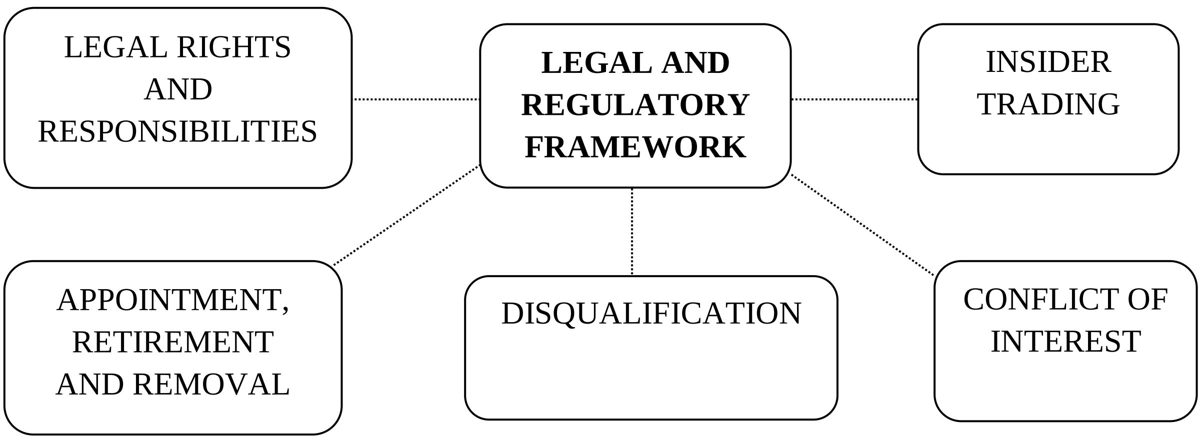
Induction package

Director's duties:

- Brief outline of director's role and responsibilities under codes of best practice.

Company strategies:

(7) Legal and regulatory framework governing the board of directors



Legal rights and responsibilities

The legal duties of a director are a baseline for directorial action and a concern since breach can leave a director open to criminal prosecution and imprisonment (e.g. corporate manslaughter).

Objective

The law is there to protect the owners of the company.

Power

Directors do not have unlimited power.

Fiduciary duties

- The duty to act in good faith.
- The duty of skill and care.

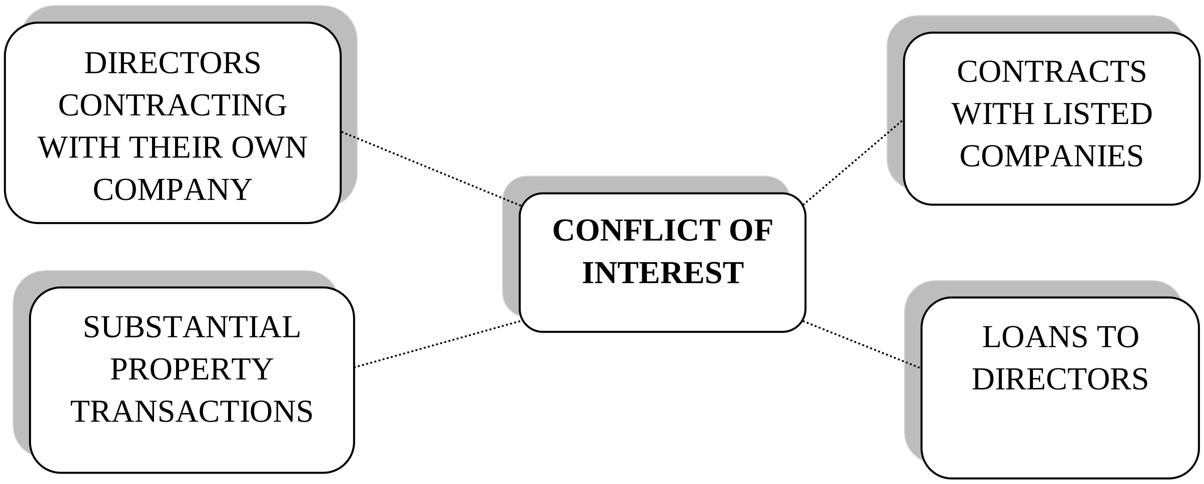
Penalties

Directors who breach duties may face civil action by the company. If the director is in breach:

- Any contract made by the director may be void.
- They may be personally liable for damages in compensation for negligence.
- They may be forced to restore company property at their own expense.

Conflict and disclosure of interests

The fiduciary duty of directors is to act in the best interests of shareholders.



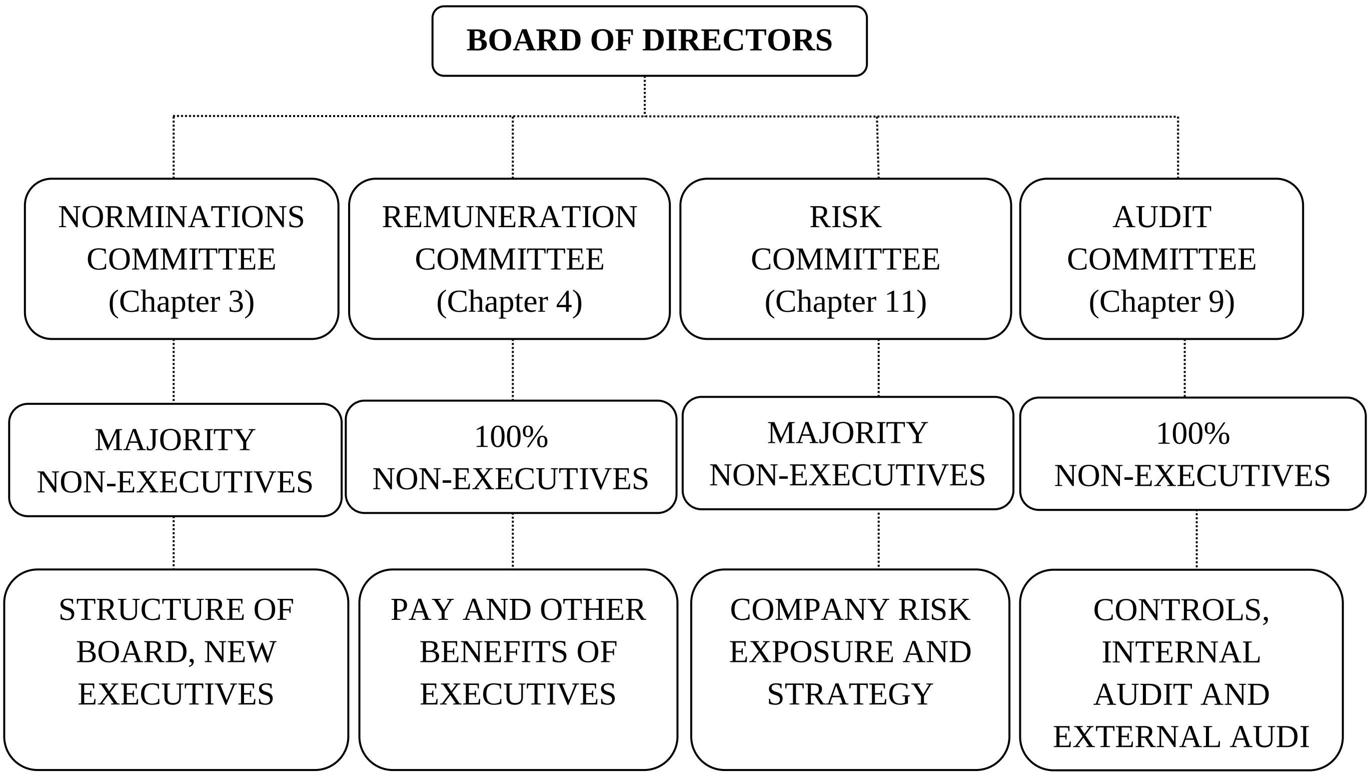
Disclosure

Companies are required, in the form of notes in the annual accounts, to disclose any information concerning transactions involving the directors.

Insider dealing/ trading

- Inside information is information which is not available to the market or general public and is supposed to remain confidential.
- These types of transactions in the company's own shares are considered to be fraudulent.

(8) Board committees



Important of committees

Board sub-committees are a generally accepted part of board operations.

Positives that come out of the creation and use of such structures are:

- Reduces board workload and enables them to improve focus on other issues.
- Creates structures that can use inherent expertise to improve decisions in key areas.
- Communicates to shareholders that directors take these issues seriously.

- Increase in shareholder confidence.
- Communicates to stakeholders the importance of remuneration and risk.
- Satisfy requirements of the UK Corporate Governance Code (2010) (or other governance requirements).

(9) Nominations committee

Responsibilities of nominations committee

The main responsibilities and duties of the nominations committee are to:

- Review regularly the structure, size and composition of the board and make recommendations to the board.
- Consider the balance between executives and NEDs on the board of directors.
- Ensure appropriate management of diversity to board composition.
- Provide and appropriate balance of power to reduce domination in executive selection by the CEO/ chairman.
- Regularly evaluate the balance of Skills, knowledge and experience of the board.
- Give full consideration to succession planning for directors.
- Prepare a description of the role and capabilities required for any particular board appointment including that of the chairman.
- Identify and nominate for the approval by the board candidates to fill board vacancies as and when they arise.
- Make recommendations to the board concerning the standing for reappointment of directors.
- Be seen to operate independently for the benefit of shareholders.

CEO/ chairman succession

The search for a potential replacement CEO begins immediately after a new CEO is appointed:

- For the nomination committee to have access to senior managers to gauge performance.
- To have some idea of a successor in case the new CEO dies or leaves.
- To monitor senior managers and cultivate possible successors over time.
- For a search firm (‘head-hunters’) to be retained for this and other directorship identification.
- To think very carefully as to whether the company wants a visionary at the helm or someone who can execute strategy effectively.
- The NED chairman should meet independence criteria at the time of appointment.

(10) Remuneration Committee

The role of the remuneration committee

The role of the remuneration committee is to have an appropriate reward policy that **attracts, retains and motivates** directors to achieve the long-term interests of shareholders.

Responsibilities of the remuneration committee

The overall responsibilities of the remuneration committee are to:

- Determine and regularly review the framework, broad policy and specific terms for the remuneration and terms and conditions of employment of the chairman of the board and of executive directors (including design of targets and any bonus scheme payments).
- Recommend and monitor the level and structure of the remuneration of senior managers.
- Establish pension provision policy for all board members.
- Set detailed remuneration foe all executive directors and the chairman, including pension rights and any compensation payments.
- Ensure that the executive directors and key management are fairly rewarded for their individual contribution to the overall performance of the company.
- Demonstrate to shareholders that the remuneration of the executive directors and key management is set by individuals with no personal interest in the outcome of the decisions of the committee.
- Agree any compensation for loss of office of any executive director.
- Ensure that provisions regarding disclosure of remuneration, including pensions, as set out in the Directors' Remuneration Report.
  Regulations 2002 and the Code are fulfilled.

(11) Directors' remuneration

Remuneration is defined as payment or compensation received for services or employment and includes base salary, any bonuses and any other economic benefits that an employee or executive receives during employment.

Work of the remuneration committee

- Provide a package needed to **attract, retain and motivate** executive directors of the quality required, but avoid paying more than is necessary.
- Judge where to position the remuneration package relative to other companies and labour market conditions.

- Be aware of what comparable companies are paying and should take account of relative performance.
- Be sensitive to the wider scene, including pay and employment conditions elsewhere in the company (especially when determining annual salary increases).

Components of directors' remuneration package

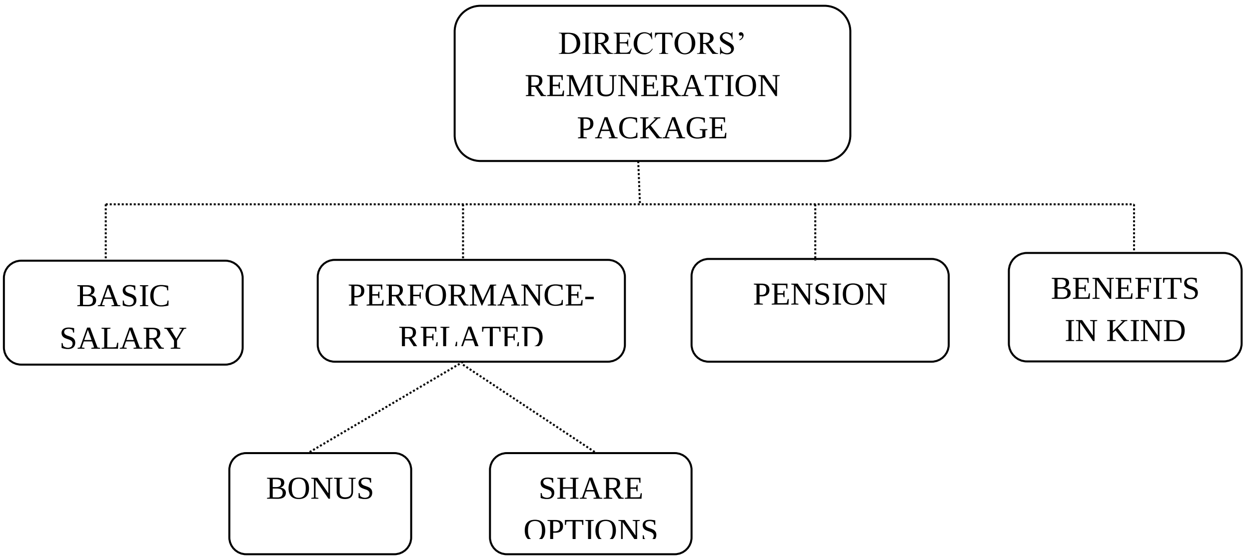


Illustration 1-Tesco CEO's remuneration package

The following information is summarized from Tesco plc's 2017 Annual Report.

Element	Purpose	Calculation	£000
Basic salary	To attract and retain talented people	Determined by responsibilities, skills and experience Benchmarked against other large FTSE 100 retailers and international equivalents	1,563 (including benefits)
Short-term performance related pay			
Cash bonus	Motivates year-on-year earnings growth and delivery of strategic business priorities	Based on specific objectives and EPS(earnings per share) targets e.g. development of international and non-food businesses	2,300
Deferred share bonus	Generates focus on medium-term targets and, by incentivizing share price and dividend growth,	Based on total shareholder return targets	1,690

	ensures alignment with shareholder interests		
Long- term performance related pay			
Performance share plans and share options	Assures a focus on long-term business success and shareholder returns	Based on a mix of ROCE (return on capital employed), EBIT (earnings before interest and tax) and EPS	1,205
		Total	**£5,472,000**

Other forms of compensation

The guaranteed bonus and 'golden hellos'

- The purpose of a bonus is to adjust pay on the basis of performance.
- Although not common, guaranteed bonuses are sometimes used to retain CEOs in struggling organizations.

Loyalty bonuses and retention payments

- Loyalty bonuses are also used to retain senior executives.

Loans

- Loans to directors have not been outlawed, under Sarbanes-Oxley (SOX).

Retirement benefits

- A retirement benefit such as lifetime use of the company plane or a sizeable pension payout could be awarded.

Termination

- Awards may be made on termination of contract simply for services rendered over a number of years.

(12) Directors' remuneration: other issues

DIRECTORS' REMUNERATION: OTHER ISSUES

LEGAL | ETHICAL | COMPETITIVE | REGULATORY

There are a number of other issues relating to directors' remuneration which a company should consider. These are:

- Legal: what are the legal implications of the company/ director relationship in terms of remuneration, especially when things go wrong?
- Ethical: what ethical considerations should a company have in setting directors' remuneration?
- Competitive: how does a company remain competitive and ensure that they attract good quality directors?
- Regulatory: what are the regulatory requirements that a company should adhere to in relation to its directors' remuneration?

(13) Non-executive directors' remuneration

The board and shareholders should determine the NED's remuneration within the limits set out in the Company's constitution.

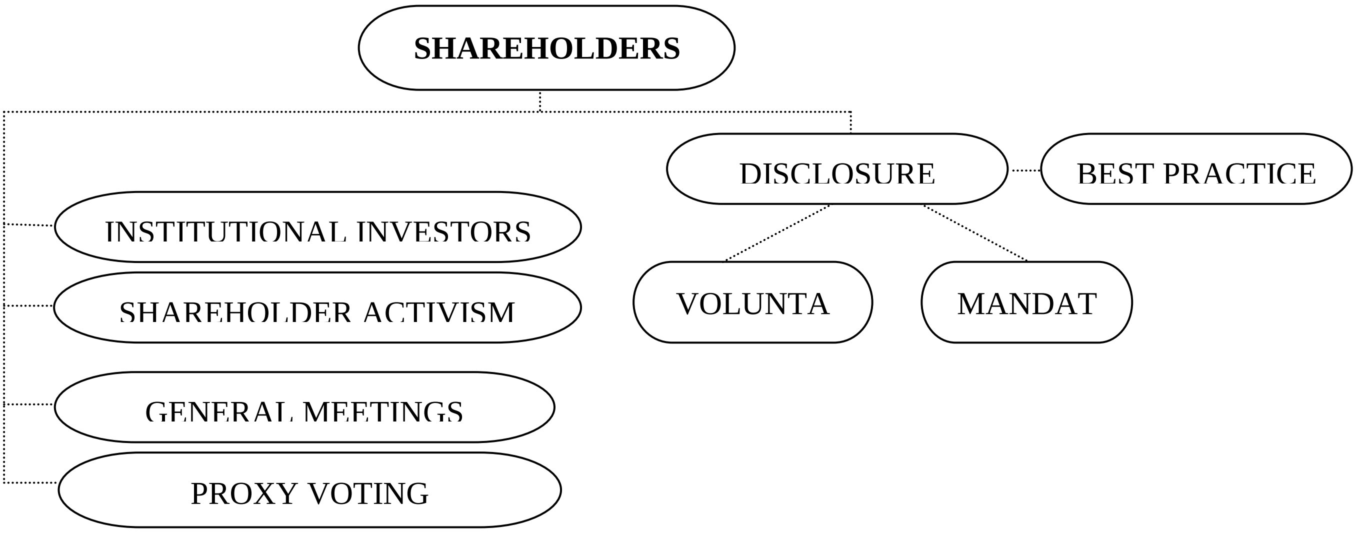
NED remuneration consists of a basic salary and non- executive directors may receive share awards.

Equity-based remuneration to non-executive directors should be fully vested on the grant date, but still subject to applicable holding periods.

Performance measures remuneration for non executive has significant potential to conflict with their primary role as an independent representative of shareowners.

Chapter - 12

Reporting to stakeholders



(1) Development of corporate governance regarding shareholders and disclosure

The **Cadbury Report (1992)** first recognized the importance and role of the institutional shareholders. There is a need for greater director dialogue and engagement with this group.

Also in the 2010 review of the **UK Corporate Governance Code** the Financial Reporting Council concluded that the impact of shareholders in monitoring the code could and should be enhanced by better interaction between the boards of listed companies and their shareholders.

The **UK Corporate Governance Code (2016)** recommends that there should be a dialogue with shareholders based on the mutual understanding of objectives.

The board as a whole has responsibility for ensuring that a satisfactory dialogue with shareholders takes place. The board should use general meetings to communicate with investors and to encourage their participation.

(2) Institutional Investors

Institutional investors manage funds invested by individuals.

In the UK there are four types of institutional investor:

- Pension funds
- Life assurance companies
- Unit trust
- Investment trusts

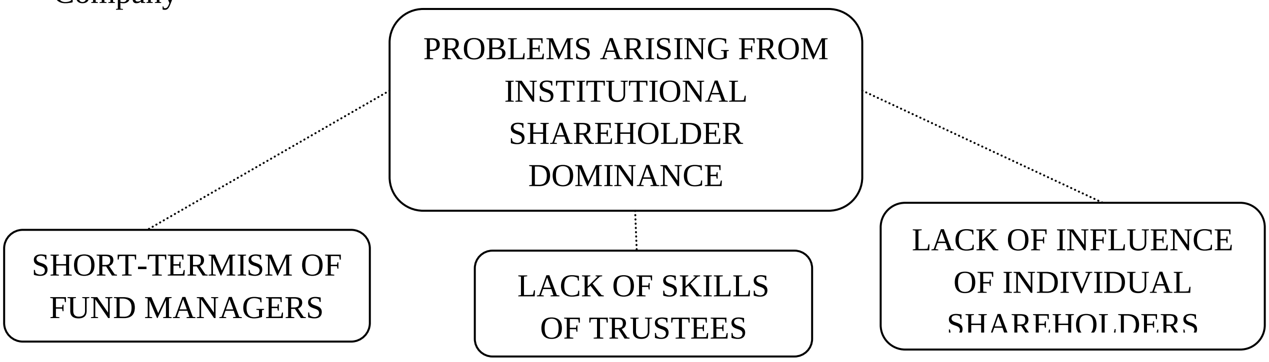
Importance of institutional investors

Potentially positive contribution to governance by skills and expertise to contribute towards the direction and management of a company.

Potential problems

In the separation between ownership and control there are a number of intermediaries, creating a complex web of agency relationships:

- Investor
- Pension fund trustee
- Pension fund manager
- Company



Shareholder activism

This activism can be in the form of:

- Making positive use of voting rights
- Engagement and dialogue with the directors of investee companies
- Paying attention to board composition/ governance of investee companies (evaluation of governance disclosure)
- Presenting resolutions for voting on at the AGM (rarely used in UK)
- Requesting an EGM and presenting resolutions

Institutional shareholder intervention

Intervention by an institutional investor in a company whose stock it holds is which it would be appropriate for institutional investors to intervene:

- Strategy: this might be in terms of products sold, markets serviced, expansion pursued or any other aspect of strategic positioning.
- Operational performance: this might be in terms of divisions within the corporate structure that have persistently under-performed.
- Acquisitions and disposals: this might be in terms of executive decisions that have been inadequately challenged by NEDs.
- Remuneration policy: this might relate to a failure of the remuneration committee to curtain extreme or self-serving executive rewards.
- Internal controls: might relate to failure in health and safety, quality control, budgetary control or IT projects.
- Succession planning: this might relate to a failure to adequately balance board composition or recommendation of replacement executives without adequate consideration of the quality of the candidate.
- Social responsibility: this might relate to a failure to adequately protect or respond to instances of environmental contamination or other areas of public concern.
- Failure to comply with relevant codes: consistent and unexplained non-compliance in a principles-based country will be penalized by the market. In a rules-based country it would have been penalized as a matter of law.

(3) General meetings

A general meeting of an organization is one which all shareholders or members are entitled to attend.

GENERAL MEETINGS

Annual General Meeting

- Must be held once every calendar year.
- Legally required.
- Separate resolutions for each issue.
- Not less than 21 days' notice required.
- First must be held no more than 18 months after date of incorporation, and thereafter no more than 15 months between meetings.
- All shareholders must be notified and entitled to attend.
- Annual accounts and appointment of auditors (if appropriate) approved at this meeting.

Extraordinary General Meeting

- No set timetable- held on an 'as required' basis.
- No legal obligation to have any.
- Separate resolutions for each issue.
- Not less than 14 days' notice required.
- All shareholders must be notified and entitled to attend.
- Agenda dictated by need for meeting.

(4) Disclosure – General principles

Shareholders are the legal owners of a company and therefore entitled to sufficient information to enable them to make.

- The AGM is seen as the most important, and perhaps only, opportunity for the directors to communicate with the shareholders of the company.
- As the only legally-required disclosure to shareholders, the annual report and accounts are often the only information shareholders receive from the company.

General principles of disclosure relate to the need to create and maintain communication channels with shareholders and other stakeholders. This disclosure becomes the mechanism through which governance is given transparency.

MORE REGULAR AND CONSTRUCTIVE DIALOGUE BETWEEN COMPANY AND SHAREHOLDER =

- DIRECTORS UNDERSTANDING INTERESTS AND CONCERNS OF SHAREHOLDERS
- SHAREHOLDERS UNDERSTANDING WHAT THE COMPANY IS TRYING TO ACHIEVE
- INCREASED SHAREHOLDER INTEREST ENCOURAGING CHECKS ON MANAGERS OF COMPANY
- POTENTIAL BENEFITS FROM CLOSER INTEREST BY MAJOR SHAREHOLDERS IN COMPANY AFFAIRS

(5) Disclosure: best practice corporate governance requirements

The issue of governance and disclosure are closely intertwined. Disclosure is the means by which governance is communicated and possibly assured since it leads to stakeholder scrutiny and shareholder activism.

Detailed inclusion in the annual report

UK CODE-MAIN POINTS OF DISCLOSURE COVERED

- NOMINATION COMMITTEES
- DIRECTORS
- REMUNERATION COMMITTEE
- ANNUAL GENERAL MEETINGS
- AUDIT COMMITTEE

(6) Mandatory versus voluntary disclosure

Organizations disclose a wide range of information, both mandatory and voluntary.

DISCLOSURE

MANDATORY INFORMATION WHICH MUST BE PUBLICLY DISCLOSED TO COMPALY WITH A SET OF LAWS OR RULES

VOLUNTARY INFORMATION WHICH A COMPANY MAY DISCLOSE SHOULD IT CHOOSE TO DO SO.

Test your understanding 1

(a) Mandatory disclosure example:

- Statement of comprehensive income (income or profit and loss statement)
- Statement of financial position (balance sheet)
- Statement of cash flow
- Statement of changes in equity
- Operating segmental information
- Auditors' report
- Corporate governance disclosure such as remuneration report and some items in the directors' report (e.g. summary of operating position)
- In the UK, the business review is compulsory
- Risk information on capital cover-Basel11

NB – In addition the IIRC will report in December 2014. The IIRC's stated objective was to develop and internationally accepted integrated reporting framework by 2014 to enable organizations to provide concise communications of how they create value over time.

(b) Voluntary disclosure examples:

- Risk information
- Operating review
- Social and environmental information
- Chief executive's review

Annual report

The annual report becomes the tool for 'voluntary disclosure'. The report includes:

(1) Chairman and CEO statements regarding company position
This is voluntary in the sense that it is a requirement of the Code but obviously to not include this would be unimaginable.

(2) **Business review** (formerly OFR) – This detailed report is written in non-financial language in order to ensure information is accessible by a broad range of users, not just sophisticated analysts and accountants.

(3) **The accounts** – Including statement of comprehensive income, statement of financial position and cash flow statements plus notes and compliance statements.

(4) **Governance** – A section devoted to compliance with the Code including all provisions shown above.

(5) **AOB (any other business)** – Shareholder information including notification of AGM, dividend history and shareholder taxation position.

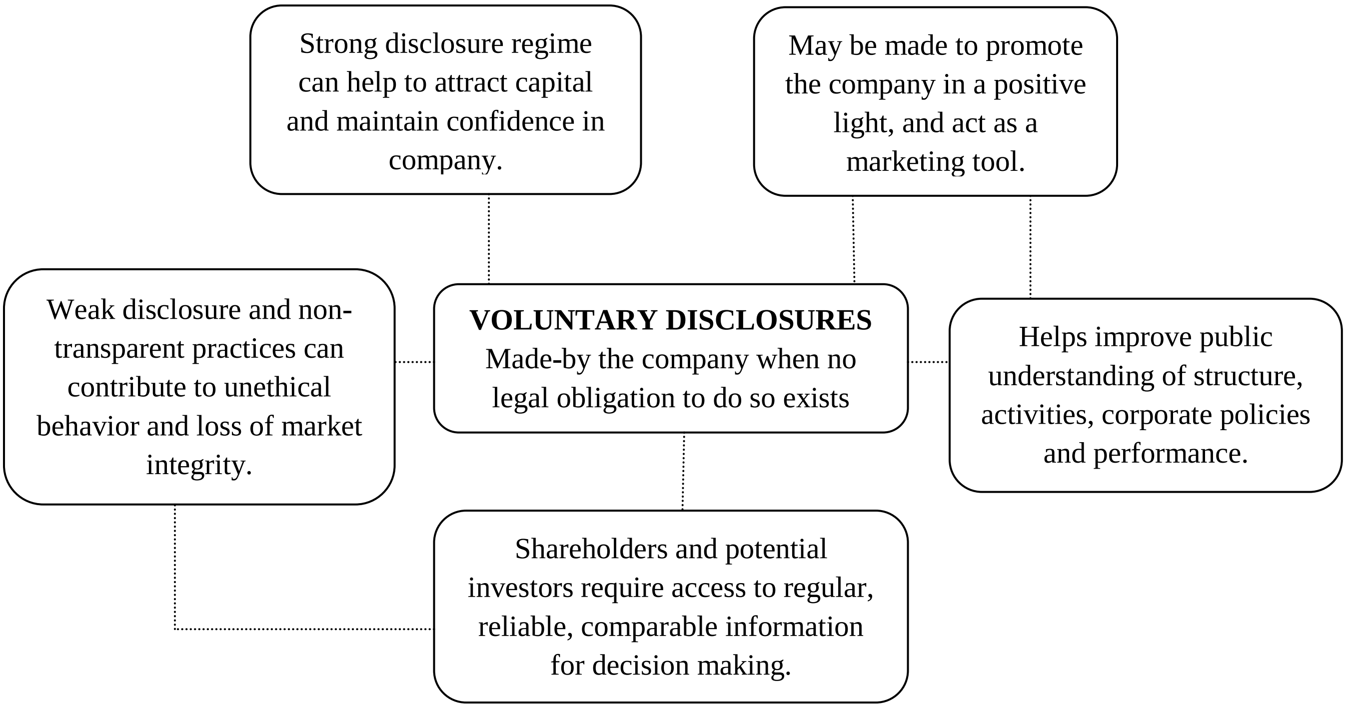
(6) **Stock exchange listing rules** are also a source of regulation over disclosure.

Expansion of disclosure beyond the annual report

Since disclosure refers to the whole array of different forms of information produced by the company it also includes:

- Press releases
- Management forecasts
- Analysts' presentations
- The AGM
- Information on the corporate web site such as stand – alone social and environmental reporting.

'The lifeblood of the markets is information and any barriers to the flow-represents imperfection. The more transparent the activities of the company, the more accurately securities will be valued.' (Cadbury Report)



The motivations for voluntary disclosure are thus as follows:

- **Accountability:** disclosure is the dominant philosophy of the modern system and the essential aspect of corporate accountability.
- **Information asymmetry:** attempts to deal with information asymmetry between managers and owners in terms of agency theory. The more this is reduced the less chance there is of moral hazard and adverse share selection problems.
- **Attracts investment:** institutional investors are attracted by increased disclosure and transparency. Greater disclosure reduces risk and with it the cost of capital to the company.
- **Compliance:** non-compliance threatens listing and fines through civil action in the courts. In the US non-compliance makes directors personally liable for criminal prosecution under SOX.
- **Alignment of objectives:** possibly 50% of directors' remuneration is in relation to published financial indicators.
- **Assurance:** the mass of disclosure gives the user assurance that the management are active and competent in terms of managing the operations of the organization.
- **Stakeholders:** greater voluntary disclosure assists in discharging the multiple accountabilities of various stakeholder groups.

(7) Sustainability

SUSTAINABILITY

Meets needs of the present without compromising the needs of future-generations

Long-term maintenance of systems according to environmental, economic and social considerations

Sustainable development is development that meets the needs of the present without compromising the ability of future generations to meet their own needs (WCED 1987).

Sustainability can be thought of as an attempt to provide the best outcomes for the human and natural environments both now and into the indefinite future.

First definition

Business activities should be sustainable. Development is sustainable as long as future generations can also meet their requirements.

However, this definition is limited to environmental concerns. Recent thinking has also linked sustainability to economic and social concerns.

Second definition

This definition also incorporates economic and social concerns. To be precise, the definition includes the concept of the Triple Bottom Line (TBL) of **John Elkington.**

Economic perspective

Meadows recognized that the earth is a finite system and therefore economic development, based on this finite system, must also be limited.

Sustainability relates to the organization in terms of planning for long-term growth, ensuring that the organization will continue to be in existence for the foreseeable future.

Examples of unsustainable activities include:

- Strategies for short-term gain(e.g. increase in share price)
- Paying bribes or forming cartels
- Suspect accounting treatments and underpayment of taxes

Social perspective

This perspective recognizes that organizations have an impact on communities and may in fact change their social make – up.

Sustainability in this context relates to the concept of social justice.

Examples of situations where social justice appears to be required include:

- Rich consuming countries and poorer manufacturing countries, and
- Urban ‘rich’ and rural ‘poor’

Environmental perspective

This perspective recognizes that organizations have an impact on the environment and that lack of concern means deterioration and eventual loss of some resources.

Sustainability in this context relates to the effective management of environmental resources so that they continue to be available for future generations.

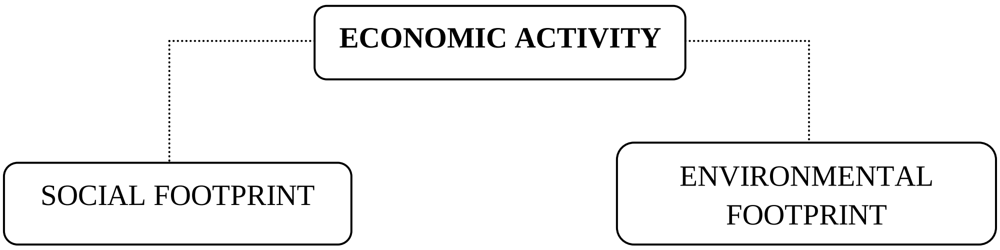
Examples

- The use of non-renewable resources including oil, gas and coal
- Long-term damage to the environment from carbon dioxide and chlorofluorocarbons (CFCs)
- Whether future generations can actually enjoy the same standard of living, given the finite nature of many resources.

Significance of sustainability

- Sustainability affects every level of organization, from the local neighbourhood to the entire planet.
- It is the long- term maintenance of systems according to environmental, economic and social considerations.
- Sustainability can be measured empirically (using quotients) or subjectively.

(8) Effects of economic activity



Economic activity is only sustainable where its impact on society and the environment is also sustainable.

Environmental footprint

In the same way that humans and animals leave physical footprints that show where they have been, so organizations leave evidence of their operations in the environment. They operate at a net cost to the environment.

The environmental footprint is an attempt to evaluate the size of a company's impact on the environment in three respects:

- The company's resource consumption.
- Any harm to the environment brought about by pollution emissions.
- A measurement of the resource consumption and pollution emissions in terms of harm to the environment in either qualitative, quantitative of replacement terms.
- Where resource use exceeds provision, then the activity can be termed unsustainable.

Measuring impact of economic activity

There are two methods of measuring sustainability; the quotients approach and the subjective approach.

Quotients approach	Subjective approach
Measures sustainability in terms of the amount of a resource available compared with the actual use of that resource.	Measures intentions of organizations to achieve certain goals or objectives.
Similar in concept to the triple bottom line (TBL) method of accounting (see later in this chapter) as it provides a quantifiable method of checking social and environmental footprints.	However, lack of quantification means that 'progress' can be made towards the intention, although it will be difficult to determine how much progress has been made or whether that progress is sustainable.

For example, water usage can be compared with the amount of fresh water being generated. If usage > generation then the activity is not sustainable.	For example, the Millennium Development Goals of the United Nations have statements such as 'ensure environmental stability'.
Progress towards sustainability can be measured by comparing water usage over a period of time – the activity becoming sustainable where usage is less than production.	'Progress' can be made towards this in terms of reducing carbon emissions. However, the exact reduction will be unclear while reduction may have other negative impacts (e.g. increase resource use in other areas).

Illustration 3 – environmental footprint

The environmental footprint

An economic activity may require 15 million gallons of water. If the organization's share of available fresh water is less than this, then the activity can be termed unsustainable. Using the quotients approach, this can be shown as follows:

USE OF ENVIRONMENTAL RESOURCE
PRODUCTION FO ENVIRONMENTAL RESOURCE
=
RESULTS > 1 UNSUSTAINABLE

WATER USE = 15 MILLION GALLONS
WATER PRODUCTION = 10 MILLION GALLONS
=
1.5, e.g. UNSUSTAINABLE

However, the environmental footprint extends to more than just water use, e.g. the production of laundry detergent has various environmental impacts:

Activity	Environmental footprint – and how to decrease it
Production of detergent.	Use of chemicals within the product: • Improving the chemical formula to decrease the amount of chemicals used • Manufacturing the product in fewer locations to obtain manufacturing economies and reduce emissions.
Transportation from manufacturing plant to consumer.	Energy consumed moving the product: • Manufacturing the product in fewer locations but using better logistical networks to distribute the product.
Packaging for the product.	Type and amount of material used in packaging: • Using cardboard rather than plastic focuses packaging on renewable resources • Decreasing the weight of packaging lessens resource use and transportation costs.

Social footprint

The social footprint evaluates sustainability in three areas of capital:

- Human Capital, consisting of personal health, knowledge, skills, experience, and other resources (including human rights and ethical entitlements) that individuals have and use to take effective action.
- Social Capital, consisting of networks of people and the mutually-held knowledge and skills they have and use in order to take effective action.
- Constructed Capital, consisting of material things, such as tools, technologies, roads, utilities, infrastructures, etc., that people produce and use in order to take effective action.

Organizations need to ensure that their economic activities are sustainable in each of these three areas.

Social footprint

The social footprint evaluates sustainability in three areas termed 'Anthro Capital'.

Anthro Capital		
social	**Human**	**Constructed**
Social networks and mutually-held knowledge for collectives to take effective action.	Personal health, knowledge, skills, experience and other resources (including human rights and ethical entitlements) required for individuals to take effective action.	Physical infrastructures in society such as roads, utilities, etc. that people build.

Sustainability can be shown using the quotients approach as follows:

SUPPLY OF SOCIAL CAPITAL / NEED FOR SOCIAL CAPITAL = RESULTS < 1 UNSUSTAINABLE

$16 MILLION RAISED IN TAXES / $20 MILLION NEEDED FOR SCHOOL = 0.8, e.g. UNSUSTAINABLE

Accounting for sustainability

'FULL COST' ACCOUNTING TRIPLE BOTTOM LINE (TBL)

ECONOMIC OBJECTIVES

ENVIRONMENTAL

SOCIAL OBJECTIVES

Two methods which attempt to account for sustainability are 'full cost' and 'triple bottom line' accounting.

Full cost accounting

- Full cost accounting means calculating the total cost of company activities, including environmental, economic and social costs.
- It attempts to include all the costs of an action, decision or manufacture of a product into a costing system, and as such will include many non-financial costs of certain actions.
- Full Cost Accounting (FCA) is about internalizing all environmental costs onto the P&L, i.e. making externality costs visible and chargeable as an expense.

Full Cost Accounting (FCA)

Full Cost Accounting (FCA) attempts to include all the costs of an action, decision or manufacture of a product into a costing system. Most budgets and financial accounts are based on actual costs incurred. FCA includes the additional (and in many situations non-financial costs) of those actions. The aim is to internalise all costs, including those which are incurred outside of the company.

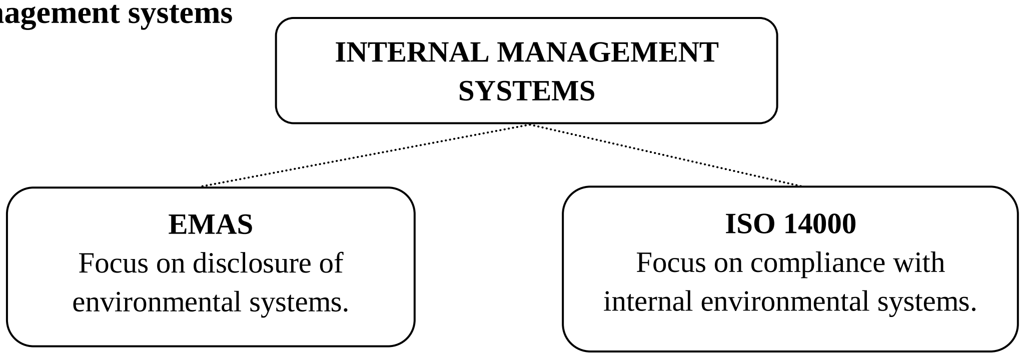
Triple Bottom Line (TBL) accounting

- TBL accounting means expanding the traditional company reporting framework to take into account environmental and social performance in addition to financial (economic) performance.
- The concept is also explained using the triple ‘P’ headings of ‘**People, Planet and Profit’**.

TBL and business ethics

Ethical practice may therefore simply relate to businesses limiting environmental, economic and social damage according to their actual ability in those areas.

(9) Management systems



EMAS and ISO 14000

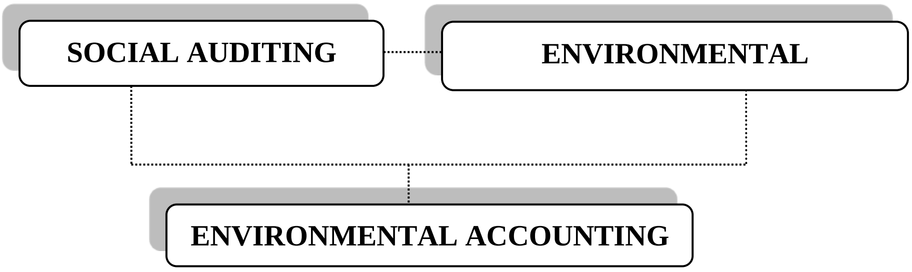
EMAS	ISO 14000
What is it?	
EMAS is the Eco-Management and Audit Scheme. It is a voluntary initiative designed to improve companies' environmental performance. It was established by the EU in 1993.	ISO 14000 is a 'series' of standards dealing with environmental management and a supporting audit program me. It was developed to support the UN initiative on 'sustainable development' in the 1992 Conference on Environment and Development.
What does it do (in overview)	
Its aim is to recognize and reward those organizations that go beyond minimum legal compliance and continuously improve their environmental performance. EMAS requires participating organizations to regularly produce a public environmental statement that reports on their environmental performance. Publication of environmental information is voluntary, although the accuracy and reliability is independently checked by an environmental verifier to give credibility and recognition to that information.	The ISO formulates the specifications for an Environmental Management System (EMS), guidance for its use and the standard against which it can be audited and certified. In this context, environmental management relates to what the organization does to: • Minimize harmful effects on the environment caused by its activities, and to • Achieve continual improvement of its environmental performance.
What must the organization do to comply?	
EMAS requires participating organizations to implement an EMS. The EMS must meet the requirements of the International Standard BS EN ISO 14001. Many organizations progress from ISO 14001 to EMAS and maintain certification / registration to both. In other words ISO 14000 is a prerequisite to applying EMAS.	To gain accreditation, an organization must: • Implement, maintain and improve an EMS • Assure itself of its conformance with its own stated environmental policy (those policy commitments of course must be made) • Demonstrate conformance • Ensure compliance with environmental laws and regulations • Seek certification of its EMS by an external third party organization • Make a self - determination of conformance.

Key elements of the standard	
Legal requirement – organizations must show that they understand and can implement all relevant environmental legislation. Dialogue/ reporting – information needs of stakeholders must be recognized and the company must provide environmental information to meet those needs. Improved environmental performance – companies are required to improve their environmental performance over time. E.g. using fewer raw materials, consuming less energy and producing less waste. Employee involvement – employees are involved from all levels of the organization – this assists in team building as well as helping to ensure success of environmental initiatives.	Identify elements of the business that impact on the environment. Produce objectives for improvement and a management system to achieve them, with regular reviews for continued improvement. Applicable to any type of business – the standard is generic because the requirements for an effective EMS are the same for any business.

Benefits of compliance with either standard

- Reduced cost of waste management.
- Savings in consumption of energy and materials.
- Lower distribution costs.
- Improved corporate image among regulators, customers and the public.
- Framework for continuous improvement of the companies' environmental performance.

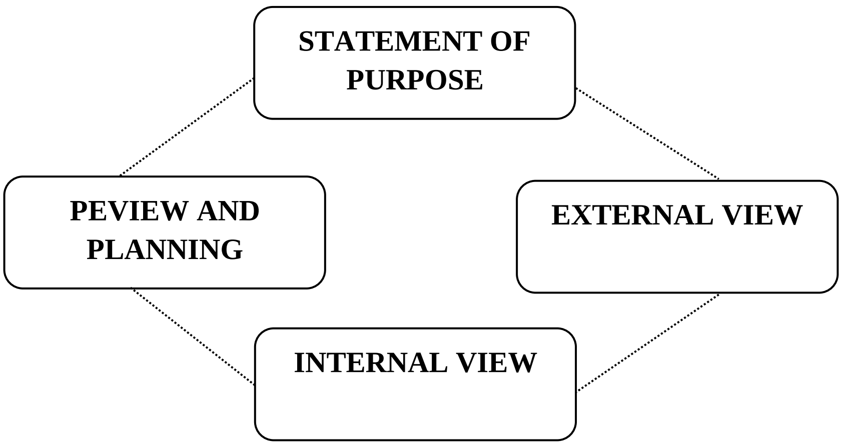
(10) Social and environmental audit



Social auditing

- A process that enables an organization to assess and demonstrate its social, economic, and environmental benefits and limitations.
- Also measures the extent to which an organization achieves the shared values and objectives set out in its mission statement.
- Provides the process for environmental auditing.

Elements of a social audit



Detail on social audit

The concept of social audit is to provide additional information on a company's activities over and above the financial accounts.

Environmental auditing

- Aims to assess the impact of the organization on the environment.
- Normally involves the implementation of appropriate environmental standards such as ISO 14001 and EMAS.

- Provides the raw data for environmental accounting.
- An environmental audit typically contains three elements:
    - Agreed metrics (what should be measured and how)
    - Performance measured against those metrics
    - Reporting on the levels of compliance or variance.

The environmental audit

An environmental audit leads into an environmental action plan.

The main areas to cover within the environment audit normally include:

- Waste management and waste minimization
- Emissions to air
- Ground and groundwater protection
- Surface water management
- Energy and utility consumption
- Environmental emergencies
- Protection of environmentally sensitive areas
- Product/ service stewardship
- Management of contractors control of visitors
- Local issues

The aims of environmental accounting are:

- To use the metrics produced from an environmental audit and incorporate these into an environmental report, and
- To integrate environmental performance measures into core financial processes to generate cost savings and reduce environmental impact through improved management of resources.

Benefits of environmental accounting

- Cost savings
- Environmental improvements
- Corporate governance

Mass balance

Environmental accounting can also be explained in terms of the 'mass balance'. This system shows what inputs (that is materials) have been converted into finished goods as well as emissions and recyclable waste products. In effect, the mass balance shows the inputs to a production process in weight terms compared to the outputs produced. The aim is to minimize inputs and non-recyclable outputs.

Environmental reporting

It typically contains details of environmental performance in areas such as:

- Measures of emissions (e.g. pollution, waste and greenhouse gases)
- Consumption (e.g. of energy, water and non renewable mineral deposits).

Social reporting

- Human rights issues
- Work place, occupational health and safety
- Training and employee issues
- Fair pay for employees and suppliers
- Fair business practices
- Minority and equity issues
- Marketplace and consumer issues
- Community involvement
- Indigenous peoples
- Social development
- Charitable, political donations and sports sponsorship.

(11) Intergrated reporting

What is Integrated Reporting?

Integrated Reporting demonstrates the linkages between an organization's strategy, governance and financial performance and the social, environmental and economic context within which it operates.

An Intergrated Report should be a single report which is the organization's primary report – in most jurisdictions the Annual Report or equivalent.

An Integrated Report should demonstrate in a clear and concise manner an organization's ability to create and sustain value in the short, medium and longer term, about value creation over time and related communications regarding aspects of value creation.

Integrated reporting is needed by business and investors.

Traditional definition of capital

(1) Financial assets or the financial value of assets, such as cash.
(2) The factories, machinery and equipment owned by a business and used in production.

Financial Capital

Financial capital plays an important role in our economy, enabling the other types of capital to be owned and traded. However, unlike the other types, it has no real value itself but is representative of natural, human, social or manufactured capital; e.g. shares, bonds or banknotes.

Alternative definitions of capital

It is now recognized that there are five other types of sustainable capital from where we derive the goods and services we need to improve the quality of our lives. These are:

Manufactured Capital

This form of capital can be described as comprising of material goods, or fixed assets which contribute to the production process rather than being the output itself – e.g. tools, machines and buildings.

Intellectual capital

This form of capital can be described as the value of a company or organization's employee knowledge, business training and any proprietary information that may provide the company with a competitive advantage. Intellectual capital is considered an asset, and can broadly be defined as the collection of all informational resources a company has at its disposal that can be used to drive profits, gain new customers, create new products, or otherwise improve the business.

Human capital

This can be described as consisting of people's health, knowledge, skills and motivation. All these things are needed for productive work. Enhancing human capital through education and training is central to a flourishing economy.

Social capital

This can be described as being concerned with the institutions that help us maintain and develop human capital in partnership with others; e.g. families, communities, businesses, trade unions, schools, and voluntary organizations.

Natural capital

This can be described as any stock or flow of energy and material within the environment that produces goods and services. Natural capital is the value that nature provides for us, the natural assets that society has and is therefore not only the basis of production but of life itself. It includes resources of renewable and non-renewable materials e.g. land, water, energy and those factors that absorb, neutralize or recycle wastes and processes – e.g. climate regulation, climate change, CO_2 emissions.

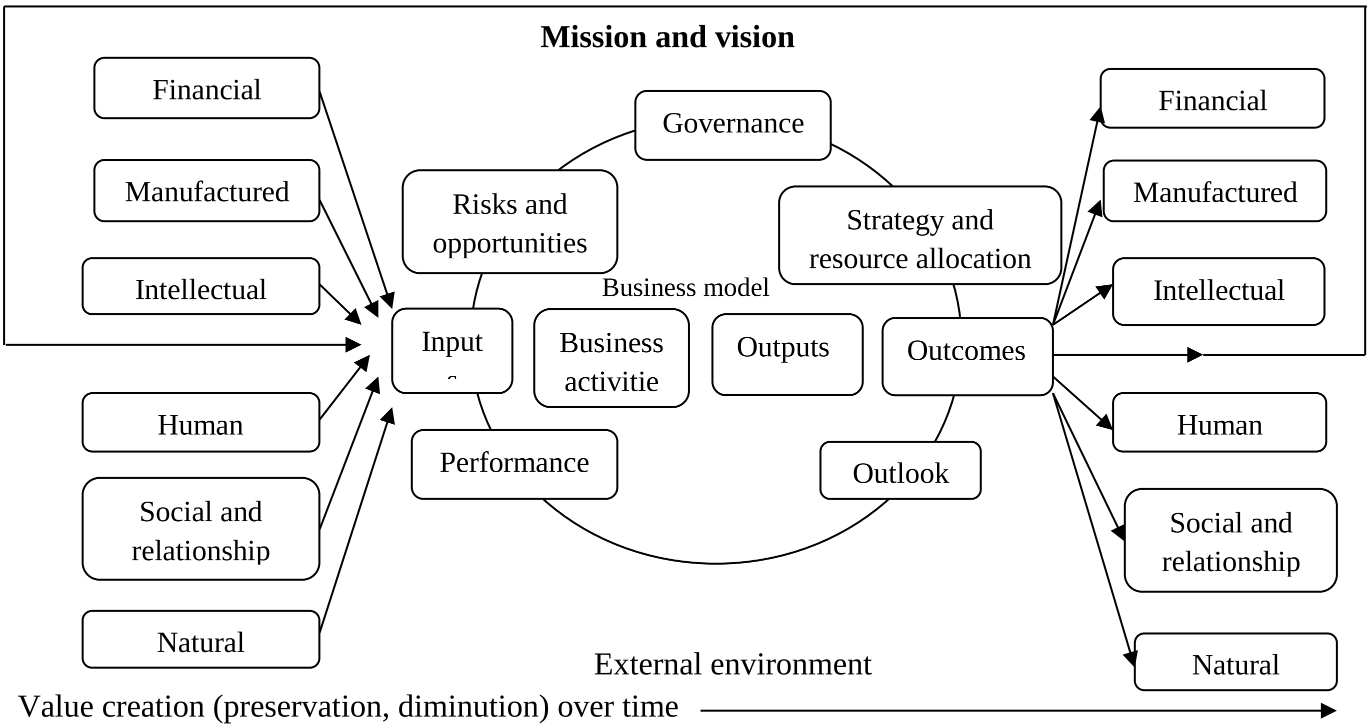
The concept of integrated reporting (<IR>)

A stated aim of <IR> is to support integrated thinking and decision making. Integrated thinking is described in the <IR> Framework as "the active consideration by an organization of the relationships between its various operating and functional units and the capitals that the organization uses or affects".

"The primary purpose of an integrated report is to explain to providers of financial capital how an entity creates value over time. An integrated report benefits all stakeholders interested in an entity's ability to create value over time, including employees, customers, suppliers, business partners, local communities, legislators, regulators, and policymakers."

The objectives for integrated reporting include:

- To improve the quality of information available to providers of financial
- To provide a more cohesive and efficient approach to corporate reporting
- To enhance accountability and stewardship
- To support integrated thinking, decision making and actions that focus on the creation of value over the short, medium and long term.



Chapter - 13

Management internal control systems and reporting

Cadbury Report (1992)

Directors should establish a sound system of internal control and review this system on a regular basis.

The Turnbull report states the need for directors to review their systems of internal control and report these to shareholders.

Internal control and risk management are fundamental components of good corporate governance.

The UK Corporate Governance Code recommends that **'The board should maintain sound risk management and internal control systems'.**

Internal controls and COSO

COSO now produces guidance on the implementation of internal control systems in large and small companies.

In COSO, internal control is seen to apply to three aspects of the business:

(1) Effectiveness and efficiency of operations – that is the basic business objectives including performance goals and safeguarding resources.
(2) Reliability of financial reporting – including the preparation of any published financial information.
(3) Compliance with applicable laws and regulations to which the company is subject.

Turnbull Report requirements

'The directors should, at least annually, conduct a review of the effectiveness of the group's system of internal control and should report to shareholders that they have done so. The review should cover all controls, including financial, operational and compliance controls and risk management.'

Objectives of an internal control system

An internal control system is to ensure, as far as practicable:

- The orderly and efficient conduct of its business, including adherence to internal policies
- The safeguarding of assets of the business
- The prevention and detection of fraud and error
- The accuracy and completeness of the accounting records, and
- The timely preparation of financial information.

Benefits of an internal control system are therefore:

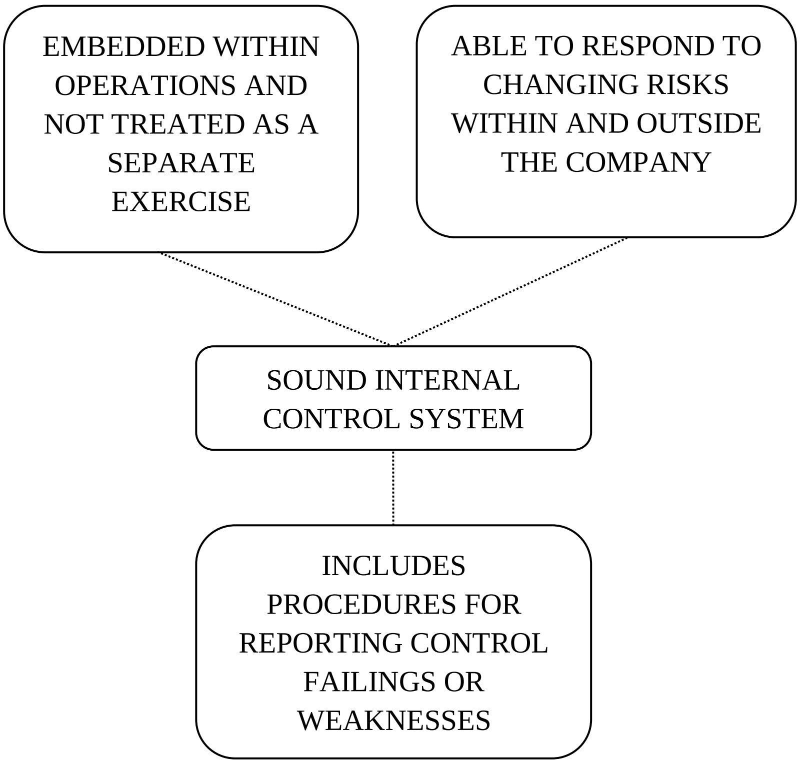
- Effectiveness and efficiency of operations.
- Reliability of financial reporting.
- Compliance with applicable laws and regulations.

These may further give rise to improved investor confidence.

Limitations of internal control systems

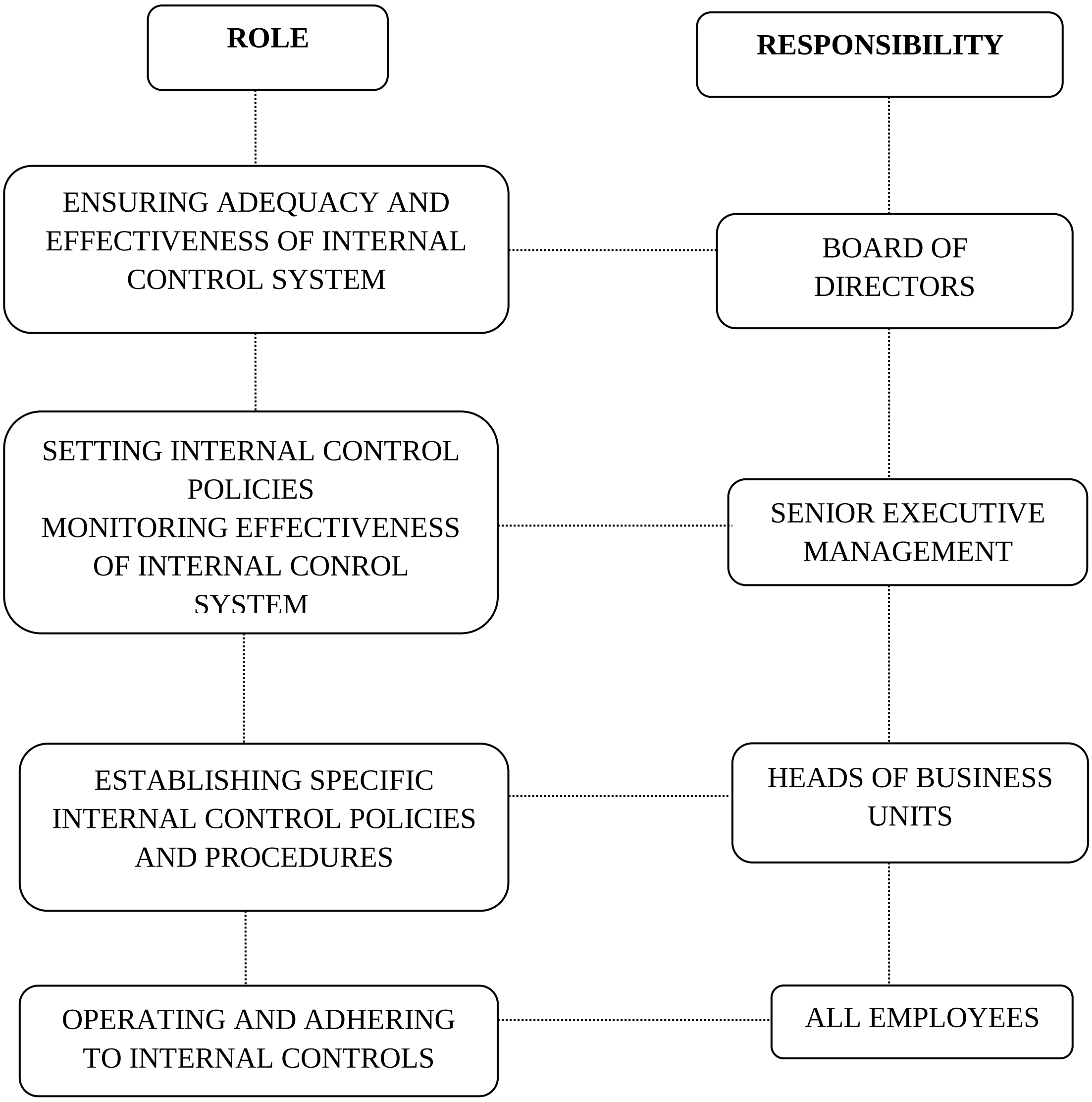
- Poor judgement in decision – making
- Human error can cause failures although a well, control environment
- Control processes being deliberately circumvented by employees and others
- Management overriding controls
- The occurrence of unforeseeable circumstances

Sound control systems



Roles in risk management and internal control

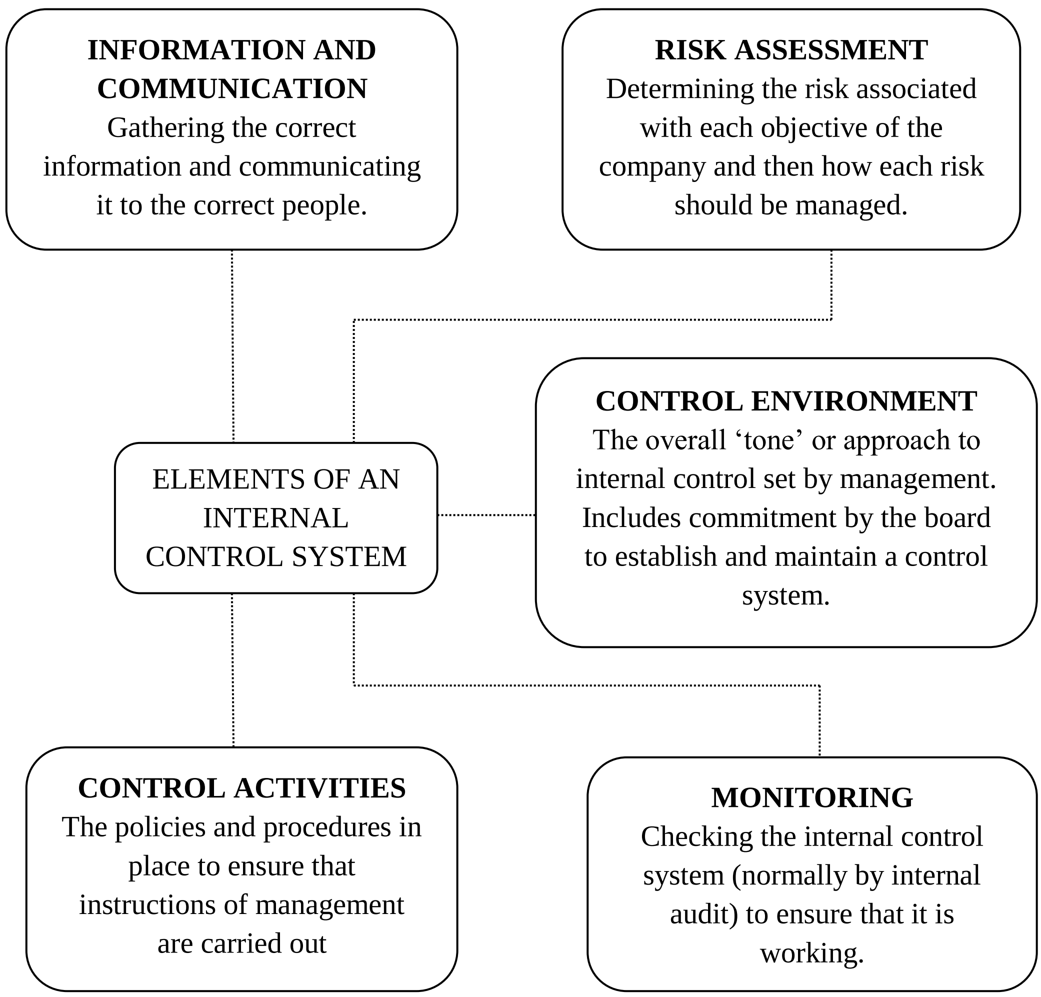
- Responsibility for internal control is not simply an executive management role.
- All employees have some responsibility for monitoring and maintaining internal controls.
- Roles in monitoring range from the CEO setting the ‘tone’ for internal control compliance, to the external auditor, reporting on the effectiveness of the system.



Review effectiveness of internal control

- The review is a normal responsibility of management
- The review itself, however, will be delegated to the audit committee
- The board must provide information on the internal control system and review in the annual accounts
- The review should be carried out at least annually

Elements of an effective internal control system



(2)Risk assessment

The risk assessment should be conducted for each business within the organization, and should consider, for example:

- Internal factors
- External factors

The risk assessment process should also distinguish between:

- Risks that are controllable
- Risks that are not controllable

(3)Control activities

These are policies and procedures that ensure that the decisions and instructions of management are carried out.

The APC list of internal controls can be remembered as:

- **S** Segregation of duties
- **P** Physical
- **A** Authorisation and approval
- **M** Management
- **S** Supervision
- **O** Organisation
- **A** Arithmetic and accounting
- **P** Personnel

(4)Information and communication

The quality of information systems is a key factor in this aspect of internal control.

(5)Monitoring

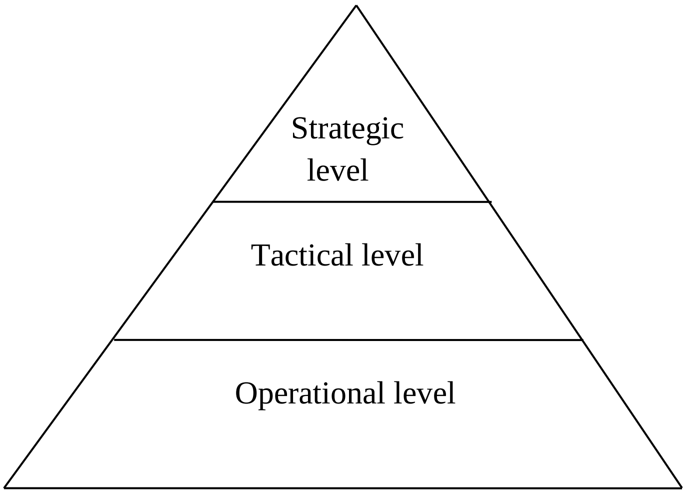
It is critical that the internal control system is reviewed and monitored frequently.

The board may delegate some if its duties in this context to the Audit Committee/ Risk Committee with the former having a review of Internal Financial Controls as part of its role.

Information flows for management

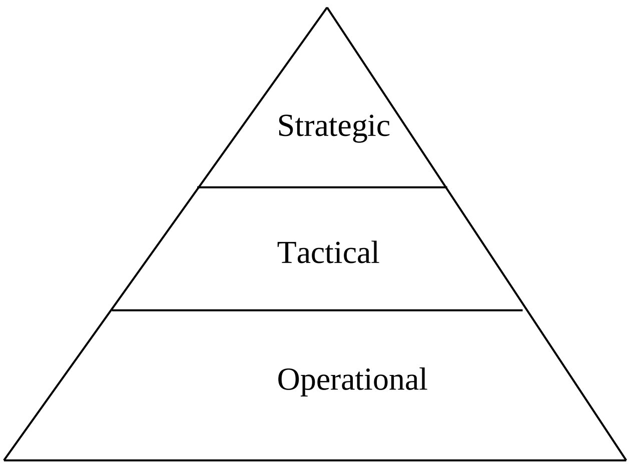
- There should be effective channels of communication within the organization, so that all managers receive timely information that is relevant to the performance of their tasks and duties.
- Information should be provided regularly to management so that they can monitor performance with respect to efficiency, effectiveness in achieving targets, economy and quality.
- Managers need both internal and external information to make informed business decisions and to report externally.
- The actual information provided to management varies depending on the different levels of management.
- Different information systems are available to provide the required information.

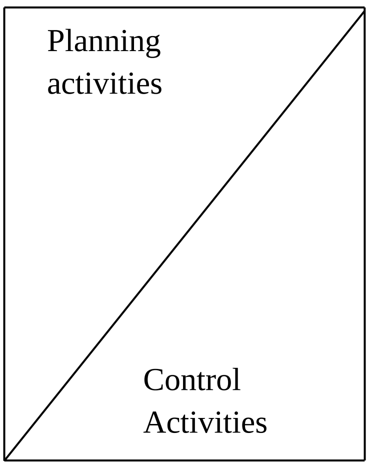
The information requirements of managers



Level	Activity
Strategic	Involved with monitoring and controlling the organization as a whole, making decisions on areas such as opening of new shops and factories or investment in new product line.
Tactical	Responsible for implementing the decisions of strategic managers and ensuring that the different divisions or departments within the organization are operating correctly.
Operational	Controlling the day-to-day operations of the organization, reporting queries or problems back to tactical management for decisions as necessary.

The mix of the planning/ risk and monitoring/ internal control activities is sometimes shown in diagrammatic form as follows:

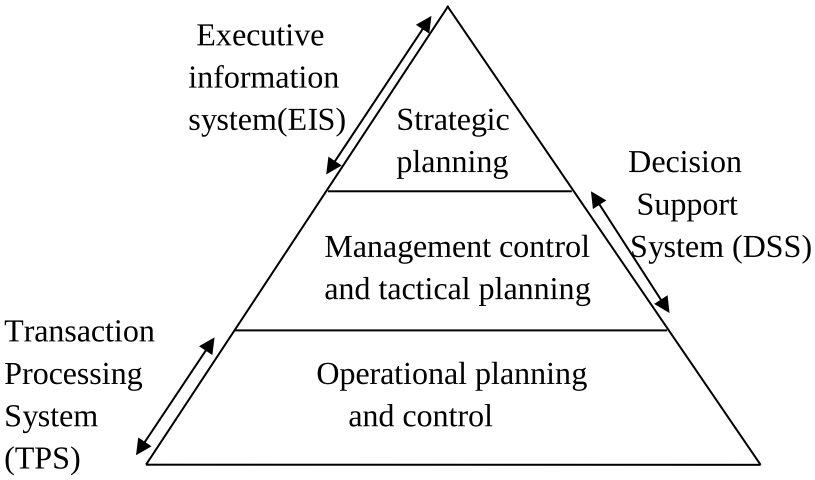




Types of information system

- Executive Information System (EIS)
- Management Information System (MIS)
- Decision Support System (DSS)
- Transaction Processing System (TPS)

Management hierarchy



Information characteristics and quality

The information should meet the criteria of 'good' information:

- Accurate
- Complete
- Cost-beneficial
- User-targeted
- Relevant
- Authoritative
- Timely
- Easy to use

The table below shows the characteristics of information and how their quality varies depending on what is made available.

Characteristic	**Strategic**	→	**Operational**
Time period	Forecast	→	Historical
Timeliness	Delayed	→	Immediately available
Objectivity	Subjective	→	Objective
Quantifiability	Qualitative	→	Quantitative
Accuracy	Approximate	→	Accurate

Certainty	Uncertain	→	Certain
Completeness	Partial	→	Complete
Breadth	Broad	→	Specific
Detail	Little detail	→	Highly detailed

Fraud risk management strategy

In common with any other type of risk, a risk management strategy needs to be developed for fraud. This strategy should include three key elements:

- Fraud prevention.
- Fraud detection.
- Fraud response.

Fraud prevention

The aim of preventative controls is to reduce opportunity and remove temptation from potential offenders.

Some specific examples of fraud prevention include:

- An anti-fraud culture
- Risk awareness
- Whistle blowing
- Sound internal control systems

A fraud policy statement, effective recruitment policies and good internal controls can minimize the risk of fraud.

Fraud detection

A common misbelieve is that external auditors find fraud.

Some methods of discovering fraud are:

- Performing regular checks, e.g. stocktaking and cash counts.
- Warning signals or fraud risk indicators (see previous section). For example:
    - Failures in internal control procedures
    - Lack of information provided to auditors
    - Unusual behavior by individual staff members
    - Accounting difficulties.
- Whistleblowers

Fraud response

The Organisation's response to fraud may include:

- Internal disciplinary action, in accordance with personnel policies.
- Civil litigation for the recovery of loss.
- Criminal prosecution through the police.

Within the response plan responsibilities should be allocated to:

- Managers, who should take responsibility for detecting fraud in their area
- Finance Director, who has overall responsibility for the organizational response to fraud including the investigation. This role may be delegated to a fraud officer or internal security officer.
- Personnel (Human Resources Department), who will have responsibility for disciplinary procedures and issues of employment law and practice.
- Audit committee, which should review the details of all frauds and receive reports of any significant events.
- Internal auditors, who will most likely have the task of investigating the fraud.
- External auditors, to obtain expertise.
- Legal advisors, in relation to internal disciplinary, civil or criminal responses.
- Public relations, if the fraud is so significantly large that it will come to public attention.
- Police, where it is policy to prosecute all those suspected of fraud.
- Insurers, where there is likely to be a claim.

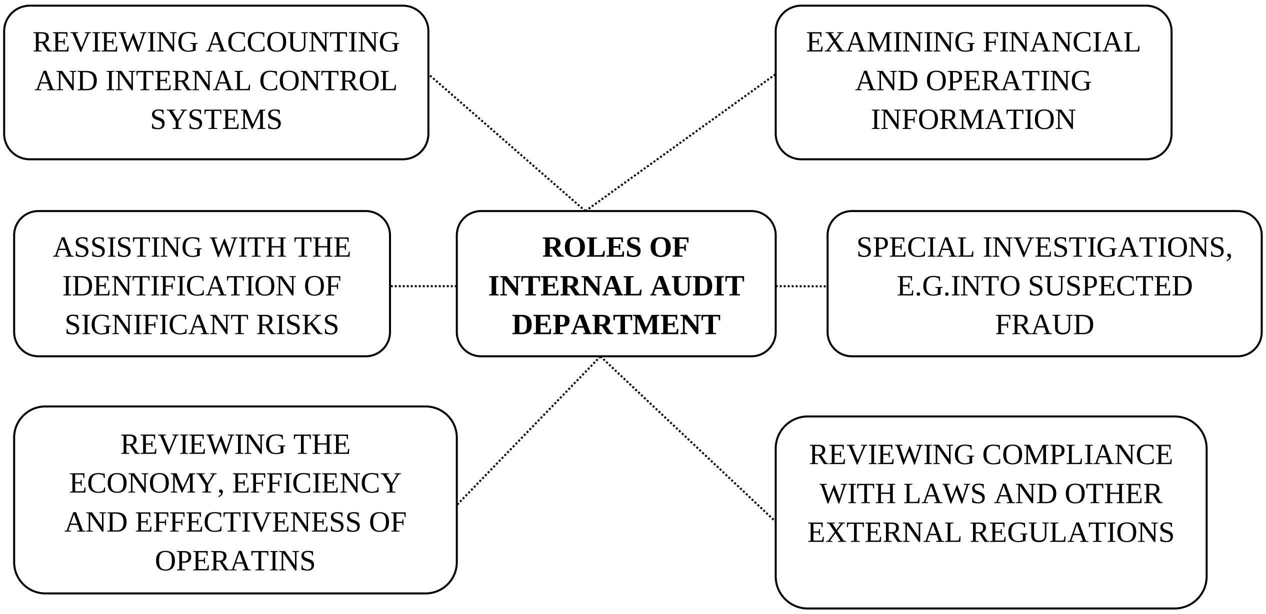
Chapter - 14

Audit and compliance

(1) Function and importance of internal audit

- Reviews the effectiveness of other controls within a company.
- Ensuring that other controls are working correctly.
- Checking compliance with legislation.
- Reports to the audit committee.

Roles of internal audit



Types of audit work

Examples of audit types are:

- Financial audit
- Operational audit
- Project audit
- Value for money audit
- Social and environmental audit
- Management audit

Features of internal audit

- Organizational status.
- Scope of function.
- Technical competence.
- Due professional care.

(2) Factors affecting the need for internal audit.

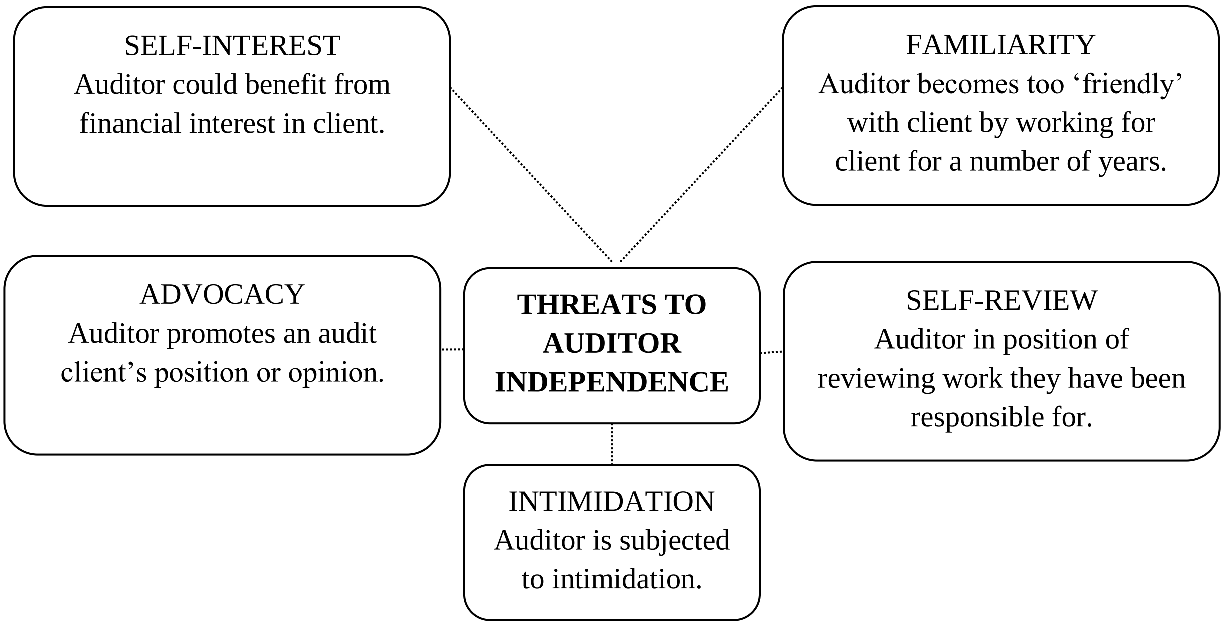
There are a number of factors that affect the need for internal audit.

- The scale, diversity and complexity of the company's activities.
- The number of employees.
- Cost/ benefit considerations.
- Changes in the organizational structures, reporting processes or underlying information systems.
- Changes in key risks (could be internal or external in nature).
- Problems with existing internal control systems.
- An increased number of unexplained or unacceptable events.

(3) Auditor independence

- Internal audit is an independent objective assurance activity.

(4) Potential ethical threats



(5) Audit committee

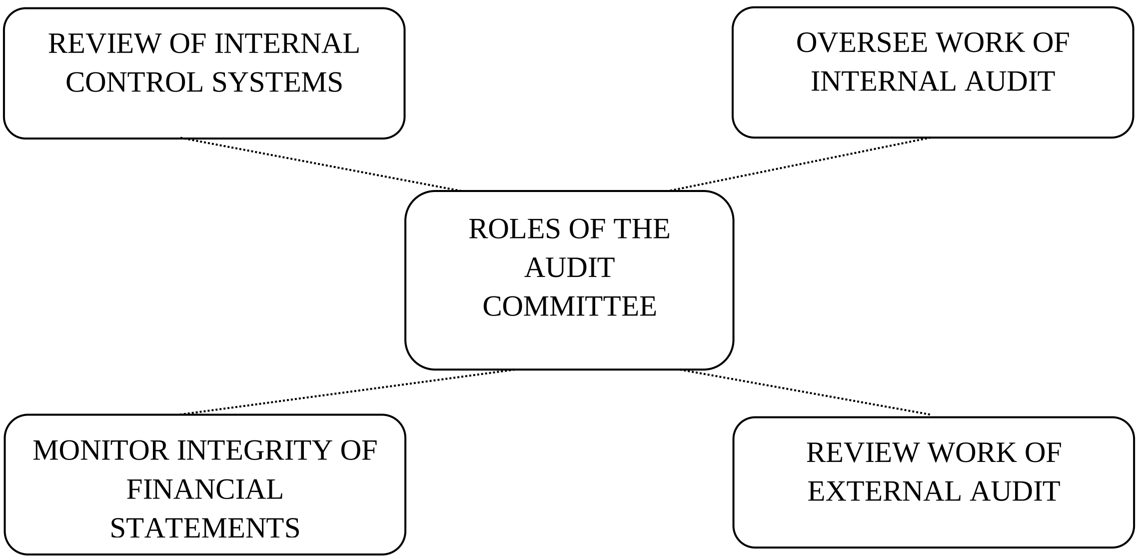
The audit committee is a committee of the board of directors consisting entirely of independent non executive directors (NEDs) (at least three in larger companies), of whom at least one has had recent and relevant financial experience.

The audit committees' key function is to provide evidence of increased accountability to shareholders.

It is critical that the audit committee be independent, comprised of non executive directors and have written terms of reference.

Roles of the audit committee

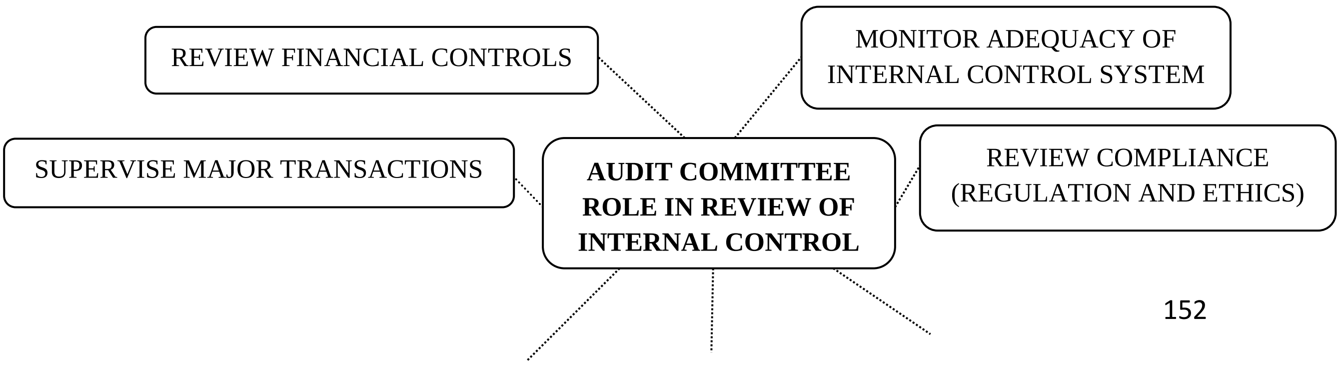
- The key roles of the audit committee are 'oversight', 'assessment' and 'review' of other functions and systems in the company.
- Most of the board objectives relating to internal controls will be delegated to the audit committee.



(6) The audit committee and internal control

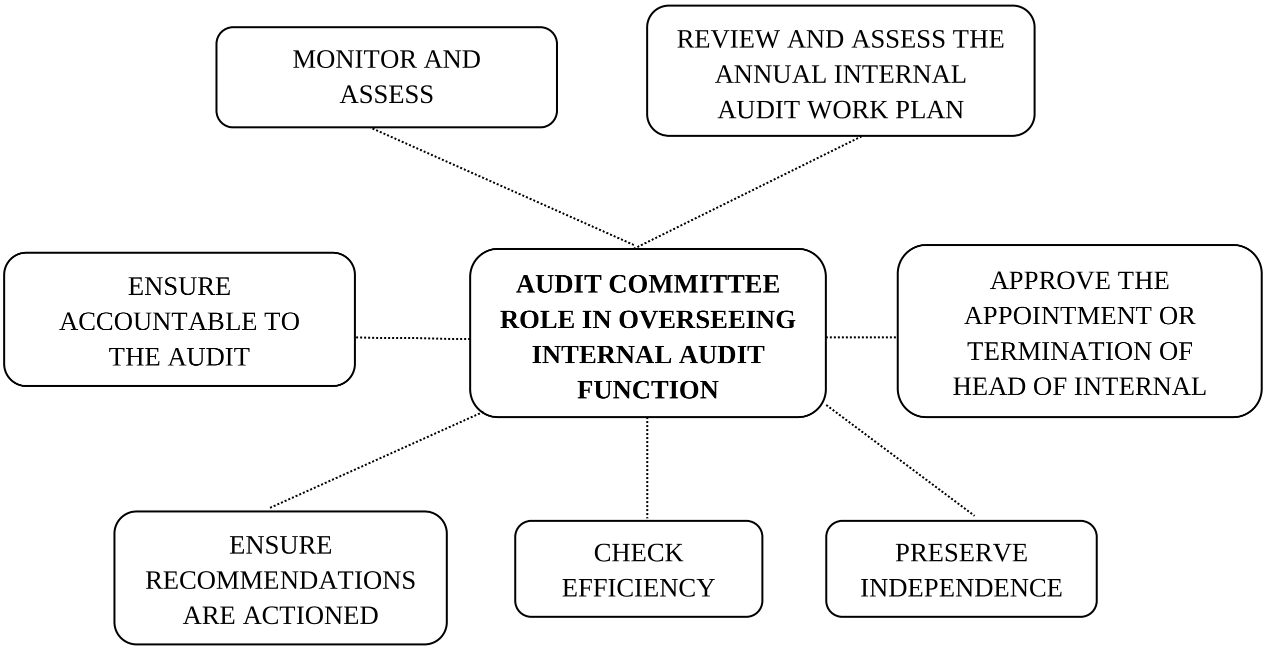
The board is responsible for the total process or risk management, which includes ensuring that the system of internal control is adequate and effective.

The board delegates this internal control responsibility to the audit committee.



(7) The audit committee and internal au

As part of their obligation to ensure adequate and effective internal controls, the audit committee is responsible for overseeing the work of the internal audit function.



(8) The audit committee and external auditors

The audit committee is responsible for oversight of the company's relations with its external auditors. The audit committee should:

- Have the primary responsibility for making a recommendation to the board on the appointment, re-appointment or removal of the external auditors
- 'Oversee' the selection process when new auditors are being considered
- Approve (though not necessarily negotiate) the terms of engagement of the external auditors and the remuneration for their audit services
- Have annual procedures for ensuring the independence and objectivity of the external auditors
- Review the scope of the audit with the auditor, and satisfy itself that this is sufficient

- Make sure that appropriate plans are in place for the audit at the start of each annual audit
- Carry out a post – completion audit review.

Chapter - 15

Identification, assessment and measurement of risk

(1) Risk and corporate governance

- Risk analysis is best carried out in the context of the OECD principles of good corporate governance.
- An overriding risk is that an organization fails to meet the appropriate corporate governance regulations.

OECD principles of good corporate governance

Principle	In the context of risk
Rights of shareholders Shareholders' rights are protected and facilitated.	Company does not allow shareholders their rights e.g. does not provide necessary communications to, or allow comments in, general meetings.
Equitable treatment of shareholders & stakeholders All shareholders (including those with small shareholdings or those in foreign countries) and stakeholders are treated the same.	Under an acquisition all shareholders may not be offered the same price for their holding. Companies may ignore stakeholders or treat some stakeholder groups incorrectly (e.g. attempt to make employees redundant without appropriate consultation).
Disclosure and transparency Timely and adequate disclosure should be made of all material matters (e.g. financial situation of the company).	Directors do not provide appropriate reports or financial statements and do not disclose the true situations such as Enron). This heading implies that internal control systems will also be adequate to detect fraud and other irregularities.
Responsibility of the board The board should be effective and provide strategic guidance for the company.	The board either does not control the company adequately (leading to losses) or attempts to run the company for its benefit rather than for the benefit of other stakeholders.

(2) Necessity of risk and risk management

A risk can be defined as an unrealized future loss arising from a present action or inaction.

- Risks are the opportunities and dangers associated with uncertain future events.
- Risks can have an adverse ('downside exposure') or favourable impact ('upside potential') on the organisation's objectives.

Why incur risk?

INCUR RISK TO

GAIN COMPETITIVE ADVANTAGE.

INCREASE FINANCIAL RETURN.

- To generate higher returns a business may have to take more risk in order to be competitive.
- Conversely, not accepting risk tends to make a business less dynamic, and implies a 'follow the leader' strategy.
- Incurring risk also implies that the returns from different activities will be higher – 'benefit' being the return for accepting risk.
- Benefits can be financial – decreased costs, or intangible – better quality information.
- In both cases, these will lead to the business being able to gain competitive advantage.

The As Low As Reasonably Practicable Principle (ALARP)

As we cannot eliminate risk altogether the ALARP principle, simply states that residual risk should be as low as reasonably practicable. Taking into consideration, the costly nature of risk reduction:

- The ALARP principle expresses a point at which the cost of additional risk reduction would be grossly disproportionate to the benefits achieved.
- The ALARP principle is usually applied to safety critical, high integrity systems where health and safety risks cannot be eliminated e.g. Oil rigs.
- An extreme example to clarify the point:
    - A company spending a million pounds to prevent a member of staff suffering from a bruised knee is grossly disproportionate.
    - A company spending a million pounds to prevent a major explosion capable of killing 150 people is proportionate.

Why manage risk?

Management needs to manage and monitor risk on an ongoing basis for a number of reasons:

- To identify new risks that may affect the company so an appropriate risk management strategy can be determined.
- To identify changes to existing or known risks so amendments to the risk management strategy can be made. For example, where there is an increased likelihood of occurrence

of a known risk, strategy may be amended from ignoring the risk to possibly insuring against it.

- To ensure that the best use is made of opportunities.
- Risk management is a key part of Corporate Governance. It is required by the Combined Code and codes of other jurisdictions.

Managing the upside of risk

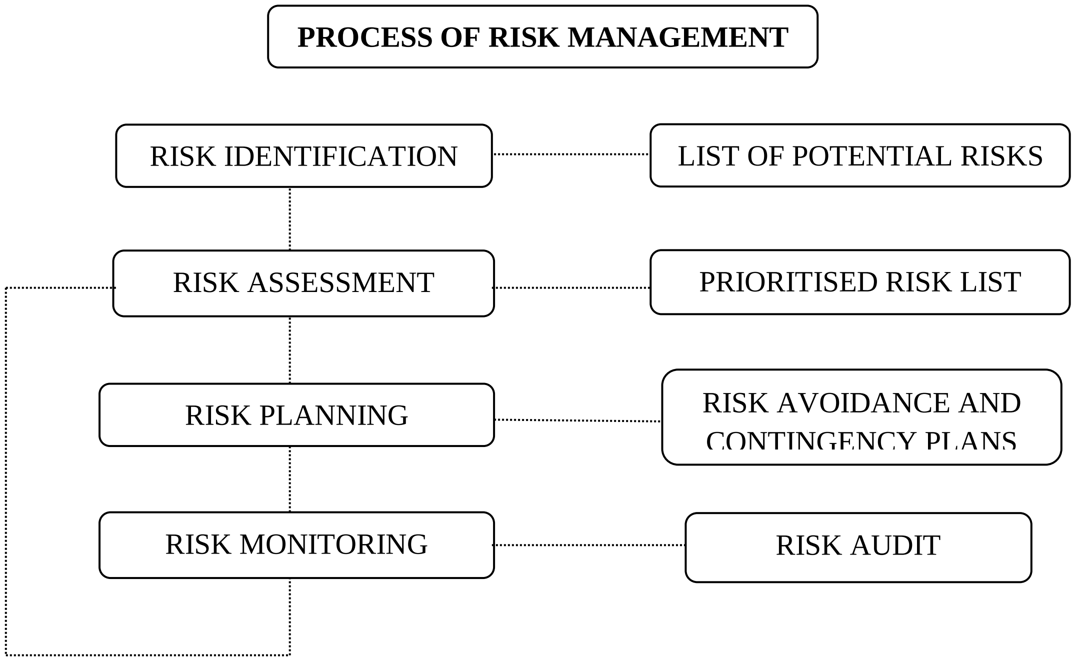
Historically, the focus of risk management has been on preventing loss. However, recently, organisations are viewing risk management in a different way, so that;

- Risks are seen as opportunities to be seized (as discussed above)
- Organizations are accepting some uncertainty in order to benefit from higher rewards associated with higher risk
- Risk management is being used to identify risks associated with new opportunities to increase the probability of positive outcomes and to maximize returns
- Effective risk management is being seen as a way of enhancing shareholder value by improving performance

(3) Risk management

- Risk management is therefore the process of reducing the possibility of adverse consequences either by reducing the likelihood of an event or its impact, or taking advantage of the upside risk.
- Management-are responsible for establishing a risk management system in an organization.
- The process of establishing a risk management system is summarized in the following diagram.

Risk management process



Enterprise Risk Management (ERM)

Enterprise Risk Management – Integrated Framework, the Committee of Sponsoring Organisations, COSO, 2004

Principles of ERM

The key principles of ERM include:

- Consideration of risk management in the context of business strategy
- Risk management is everyone's responsibility, with the tone set from the top
- The creation of a risk aware culture
- A comprehensive and holistic approach to risk management
- Consideration of a broad range of risks (strategic, financial, operational and compliance)
- A focused risk management strategy, led by the board (embedding risk within an organisation's culture – see more in chapter 12).

The COSO ERM framework reflects the relationships between:

- The four objectives of a business (strategic, operations, reporting and compliance) which reflect the responsibility of different executives across the entity and address different needs.

- The four organizational levels (subsidiary, business unit, division and entity) which emphasise the importance of managing risks across the enterprise as a whole.
- The eight components that must function effectively for risk management to be successful.

Components of the ERM framework

- **Internal environment:** This is the tone of the organization, including the risk management philosophy and risk appetite (see more in the next chapter).
- **Objective setting:** Objectives should be aligned with the organisation's mission and need to be consistent with the organisation's defined risk appetite.
- **Event identification:** These are internal and external events (both positive and negative) which impact upon the achievement of an entity's objectives and must be identified.
- **Risk assessment:** Risks are analysed to consider their likelihood and impact as a basis for determining how they should be managed.
- **Risk response:** Management selects risk response(s) to avoid, accept, reduce or share risk. The intention is to develop a set of actions to align risks with the entity's risk tolerances and risk appetite.
- **Control activities:** Policies and procedures help ensure the risk responses are effectively carried out.
- **Information and communication:** The relevant information is identified, captured and communicated in a form and timeframe that enables people to carry out their responsibilities.
- **Monitoring:** The entire ERM process is monitored and modifications made as necessary.

(4) Risk identification: Strategic and operational risks

RISK

CATEGORISED BY

STRATEGIC
AFFECTS THE OVERALL MISSION OF THE COMPANY

OPERATIONAL
AFFECTSS THE DAY-TO-DAY ACTIVITIES OF THE COMPANY

Strategic risks:

- Risks arising from the possible consequences of strategic decisions taken by the organization
- Also arise from the way that an organization is strategically positioned within its environment
- Should be identified and assessed at senior management and board or director level
- PESTEL and SWOT techniques can be used to identify these risks.

Operational risks:

- Refer to potential losses that might arise in business operations
- Include risks of fraud or employee malfeasance, poor quality production or lack of inputs for production
- Can be managed by internal control systems.

Operational risks:

- Refer to potential losses that might arise in business operations.
- Can be defined broadly as 'the risk of losses resulting from inadequate or failed internal processes, people and systems, or external events' (Basel Committee on Banking Supervision).
- Include risks of fraud or employee malfeasance as well as risks from production (such as poor quality) or lack of production (not having inputs available at the correct time).
- Can be managed by internal control systems.

(5) Risk identification: Business risks

The risks listed below are not exhaustive.

Market risks: Risks which derive from the sector in which the business is operating, and from its customers.

Product risk: The risk that customers will not buy new products (or services) provided by the organization or that the sales demand for current products and services will decline unexpectedly.

Commodity price risk: Businesses might be exposed to risks from unexpected increases (or falls) in the price of a key commodity.

Product reputation risk: Some companies rely heavily on brand image and product reputation, and an adverse event could put its reputation (and so future sales) at risk.

Credit risk: Credit risk is the possibility of losses due to non-payment, or late payment, by customers.

Currency risk: Currency risk, or foreign exchange risk, arises from the possibility of movements in foreign exchange rates, and the value of one currency in relation to another.

Interest rate risk: Interest rate risk is the risk of unexpected gains or losses arising as a consequence of a rise or fall in interest rates.

Political risk: Political risk depends to a large extent on the political stability in the countries in which an organization operates and the attitudes of governments towards protectionism.

Legal or **litigation risk** arises from the possibility of legal action being taken against an organization.

Regulatory risk arises from the possibility that regulations will affect the way an organization has to operate.

Compliance risk is the risk of losses, possibly fines, resulting from non-compliance with laws or regulations.

Technology risk arises from the possibility that technological change will occur.

Economic risk refers to the risks facing organizations from changes in economic conditions, such as economic growth or recession, government spending policy and taxation policy, unemployment levels and international trading conditions.

Environmental risk faces a business due to the environmental effects of its operations, such as pollution resulting from business activity or restrictions on the supply of natural resources to the business due to environmental factors.

Health and safety risks: Many companies engage in potentially hazardous activities, such as coal mining, that can give rise to injury or the loss of life.

Business probity risk is related to the governance and ethics of the organization.

Derivatives risk refers to the risks due to the use of financial instruments.

Entrepreneurial risk: This is the necessary risk associated with any new business venture or opportunity.

Financial risk: This is a major cause of business risk, and can be further defined as:

- **Gearing risk:** Gearing risk for non-bank companies is the risk arising from exposures to high financial gearing and large amounts of borrowing
- **Liquidity risk** relates to the possibility of a company's cash inflows not being sufficient to meet its cash outflows.

Use of risk categories

Two examples or risk categorisation by major companies are given here.

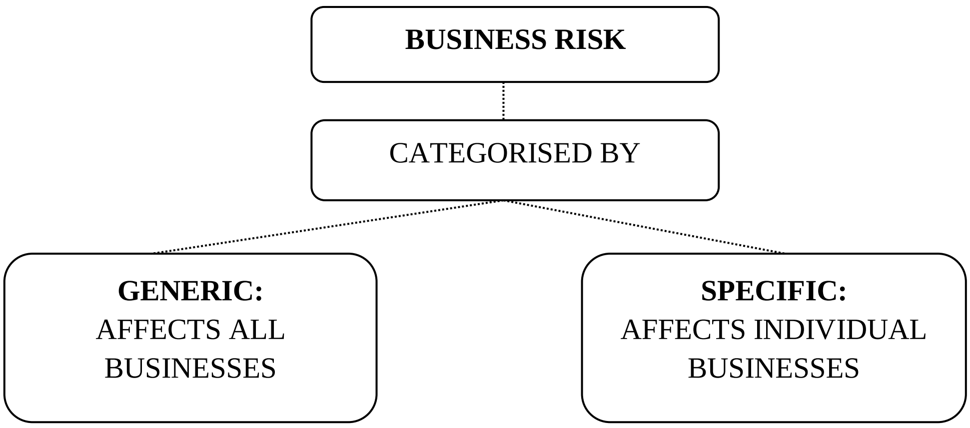
Snecma, the avionics group, identifies its risks under five different headings:

- Financial
- Human
- Image (corporate reputation, product reputation)
- Customers and partners
- Technical and production.

The commercial banking and insurance group, **Lloyds TSB,** uses 11 risk categories:

- Strategic
- Credit
- Market
- Insurance indemnity
- Operational
- Governance
- People and organization
- Products and services
- Customer treatment
- Financial soundness
- Legal, regulatory and change management

(6) Risk identification: Categories and risk relationships



Generic or Specific

Business risks can be either generic that is the risk affects all businesses, or specific to individual business sectors.

- Examples of generic risks include changes in the interest rate, non-compliance with company law, or poor use of derivative instruments.
- Generic risks can also affect different businesses in different ways; a company with substantial borrowing will be affected more by an increase in interest rates than a company with little or no borrowings.
- Similarly, a company manufacturing computers will be more at risk from the possibility of changes in legislation affecting VDUs than a company providing legal services.

The concept of related risk factors

Positively correlated risks are positively related in that one will fall with the reduction of the other, and increase with the rise of the other.

Negatively correlated risks are negatively related in that one rises as the other falls.

CORRELATION BETWEEN-RISK

POSITIVE CORRELATION
Both risks move in the same direction
For example: As the environment risk increases so does the reputational risk

NEGATIVE CORRELATION
Each risk moves in an opposite direction.
For example: as more money is spent on reducing the environmental damage, therefore reducing the risk. There is an increase in the financial risk facing the company

(7) The impact on stakeholders

BUSINESS RISK

EFFECT ON STAKEHOLDER

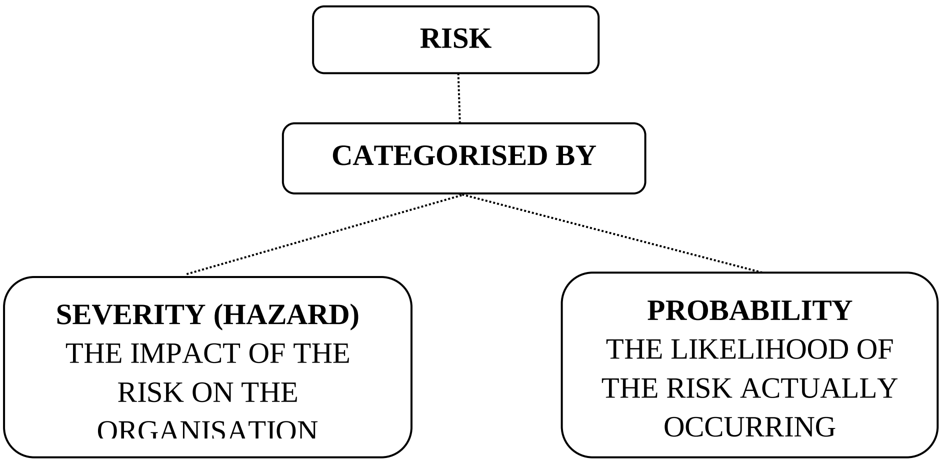
STAKEHOLDER CAUSED RISK → IMPACT MAINLY NEGATIVE ON STAKEHOLDER

STAKEHOLDER DID NOT CAUSE RISK → IMPACT NEGATIVE ON COMPANY AND ON STAKEHOLDER

Business risks initially affect the company subject to those risks. However there will be a 'knock-on' effect of those risks on stakeholders:

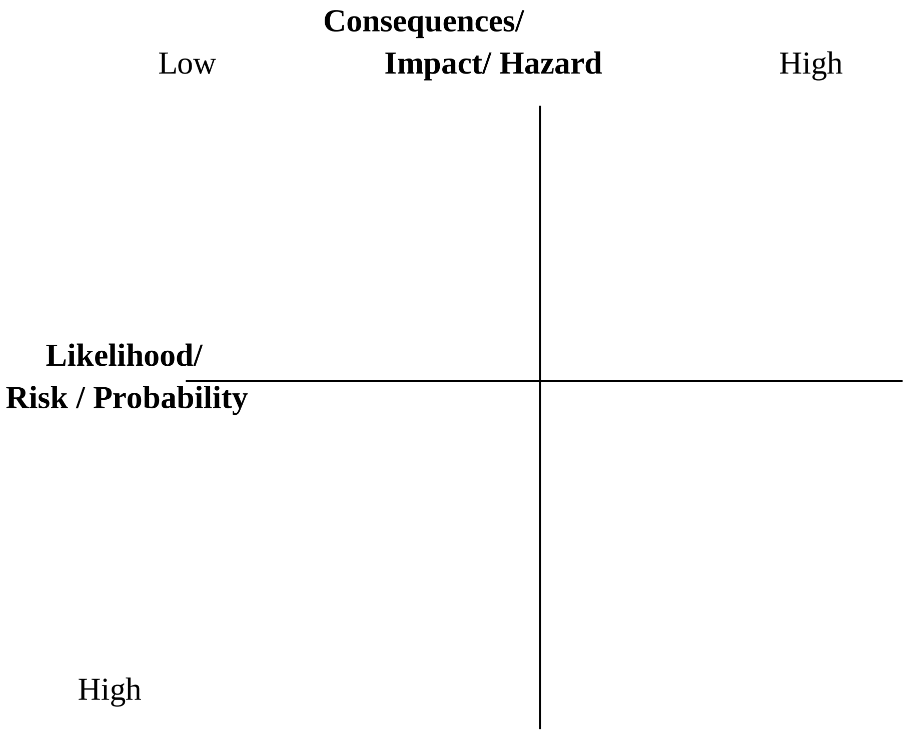
- The amount of the effect will depend on how close the stakeholder is to the company.
- In many situations, the actual impact is to affect the company again; the stakeholders will mitigate the risk by distancing themselves from the company.
- Impact on stakeholders is likely to be more severe where they actually cause the business risk in the first place.

(8) Assessing risks



A common qualitative way of assessing the significance of risk is to produce a '**risk map'**.

- The map identifies whether a risk will have a significant impact on the organization and links that into the likelihood of the risk occurring.
- The approach can provide a framework for prioritizing risks in the business.
- Risks with a significant impact and a high likelihood of occurrence need more urgent attention than risks with a low impact and low likelihood of occurrence.
- The significance and impact of each risk will vary depending on the organization:
  - E.g.an increase in the price of oil will be significant for Airline Company but will have almost no impact on a financial services company offering investment advice over the internet.
- The severity of a risk can also be discussed in terms of 'hazard'. The higher the hazard or impact of the risk, the more severe it is.
- Risks can be plotted on a diagram, as shown.



The risk management strategies that will be adopted depend on how risk is assessed on this map. They will be:

- Transfer
- Accept
- Reduce
- Avoid

Dynamic nature of risk assessment

- Risks change over time
- The environments that companies operate within (both internal and external) vary with respect to the degree of change that is faced.

STATIC — DYNAMIC (turbulent)

Increasing environmental change

STATIC	DYNAMIC (turbulent)
Nothing in the internal environment changes	Internal activities constantly changing (e.g. product launches, financial restructuring)
Nothing in the external environment changes	External environment changes (e.g. customer requirements, resource supplies)
Risks facing the business never change	Risks facing the business are always changing

- In a dynamic environment these changing risks will lead to the assessment of probability and impact in the risk map constantly altering.

(9) Risk perception

A further complication to risk assessment is the quality of information available upon which to assess the risks.

DIFFERENT RISK PERCEPTIONS

OBJECTIVE
Assessment made with high degree of certainty

SUBJECTIVE
Very difficult to assign value to impact & likelihood

Subjective risk perception has obvious limitations, including:

- It may affect the suitability of selected risk mitigation techniques
- It may impact resource decisions.

Examples of objective and subjective risk assessment	
Objective measurement	**Subjective measurement**
Impact: Number of homes affected if a local power distribution plant ceases to operate. (The number of homes served by that plant is known since it covers a precise geographical area).	**Impact:** The amount of revenue lost by businesses if websites are "down" due to loss of power. (This would depend on the amount of revenue that flows through the website, and is hard to determine exactly how much would have been earned in the specific period of a power outage).
Likelihood: Drawing an ace of spades out of a normal pack of cards. (1 in 52 chance).	**Likelihood:** The FTSE 100 rises by 50 points in the next week. This could be affected by so many variables that it would be impossible to quantify.

Tools and techniques for quantifying risks

A number of tools can be used to quantify the impact of risks on the organization, some of which are described below. These will have been covered in your earlier studies, in papers F5 and F9.

- **Scenario planning:** In which different possible views of the future are developed, usually through a process of discussion within the organization.
- **Sensitivity analysis:** In which the values of different factors which could affect an outcome are changed to assess how sensitive the outcome is to changes in those variables.
- **Decision trees:** Often used in the management of projects to demonstrate the uncertainties at each stage and evaluate the expected value for the project based on the likelihood and cash flow of each possible outcome.
- **Computer simulations:** Such as the Monte Carlo simulation which uses probability distributions and can be run repeatedly to identify many possible scenarios and outcomes for a project.
- **Software packages:** Designed to assist in the risk identification and analysis processes.
- **Analysis of existing data:** Concerning the impact of risks in the past.

(10) Risk registers

The risk register is a very important and practical risk management tool that all companies should have these days.

The risk register is often laid out in the form of a tabular document with various headings:

1) The risk title
2) The likelihood of the risk
3) The impact of the risk should it arise
4) The risk owners name will be given
5) The date the risk was identified
6) The date the risk was last considered will be given
7) Mitigation actions should be listed
8) An overall risk rating might be given
9) Further actions to be taken in the future will be listed
10) The 'action lead' name will be detailed
11) A due date will be stated
12) A risk level target might be given

Chapter – 16

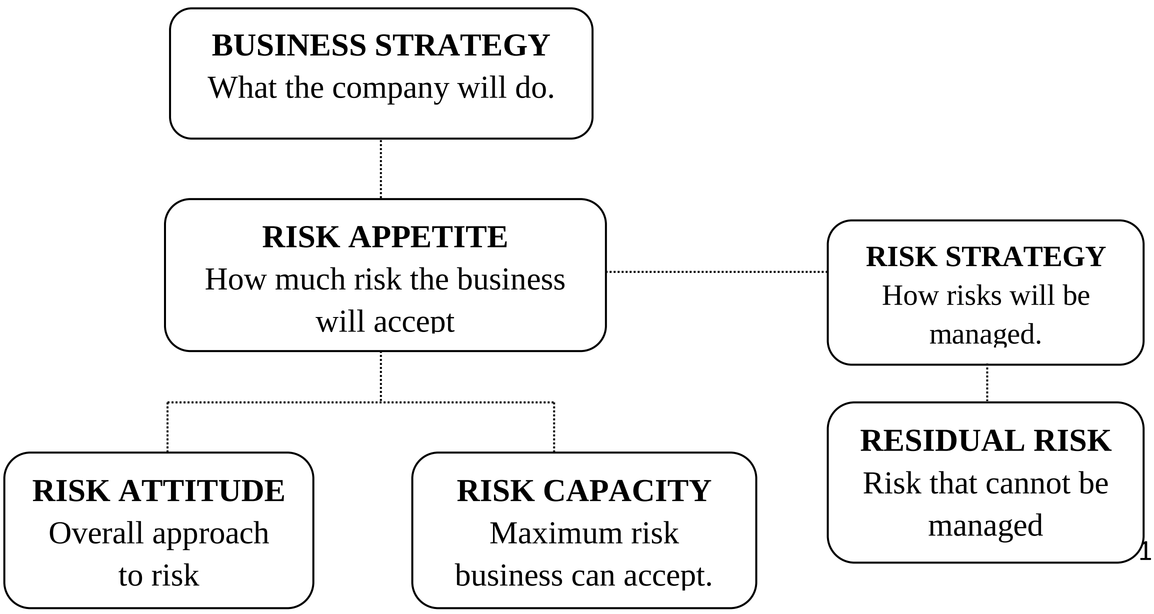
Managing, monitoring and mitigating risk

The role of the board in risk management

The board of an organization plays an important role in risk management.

- It considers risk at the strategic level and defines the organization's appetite and approach to risk.
- The board is responsible for driving the risk management process and ensuring that manageress responsible for implementing risk management have adequate resources.
- The board is responsible for ensuring that risk management supports the strategic objectives of the organization.
- The board will determine the level of risk which the organization can accept in order to meet its strategic objectives.
- Board ensures that the risk management strategy is communicated to the rest of the organization and integrated with all the other activities.
- The board reviews risks, and identifies and monitors progress of the risk management plans.
- The board will determine which risks will be accepted, which cannot be managed, or which it is not cost-effective to manage, i.e. residual risk.
- The board will generally delegate these activities to a risk committee, as discussed later in this chapter.

A framework for board consideration of risk is shown below



RISK APPETITE

RISK AVERSE
Seeking to avoid risks and withdraw from risky situations.

RISK SEEKING
Actively seek risk, in the belief that higher the risk equals higher the returns.

Risk appetite factors

- Nature of product being manufactured
- The need to increase sales
- The background of the board
- Amount of change in the market
- Reputation of the company

Risk appetite and organizational factors

Risk appetite can be seen on a continuum from risk-averse to risk-seeking.

Risk appetite

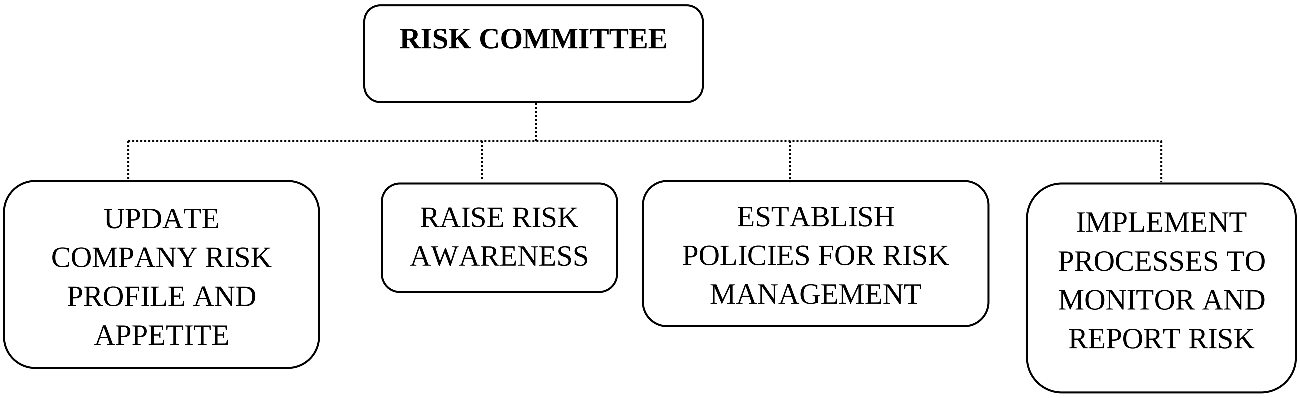
Risk Averse | Increasing Risk ⇨ | Risk Seeking

- There is no easy correlation between the risk appetite of an organization and its size, structure and development.
- In general terms:
  - A small, young company may have a higher risk appetite as it takes risks in order to get its product into the market.
  - A larger, older company may appear to be more risk – averse as it seeks to protect its current market position.

Small size: Small size normally indicates higher risk for the organization.

Large size: Large size normally indicates lower risk for the organization.

Roles of the risk committee



Composition of risk committee

The committee will include both executive and non-executive directors, with the majority being NEDs.

Executive directors are involved as they are responsible for the day-to –day operations and therefore have a more detailed understanding of the associated risks.

Roles of the risk committee

In broad terms, the risk (management) committee within an organization has the following main aims:

- Raising risk awareness and ensuring appropriate risk management within the organization.
- Establishing policies for risk management.
- Ensuring that adequate and efficient processes are in place to identify report and monitor risks.
- Updating the company's risk profile, reporting to the board and making recommendations on the risk appetite of the company.

Terms of reference of the risk (management) committee

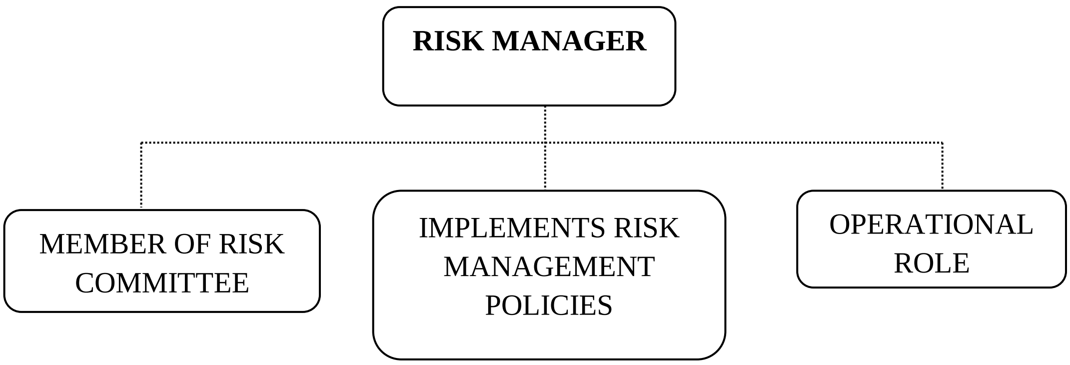
- Advising the board on the risk profile and appetite of the company and as part of this process overseeing the risk assurance process within the company.
- Acting on behalf of the board, to ensure that appropriate mechanisms are in place with respect to risk identification, risk assessment, risk assurance and overall risk management.
- Continual review of the company's risk management policy including making recommendations for amendment of that policy to the board.
- Ensuring that there is appropriate communication of risks, policies and controls within the company to employees at all management levels.

- Ensuring that there are adequate training arrangements in place so that management at all levels are aware of their responsibilities for risk management.
- Where necessary, obtaining appropriate external advice to ensure that risk management processes are up to date and appropriate to the circumstances of the company.
- Ensuring that best practices in risk management are used by the company, including obtaining and implementing external advice where necessary.

Responsibilities of the risk committee

- Assess risk management procedures
- Emphasize and demonstrate the benefits of a risk-based approach to internal control.
- Consider risk audit reports on key business areas to assess the level of business risk exposure.
- Assess risks of any new ventures and other strategic initiatives.
- If appropriate, review credit risk, interest rate risk, liquidity risk and operational risk exposures with regard to full board risk appetite.
- Consider whether public disclosure of information regarding internal control and risk management policies and key risk exposures is in accordance with the statutory requirement and financial reporting standards.
- Make recommendations to the full board on all significant matters relating to risk strategy and policies.

Role of the risk manager



- The risk manager is a member of the risk management committee, reporting directly to that committee and the board.
- The role focuses primarily on implementation of risk management policies.
- The manager is supported and monitored by the risk management committee.
- The role is more operational than strategic.
- Policy is set by the board and the risk management committee and implemented by the risk manager.

Risk awareness

RISK AWARENESS

STRATEGIC
HIGH LEVEL MONITORING OF RISK

TACTICAL
MONITORING OF RISK AT DIVISION LEVEL

OPERATIIONAL
MONITORING OF RISK IN DAY-TO-DAY OPERATIONS

Sources of information on risk

The risk committee will obtain information about risks, and weaknesses in controls, from a variety of sources including:

- Reports from departmental managers
- Whistleblowers
- Reports on key project and new business areas
- Results of internal audit reviews (possibly from the audit committee)
- Customer feedback
- Performance monitoring systems (internal and external factors)
- Directors' own observations.

Embedding risk

- The aim of embedding risk management is to ensure that it is 'part of the way we do business' (to misquote handy).
- It can be considered at two levels:
    - Embedding risk in systems
    - Embedding risk in culture.

EMBEDDING RISK IN SYSTEMS

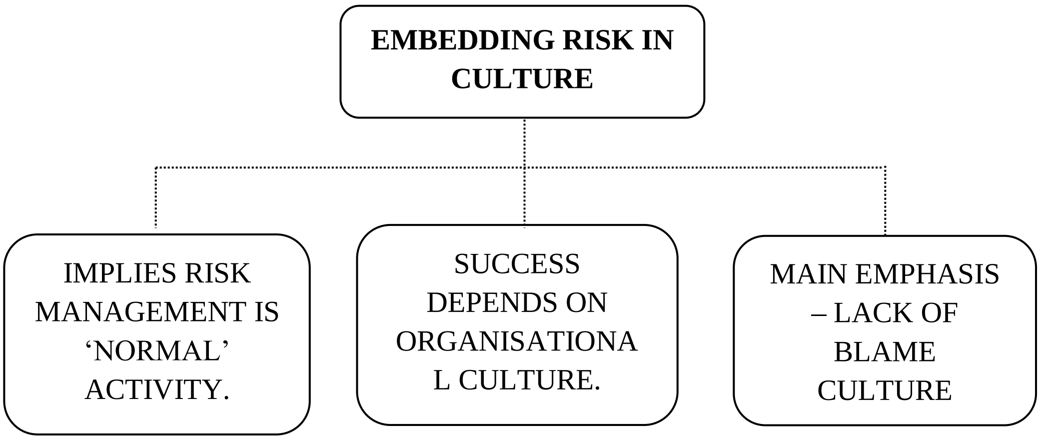
CONTROL SYSTEMS INCLUDE RISK MANAGEMENT

RISK MANANGEMENT NOT A SEPARATE SYSTEM

NEEDS BOARD SUPPORT

Embedding risk in culture

- As noted above, risk management needs to be embedded into policies and procedures in an organization.
- However, the policy may still fail unless all workers in a company (board to employees) accept the need for risk management.
- Embedding risk into culture and values therefore implies that risk management is 'normal' for the organization.



Methods of embedding risk management in the culture and values of an organization include:

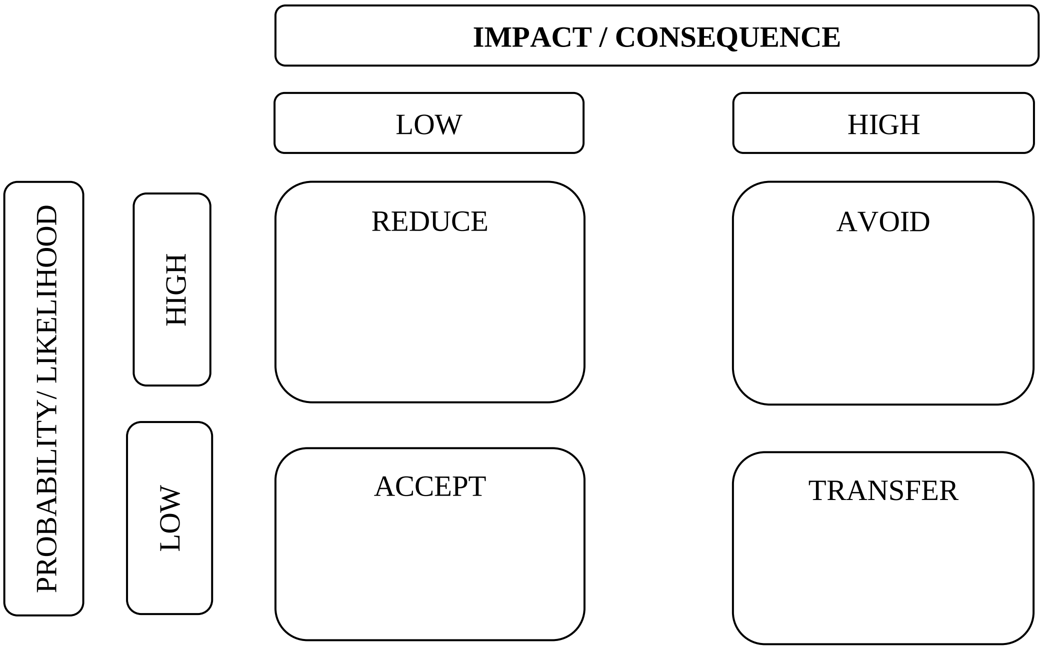
- Aligning individual goals with those of the organization
- Including risk management responsibilities within job descriptions
- Establishing reward systems which recognize that risks have to be taken in practice (e.g. not having a 'blame' culture)
- Establishing metrics and performance indicators that can monitor risks and provide an early warning if it is seen that risks will actually occur and affect the organization
- Informing all staff in an organization of the need for risk management, and publishing success stories to show how embedding risk management in the culture has benefited both organization and staff.

Risk management: TARA (or SARA)

- The risk management process was described in the previous chapter. We will now move onto the third step of the process: risk planning and formulating the risk management strategies.
- Strategies for managing risks can be explained as TARA (or SARA): Transference (or Sharing), Avoidance, Reduction or Acceptance.

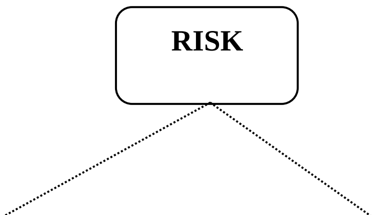
Risk mapping and risk management strategies

Risk maps can provide a useful framework to determine an appropriate risk management strategy.



Further risk management strategies

Risk avoidance and retention

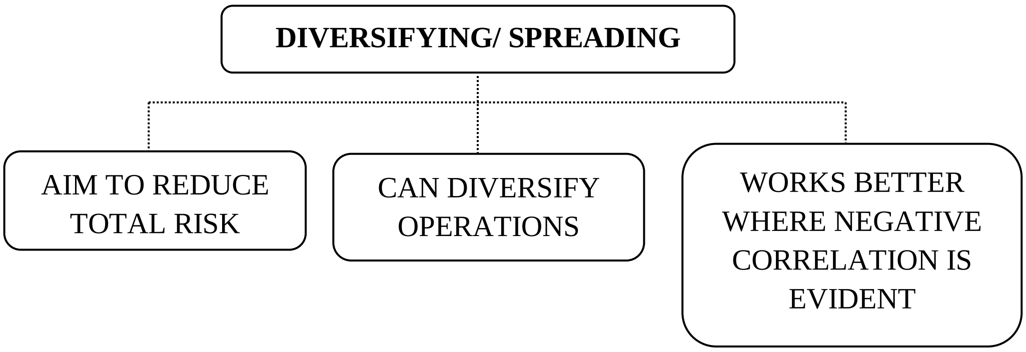


Risk avoidance: the risk strategy by which the organization literally avoids a risk by not undertaking the activity that gives rise to the risk in the first place.

Risk retention: risk strategy by which an organization retains that particular risk within the organization.

- This is a similar concept to risk **acceptance.**

Diversifying/ spreading risk



Spreading risk by portfolio management

Within an organization, risk can be spread by expanding the portfolio of companies held.

- **Backward integration** refers to development concerned with the inputs into the organization, e.g. raw materials, machinery and labour.
- **Forward integration** refers to development into activities that are concerned with the organization's outputs such as distribution, transport, servicing and repairs.
- **Horizontal integration** refers to development into activities that compete with, or directly complement, and organization's present activities. An example of this is a travel agent selling other related products such as travel insurance and currency exchange services.

Unrelated diversification

This is development beyond the present industry into products and/ or markets that may bear no clear relationship to their present portfolio. Where appropriate an organization may want to enter into a completely different market to spread its risk.

Risk strategy and Ansoff's matrix

Ansoff's product/ market matrix provides a summary of strategic options for an organization when looking to expand. The matrix is shown below.

	Existing product	**New product**
Existing market	Internal efficiency and market penetration(1)	Product development(2)
New market	Market development(3)	Diversification (4)

Option 1 – Low risk as the product and the market are known – the risk here is attempting to sell a product in the marketplace when demand is falling (e.g. video players).

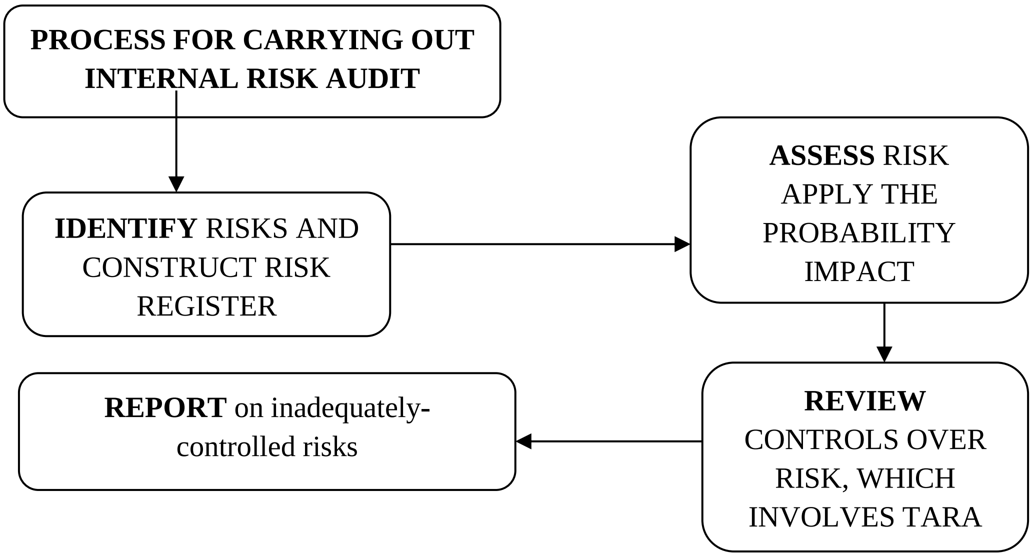
Option 2 - Higher risk – although the market is known there is a risk that customers will not like the enhanced or new product (e.g. mobile telephone that can double as an MP3 player).

Option 3 – Againg higher risk – the product is known but the marketplace is not. The main risks relate to poor sales strategy or poor market research indicating that customers want the product when they do not (e.g. Asda retreating from Germany).

Option 4 – Highest risk option – both the market and the product are new combining the risks from option 2 and 3. While the risk is highest here, so are potential returns if the new product can be successfully sold in the new market.

Risk auditing

Stages of a risk audit



Process of a risk audit

The process of internal, and external audit, in monitoring risks will include:

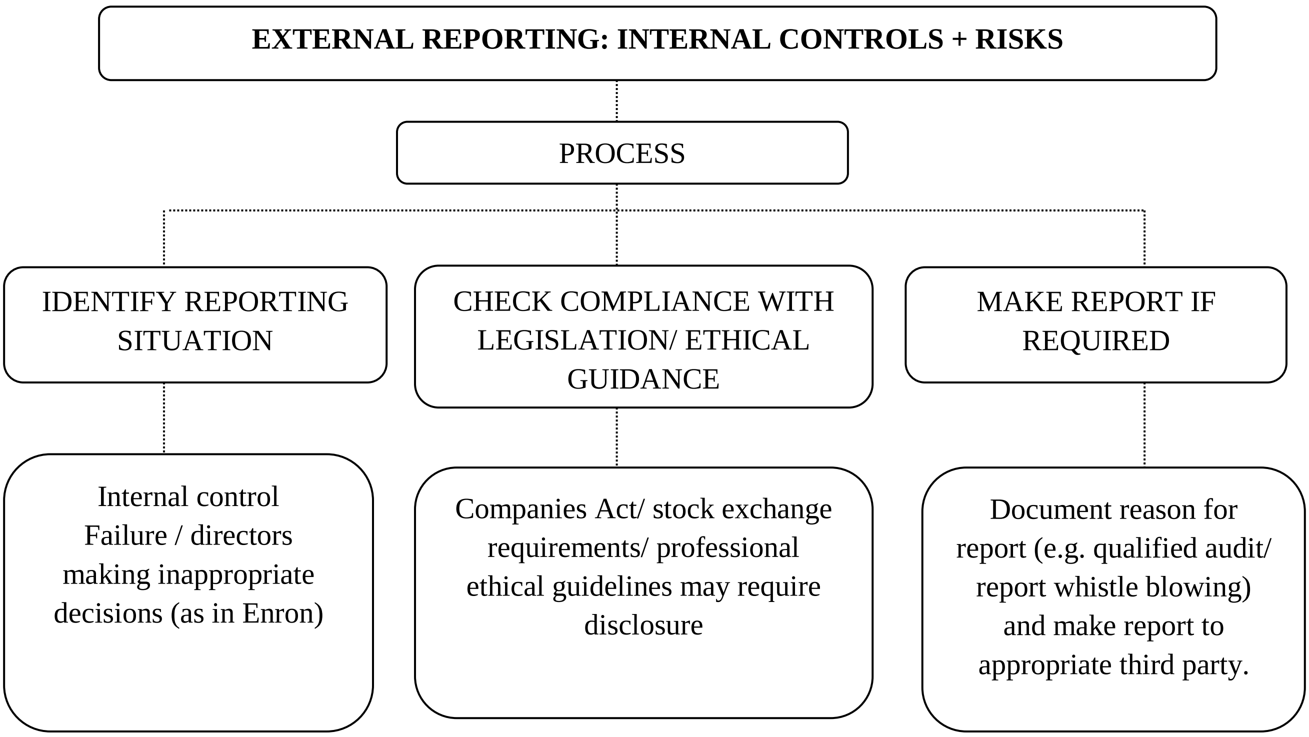
(1) Identifying the risks that exist within an organization.

(2) Assessing those risks in terms of likelihood of occurrence and impact on the organization should the risk actually occur?

(3) Reviewing the controls that are in place to prevent and / or detect the risk and assessing if they are appropriate.

(4) Informing the board (or risk management committee where one exists) about risks which are outside acceptable levels or where controls over specific risks are ineffective.

Process of external reporting of internal controls and risk



Purpose of risk auditing

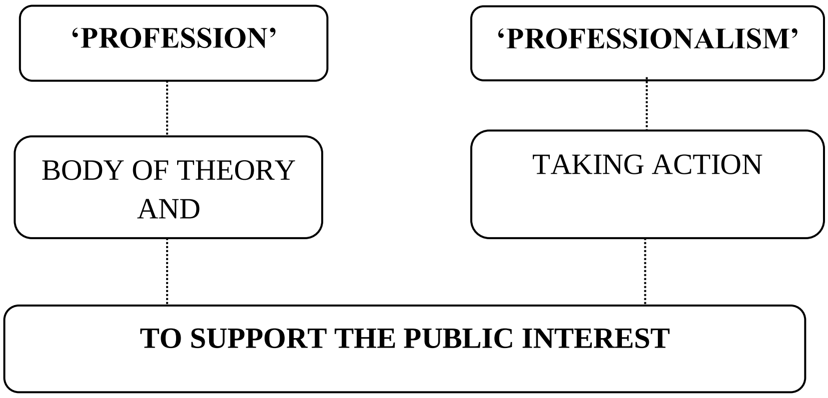
RISK AUDITING

- ASSISTS RISK MONITORING PROCESS
- PROVIDES 'FRESH PAIR OF EYES'
- MAY BE A STATUTORY REQUIREMENT

Chapter – 17

Professionalism, ethical codes and the public interest

'Profession' versus 'professionalism'



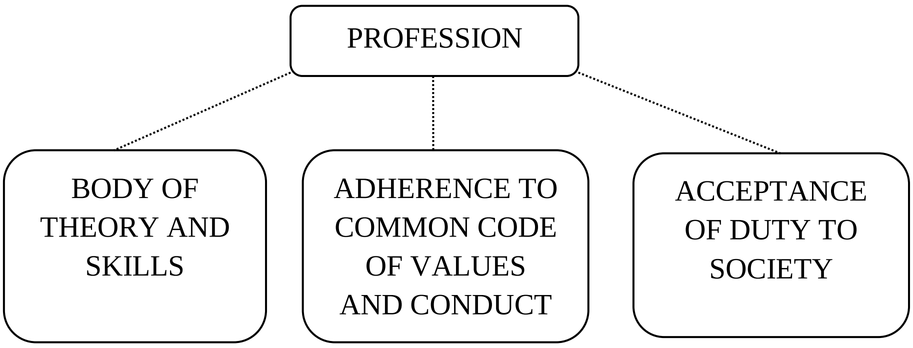
The terms profession and professionalism can be explained as follows:

Profession: a body of theory and knowledge which is used to support the public interest.

Professionalism: taking action to support the public interest.

Profession

A profession is distinguished by certain essential and defining characteristics:



Characteristic	Applicability to accounting profession
Body of theory and skills	• Technical skills (such as auditing or accounting standards) • Acquired by training and education • An examination system which ensures accountants obtain the knowledge required to act responsibly within their profession • Maintained by continuing professional development (CPD).
Adherence to common code of values and conduct	• Established by administrating body • Maintains an objective outlook • Ethical standards applicable to all members (such as ACCA's code of ethics, discussed in section 6 of this chapter).
Acceptance of a duty to society as a whole	• Professions can be trusted to act in the public interest • In return members are granted a qualification and usage of a title (such as ACCA).

Professionalism

The accounting profession

- Over time, the profession appears to be taking more of a proactive, than a reactive, approach.

A reactive approach

Taking responsibility for any negative consequences of accounting practice and, where appropriate, amending those practices to remove those consequences.

A proactive approach

Seeking out and positively contributing to the public interest.

The accountancy profession's public includes:

- Clients
- Credit providers
- Governments
- Employees
- Employers
- Investors

What is 'the public interest'?

The public interest can be defined as that which supports the good of society as a whole (as opposed to what serves the interest of individual members of society or of specific sectional interest groups).

- For an accountant, acting in the public interest is acting for the collective well-being of the community of people and institutions that it serves.
- Public interest concerns the overall welfare of society as well as the sectional interest of the shareholders in a particular company. It is generally assumed, for example, that all professional actions, whether by medical, legal or accounting professionals, should be for the greater good rather than for sectional interest.

Defining 'public interest'

There is much debate over a definition of the term 'public interest' however; the public interest is normally seen to refer to the 'common well, being' or 'general welfare.'

Public interest versus human rights

Acting in the public interest may seriously affect the idea of human rights, i.e. the degree to which members of society are allowed to act on their own. One view is that individuals should be free to act, as long as those actions do not harma other individuals.

The public interest and human rights will clash where:

- The action of an individual adversely harmas other members of society, and
- Actions of the state adversely affect some or all members of society.

Public interest and companies

The concept of public interest may affect the working of an organization in a number of ways:

- The actions of a majority of the shareholders may adversely affect the minority shareholders.
- The actions of the organization itself may be harmful to society.

Public interest and legal cases

In law, public interest is a defense to certain lawsuits.

Accountants and the public interest

- Accountants do not generally act against the public interest.
- The ethical code applicable to most accountants confirms that such action is not morally appropriate.

An area of particular relevance to accountants will be that of disclosure of information:

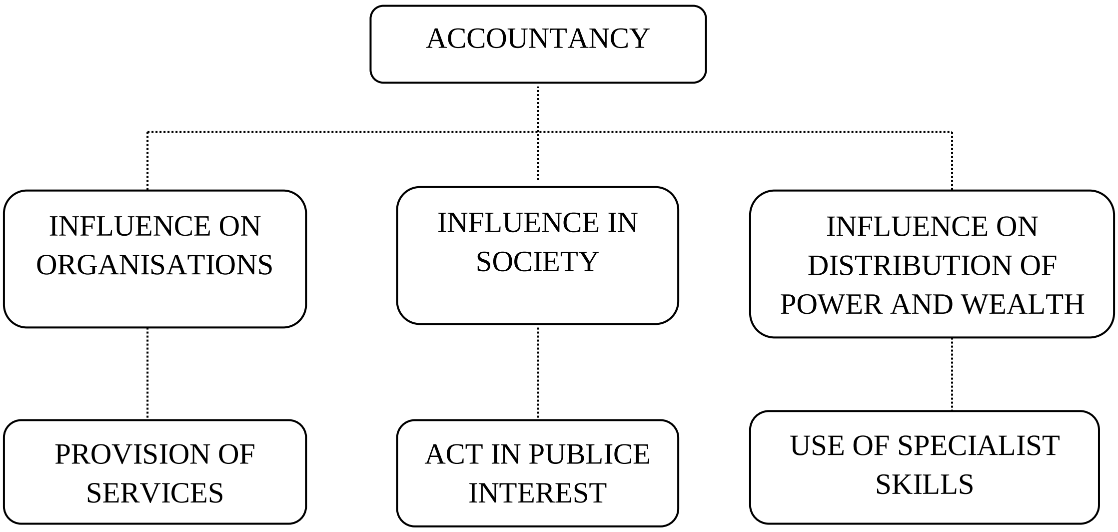
- The concept of acting in the public interest tends to apply to providing information that society as a whole should be aware of.
- In many cases 'public interest' disclosures is used to establish that disclosure is needed although there is no law to confirm this action.
- This can affect companies where they are acting against the public interest as disclosure may well be expected.

Disclose or not?

The accountant will need to evaluate each situation on its merits and then justify the outcome taken:

- In some situations lack of disclosure may be against the public interest
- In other situations, disclosing information may be against the public interest, and such information should be kept confidential to avoid harm to society.

Accountants' role and influence



Influence on organizations

- The influence of the accountancy profession on organizations is potentially very significant.
- This is largely due to the range of services that accountants can provide, including:
  - Financial accounting
  - Audit
  - Management accounting

- Taxation advice
- Consultancy

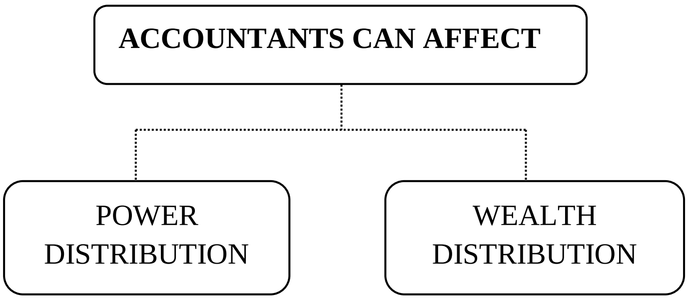
Limitations on influence

The influence of accountants is limited regarding ethical and other areas by the following factors:

The extent of organizational reporting, particularly with regards to organizations in financial difficulties

- Conflicts of interest in selling additional services
- Long-term relationship with clients
- Overall size of accountancy firms
- Focus on growth and profit.

Influence on power and wealth distribution



- Accountants have specialist skills and knowledge which can be used in the public interest.
- Society may have the objective of obtaining a more equal distribution of power and wealth.
- Given their abilities, accountants can probably advice on how that power and wealth can be distributed.

Distribution of power and wealth

Accountants may be able to influence the distribution of power and wealth in society in the following ways:

- Ensuring that organizations comply with legislation regarding payment and disclosure of directors' emoluments
- Advising the government on different tax regimes that may appear to be more equitable than others

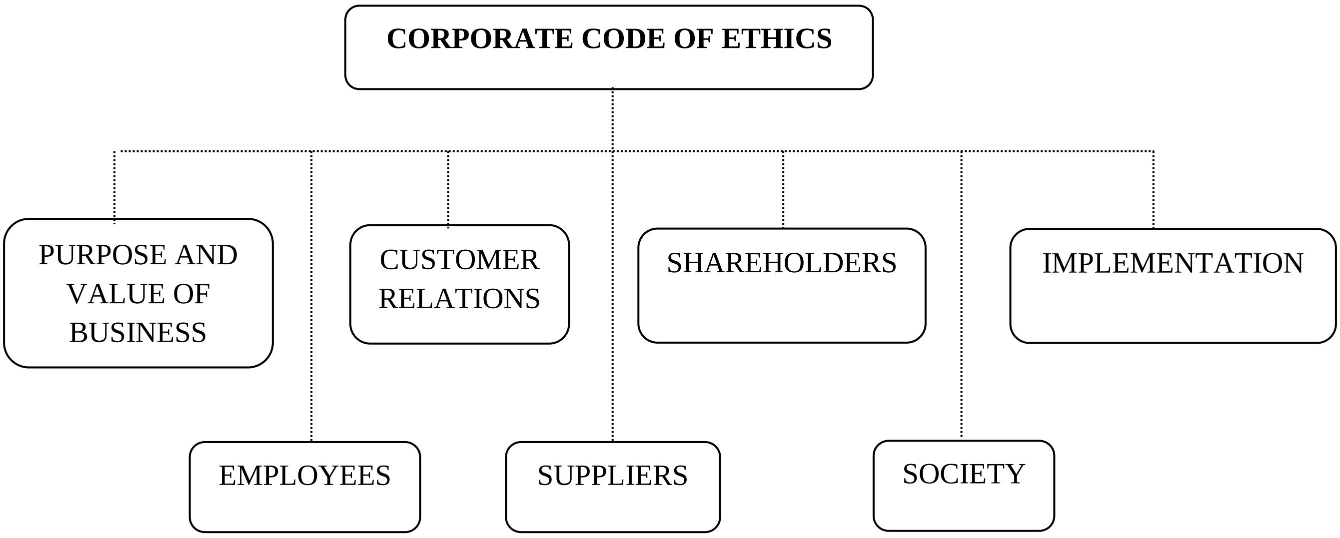
- Advising on the contents of Companies Acts
- Whistle blowing on the illegal actions of company officials.

This list is obviously incomplete!

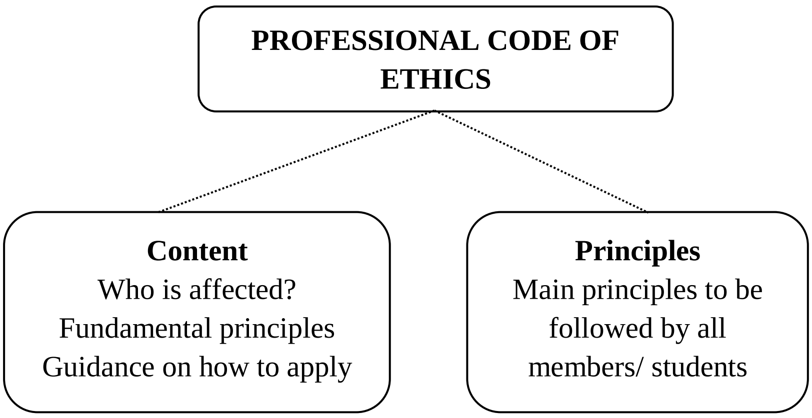
Corporate Codes of Ethics

Corporate ethics relates to the application of ethical values to business behavior.

- It encompasses many areas ranging from board strategies to how companies negotiate with their suppliers.
- It goes beyond legal requirements and is to some extent therefore discretionary.
- Many companies provide details of their ethical approach in a corporate and social responsibility (CSR) report.
- Key areas included in a code of corporate ethics:



Professional Code of ethics



Principles

Behind a professional code of ethics, there are underpinning principles, the main ones being:

- Integrity
- Objectivity
- Professional competence
- Confidentiality, and
- Professional behavior

FUNDAMENTAL ETHICAL PRINCIPLES

- Integrity
  Members should be straight forward and honest in all professional/ business relationships
- **Objectivity**
  Members do not allow bias or conflict of interest in business judgments
- **Competence**
  Duty to maintain professional knowledge and skill at appropriate level
- **Confidentiality**
  Information on clients not disclosed without appropriate specific authority
- **Professional behavior**
  Member must comply with relevant laws and avoid actions discrediting the profession

- Principles apply to all members, whether or not they are in practice
- The conceptual framework provides guidance on how the principles are applied.
- The framework also helps identify threats to compliance with the principles and then applies safeguards to eliminate or reduce those threats to acceptable levels.
- Five fundamental principles (taken from the ACCA code of conduct) are shown above.

Integrity

Integrity implies fair dealing and truthfulness.

Objectivity

Accountants need to ensure that their business / professional judgment is not compromised because of bias or conflict of interest.

Professional competence and due care

There are two main considerations under this heading:

(1) Accountants are required to have the necessary professional knowledge and skill to carry out work for clients.
(2) Accountants must follow applicable technical and professional standards when providing professional services.

Confidentiality

The principle of confidentiality implies two key considerations for accountants:

(1) Information obtained in a business relationship is not disclosed outside the firm unless there is a proper and specific authority or unless there is a professional right or duty to disclose.
(2) Confidential information acquired during the provision of professional services is not used to personal advantage.

The main reasons for disclosure are when it is:

(1) Permitted by law and authorized by the client
(2) Required by law, e.g. during legal proceedings or disclosing information regarding infringements of law
(3) There is professional duty or right to disclose (when not barred by law), e.g. Provision of information to the professional institute or compliance with ethical requirements.

Ethical considerations on disclosure

(1) The accountant needs to consider the extent to which third parties may be adversely affected by any disclosure.
(2) The amount of uncertainty inherent in the situation may affect the extent of disclosure – more uncertainty may mean disclosure is limited or not made at all.
(3) The accountant needs to ensure that disclosure is made to the correct person or persons.

Professional behavior

Accountants must comply with all relevant laws and regulations.

Conflicts of interest and ethical threats

PROFESSIONANL CODE OF ETHICS

Conflicts of interest
Self-interest
Self-review
Advocacy
Familiarity
Intimidation

Safeguards
Profession
Work environment
Individual

Conflict resolution
Obtain all necessary information
Consider courses of action

Ethical threats and safeguards

An **ethical threat** is a situation where a person or corporation is tempted not to follow their code of ethics.

An **ethical safeguard** provides guidance or a course of action which attempts to remove the ethical threat.

Ethical dilemmas and conflict resolution

Rules and principles based approaches

ETHICAL DILEMMA

RULES-BASED APPROACH

PRINCIPLES-BASED APPROACH

- Most professional institutes use a principles- based approach to resolving ethical dilemmas.
- Use of a rules-based approach is normally inappropriate as rules cannot cover every eventuality.

Rules and principles- based approaches

Rules-based approach	Principles-based approach
(1) Establish ethical rules that members must follow	(1)Establish fundamental ethical principles that members must follow.
(2) Ensure members are aware of the rules	(2)Ensure members are aware of the principles.
(3) Ensure members comply with those rules.	(3)Require members to identify and address threats to compliance with the principles and make an appropriate response to mitigate each threat.

Ethical conflict resolution

Ethical conflicts can be resolved as follows:

(1) Gather all relevant facts.
(2) Establish ethical issues involved.
(3) Refer to relevant fundamental principles.
(4) Follow established internal procedures.
(5) Investigate alternative courses of action.
(6) Consult with appropriate persons within the firm.
(7) Obtain advice from professional institute.
(8) If the matter is still unresolved, consider withdrawing from the engagement team/ assignment/role.

Corruption and Bribery

What is corruption?

Corruption is behavior in relation to persons entrusted with responsibilities in the public or private sector which violates their duties and is aimed at obtaining undue advantages of any kind for themselves or for others.

The main forms of corruption, embezzlement, fraud and extortion

Examples include but are not limited to

Bribery, including excessive ‘hospitality’

Facilitation payments

Facilitation payments are additional payments to induce officials to perform routine functions they are otherwise obligated to perform. For example, additional payments to customs officials so they priorities processing the import of your goods

Note: you can pay for legally required administrative fees or fast-track services. These are not facilitation payments.

- Buying votes
- Illicit payments to political parties
- Misappropriation of public funds

Why corruption is wrong- the business argument

Legal risks

- Regardless of what form a corrupt transaction may take, there are obvious legal risks involved.

Reputational risks

- Based on the experience of recent years, companies whose policies and practices fail to meet high ethical standards, or that take a relaxed attitude to compliance with laws, are exposed to serious reputational risks.

Financial costs

- There is now clear evidence that in many countries corruption adds upwards of 10 per cent to the cost of doing business and that corruption adds as much as 25 per cent to the cost of public procurement.

Pressure to repeat-offend

- There is growing evidence that a company is less likely to be under pressure to pay bribes if it has not done so in the past. Once a bribe is paid, repeat demands are possible and the amounts demanded are likely to rise. Zero tolerance is the only practical solution.

Blackmail

- By engaging in corrupt practices, company managers expose themselves to blackmail. Consequently the security of staff, plant and other assets are put at risk.

Impact on staff

- If a company engages in or tolerates corrupt practice, it will soon be widely known, both internally and externally. Unethical behavior erodes staff loyalty to the company and it can be difficult for staff to see why high standards should be applied within a company when it does not apply in the company's external relations. Internal trust and confidence is then eroded.

Impact on development

- It is now clear that corruption has played a major part in undermining the world's social, economic and environmental development. Resources have been diverted to improper use and the quality of services and materials used for development seriously compromised.

Evaluating anti-bribery and corruption (AB & C) procedures

The UK Act sets out six principles to help a business decide if they need to introduce changes.

(1)Proportionality

- Any action your business takes to introduce procedures only needs to be in proportion to the risks your business faces.

(2)Top-level commitment

- The ministry of justice (MoJ) advises that your business will need to show that it has been active in ensuring that staff and key business contacts understand that you do not tolerate bribery.

(3)Risk assessment

- This shows you have considered the possible risks you face as a company, especially if you are entering into new business arrangements.

(4)Communication

- Communicating your policies and procedures to staff and others who will perform services for you.

(5)Due diligence

- Knowing who you are dealing with can help protect business – so it's advised that you do a few checks and ask a few questions before engaging others to represent you in business.

(6)Monitoring and review

- You may want to keep an eye on any anti-bribery steps you take so that they keep pace with any changes in the risks your business faces.

Barriers to implementing AB & C policies

A number of obstacles can be thrown up, or unwittingly created, when implementing AB & C policies:

Competitive advantage

- The most obvious is the belief that new policies are a tedious and unnecessary chore, together with the fear that unscrupulous competitors will break any rule to win.

Managerial apathy

- Chief executives and finance directors may argue that they deal with risks every day and do not need new systems to spot bribery and corruption.

Off-the-shelf solution

- Many firms implement policy and off-the-shelf procedures before (or in place of) assessing their own unique circumstances.
- For example, some companies operating in France have set up whistle blowing hotlines without realizing that French law makes them potentially illegal.

Corporate structures

- Decentralized organizations may have more complex issues to address, as do firms with far flung offices.
- For example, many firms with distant operations tend to focus on the needs of the centre, rather than the local operations, making it more difficult to ensure that your

sales team in, say, china, is following policy. A silo mentality can also get in the way because people tend to compartmentalize risk-financial, operational etc-rather than considering cross-cutting dangers.

“Shadow” hierarchies

- The real dynamics of internal control are sometimes different from what appears on an organizational chart. Individual employees can wield power well beyond their formal spheres of responsibility. Shadow power networks not only facilitate bribery, they may have arisen in order to conceal it.

Excessive pressure to hit targets

- Internal controls can become marginalized in a culture of immediate results.

Cultures of secrecy

- Excessive sensitivity about disclosure can prevent one part of a business from learning about incidents that have occurred elsewhere. Secrecy always works to the advantage of the corrupt employee or associated party.

Heterogeneous cultures

- Problems can occur where any staffs do not share the values of the organization. Such situations can arise from mergers and acquisitions, rapid expansion, poor training of new staff or from inadequate supervision of overseas offices.

Criminal liability

- The legislation makes paying or receiving a bribe, bribing a foreign official and failing to prevent bribery at corporate level criminal offences.

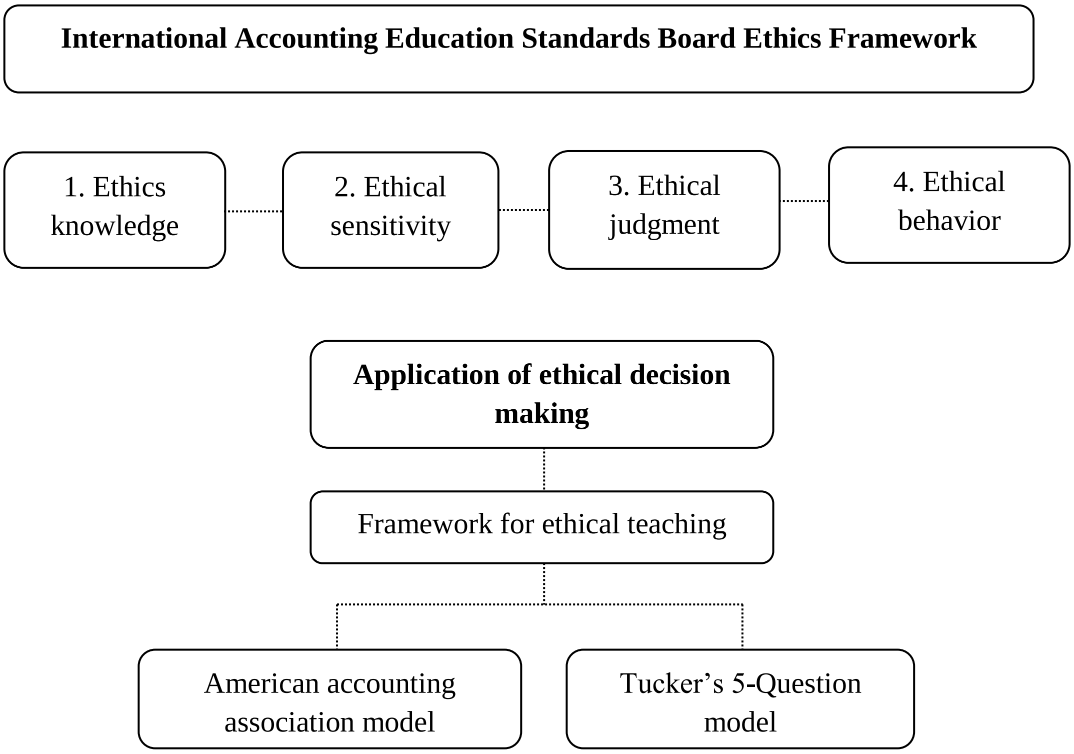
Examples:

- If a senior person, like an MD, commits a bribery offence.
- If someone, like an employee or agent, pays a bribe in order to win business for the company, to retain it or to gain a business advantage.

Defence

- However, it is a defence to show that you had adequate procedures in place to prevent bribery. The Act thus forces firms to look at bribery and corruption as key business risks that need effective corporate governance and control systems to mitigate.

Ethical decision making



American accounting association (AAA) model

The American Accounting Association model provides a framework within which an ethical decision can be made.

The seven questions in the model are:

(1) What are the facts of the case?
(2) What are the ethical issues in the case?
(3) What are the norms, principles and values related to the case?
(4) What are the alternative courses of action?
(5) What is the best course of action that is consistent with the norms, principles and values identified in step 3?
(6) What are the consequences of each possible course of action?
(7) What is the decision?

Tucker's 5-question model

Tucker provides a 5-question model against which ethical decisions can be tested. It is therefore used after the AAA model shown above to ensure that the decision reached is 'correct'. Is the decision:

- Profitable?
- Legal?

- Fair?
- Right?
- Sustainable or environmentally sound?

Ethical behaviors

ETHICAL BEHAVIOUR

ISSUE-RELATED FACTORS
Moral intensity
Moral framing

CONTEXT-RELATED FACTORS
Rewards
Authority
Bureaucracy
Work roles
Norm/ culture
National context

Accountants are normally expected to behave ethically. However, that behavior also depends on:

- The nature of the ethical issue –issue-related factors, and
- The context in which the issue takes place – context-related factors.

Moral intensity/ Moral Stance

The factors affecting moral intensity are shown below.

CONCENTRATION OF EFFECT
Whether effects of action are concentrated on a few people or affect many people a little.
E.g. Concentration on a few increases intensity

PROXIMITY
The nearness the decision maker feels to people affected by the decision.
E.g. being 'nearer' increases intensity

TEMPORAL IMMEDIACY
How soon the consequences of any effect are likely to occur.
E.g. Long time delay lowers intensity

FACTORS AFFECTING MORAL INTENSITY / MORAL STANCE

MAGITUDE OF CONSEQUENCE
Sum of the harms or benefits impacted by the problem or action
E.g. Financial loss caused by faulty advice

SOCIAL CONSENSUS
Degree to which people agree over the ethics of a problem or action
E.g. Act deemed unethical by others

PROBABILITY OF EFFECT
The likelihood that harms (or benefits) will actually happen
E.g. Higher probability = higher intensity

Contextual factors

Factor	**Effect on ethical decision making**
Systems of reward	Where rewards are based on achievement (e.g. number of sales made) then ethical decision-making may be affected. Unethical decision making may also increase where unethical behavior is unpunished or even supported by the organization.
Authority	Junior managers tend to follow instructions from senior managers. Where senior managers make unethical decisions these are likely to be followed by juniors. Senior management may also promote a climate where unethical decision-making is accepted.
Bureaucracy	Bureaucracies tend to make employees follow rules rather than think about the ethics of decisions being made. More bureaucracy may therefore mean a lower level of ethical decision-making-although this depends on authority-see above.
Work roles	Managers tend to follow the ‘work role’ expected-hence an ethical role such as an accountant will normally find managers behaving ethically-because that is expected. In other roles where ethics are believed to be compromised regularly, managers will usually also behave less ethically.
Organizational group norms and culture	Managers tend to share the norms of the group they are in, so what may be described as unethical behavior overall may be ‘ethical’ for the group. E.g. A group may decide that copying work-related software at home is ‘ethical’ and therefore all members of the group participate in this behavior.
National and cultural context	Different countries or cultures will have different ethics. Whether a decision is ethically correct or not may therefore depend on the specific culture.

Chapter 18

Organisation Structure

1. Factors affecting organisational structure

- strategic objectives – for facilitation
- nature of the environment – dynamic, complex
- diversity – small (or) MNC
- future strategy – acquiring other technology – IT impact
- people – managerial skills

TYPE	ADVANTAGES	DISADVANTAGES
Entrepreneurial	• Quick flexible decisions • Goal congruence	• Too slow for large companies • Lack for career structure for staff (demotivation) • Too many decisions for one person • Lack of specialism/
Functional (Bureaucratic)	• Specialisation is efficient • Good career opportunities and extra responsibilities	• Empire building • Conflict between functions (i.e lack of goal congruence) • Problems if product base expands (people are too specialised) • Bureaucratic/ inflexible/slow to adapt • Lack of communication between functions

TYPE	ANVANTAGES	DISADVANTAGES
Division	• Decisions taken at point of action (so quicker/better) • Increased staff motivation • Senior management concentrate on overall strategy	• Top management's level of control • Conflict between divisions e.g. transfer prices • Extra costs through repetition prices

	• Training ground for future top management • Flexible • Aids responsibility accounting (e.g. can separately appraise each division) • Can cope better with diversification than a functional structure	• Extra costs through repetition of functions e.g. marketing • Conflict over shared costs e.g. personnel • Lack of goal congruence • Can be harder to have consistent generic strategy
Matrix	• Customer has single point of contact • Customer can have bespoke service or product • Interfunctional communication enhanced • Staff motivation can be improved through variety of work and challenges • Very flexible (can easily react to changes in both the internal and external environments)	• Functional managers' expertise is 'diluted' – spread over many projects • Staff are serving two masters' conflict, role ambiguity, role overload • Time-consuming meetings and higher administrative costs

<u>Centralisation v decentralization</u>

One factor in determining the flexibility of a structure is the level at which decisions are made. The functional structure is likely to be centralized, and the divisional structure is likely to be decentralized.

- is more likely in large-scale organizations
- gives authority to make specific decisions to units and people at lower levels in the organization's hierarchy

- allows front-line staff to respond flexibly to customer demands without reference upwards to senior management
- allows local management (of dispersed units) to respond flexibly to local market conditions without reference upwards to head office.

Advantages and disadvantages

Advantages of centralisation are:

- less sub-optimising
- conformity with overall objectives – goal congruence
- standardisation
- balance between functions, divisions
- economies of scale
- top managers become better decision makers
- speedier central decisions

Disadvantates

- reduced job satisfaction
- do not possess sufficient knowledge of all organisational activities
- places stress and responsibility onto senior management
- restricted opportunity for career development toward senior management positions
- restricts the flexibility of the organisation

2 Mintzberg's structural configurations

Building blocks and coordinating mechanisms

Mintzberg argues that the organisation structure exists to co-ordinate the activities of the different individuals and work processes and that the nature of co-ordination changes with the increasing size of an organisation. He suggests that there are six main types of structure with configurations based on the following building blocks

- strategic apex – higher levels of management
- techonostructure – provides technical input that is not part of the activities
- operating core – members involved in producing goods and services

- middle line – middle and lower-level management
- support staff – support that is not part of the operating core
- ideology – beliefs and values

Mintzberg's configurations

	Environment	**Internal**	**Key building block**	**Key co-ordinating mechanism**
Simple structure	Simple / dynamic	Small Young Simple tasks	Strategic apex	Direct supervision
Machine bureaucracy	Simple / static	Large Old Regulated tasks	Techno-structure	Standardisation of work
Professional bureaucracy	Complex / static	Professional control Simple systems	Operating core	Standardisation of skills
Divisionalised	Simple / static Diverse	Very large Old Divisible tasks	Middle line	Standardisation of output
Adhorcracy	Complex/dynamic	Young Complex Tasks	Support staff	Mutual adjustment
Missionary	Simple/static	Middle-aged Simple systems	Ideology	Standardisation of norms

Link between the structure and the building blocks

As the business and its structure grow, different building blocks develop and can become more important:

Building block	**What they want**	**What they provide**	**Structure in which they dominate**
Strategic apex	Direction	Supervision	Simple
Technostructure	Efficiency	Procedures and standards	Machine bureaucracy
Operating core	Proficiency	Expertise and skills	Professional bureaucracy
Middle line	Concentration	Focus and control	Divisional
Support staff	Learning	Help and training	Adhorcracy

Combination structures

Care should be taken when combining structures or imposing structures on new business units, as conflicts might arise between the different building blocks. For example, if a business with a machine bureaucracy (and therefore lots of rules, standardisation and controls) where to acquire an adhorcracy (where the balance between the blocks is more even, and there is flexibility in the application of rules and controls), there may be difficulties both in achieving business objectives and in motivating staff.

3. Classification of control processes

- formal or informal
- focused on inputs or on outputs
- direct or indirect processes

Formal control process

Examples of control processes include:

- 'all enquiries are to be processes within 48 hours of receipt'
- Quality sampling to ensure process meets specification
- The budgeting process

Generic control processes

- Direct supervision
- Planning processes
- Performance management using targets based on key performance indicators
- Internal market processes such as transfer pricing
- The culture of the organisation, as training and personal development
- Self-control by individual employees – where leadership support frameworks to work independently

4 Managing international companies

Reasons why companies pursue a strategy of international diversification

- Increasing opportunities from global markets
- Local markets are saturated or limited
- Risks may be spread
- Take advantage of different locations such as low labour costs

Driving and restraining forces for international expansion

Driving forces:

- Technology
- Culture
- Market needs
- Cost
- Free markets
- Economic integration
- Peace/political stability
- Management vision
- Strategic intent
- Global strategy and action

Restraining factors:

- Culture
- Market differences
- Cost
- National control
- Nationalism
- War
- Management myopia / short-sightedness
- Organisation history
- Domestic focus

Possible strategies for geographical diversification

- A multi-domestic strategy where products and services are tailored to individual countries and markets, with many activities specific to particular countries
- A global strategy, where standard products are sold in different countries
- A balance between the two above strategies, where products are largely global but have minor modifications to suit the requirements of individual countries. There will generally be a trade-off between scale economies and the need to tailor products or services to local markets

The different types of multinational structure

International Divisions

- home-based structure
- lack of local tailoring of products or technology
- work best where there is a wide geographical spread but quite closely related products

International subsidiaries

- geographically based and operate independently by country
- allowing for higher degrees of local responsiveness
- extent of global co-ordination is likely to be low
- failing to achieve synergy

Global product companies

- an integrated structure
- multinational is split into product divisions
- promote cost efficiency and enhanced transfer of resources
- Japanese companies in electronics and care manufacture has been managed in this way
- Benefits are not always realised well suited to promoting defensive or consolidation strategies not suited to the promotion of aggressive or expansionist strategies

Transnational corporations

- matrix-like structures that attempt to combine the local responsiveness of the international subsidiary
- a major strength is in transferring knowledge across borders
- the key lies creating an integrated network of interdependent resources and capabilities

Potential problems for transnational corporations

- managers must be able and willing to work hard to simultaneously improve their specific focus (e.g. region, product, function) as well as looking at the global picture
- The same control problems as found in matrices

5 Boundaryless organisations

Typical boundaries found in organisations are:

- Vertical boundaries
- Horizontal boundaries
- External boundaries
- Vertical boundaries: these are the levels of authority that exist within an organisation
- Horizontal boundaries: these are the boundaries that exist between functions in an organisation
- External boundaries: these are boundaries that exist between the organisation and the outside world, including customers and suppliers

There are three main types of boundaryless organisation:

- **The hollow structure** - where non-core activities are outsourced
- **The modular structure** – where some parts of product production are outsourced
- **The virtual structure** – where the organisation is made up of a collaboration of other organizational parts

Hollow structure: hollow organisations focus on their core competencies and outsource all other activities

Modular structure: modular organisations divide their product into manageable chunks and then order different parts from internal and external providers which the organisation then assembles into an overall finished product. For example, acellular phone company might design the product and build the chip, the software and the built-in apps themselves, but then outsources the production of the glass, the chassis, the gyroscope etc

Virtual structure: virtual organisations rely heavily on information technology to link people, assets and ideas to form an (often temporary) organisation. Links are formed with external partners (which may be whole organisations, a part of an organisation or simply a team of experts) where each partner brings their own domain of expertise. This expertise is combined together to achieve common goals. A virtual organisation appears as a single entity from outside to its customers, but it is in fact a network of different organisational nodes created to respond to an exceptional, and often temporary, market opportunity. Over time, the parts (or members) of the virtual organisation might change. Once the market opportunity evaporates or is fully exploited, the virtual organisation either disbands or is absorbed into the larger organisation.

This is a way of responding quicky to the market without having to develop new areas of expertise or new production capacity, say. It makes use of valuable expertise that may exist outside the organisation.

<u>Outsourcing, strategic alliances and other types of networks</u>

Outsourcing

Outsourcing plays a key role in the boundaryless organisation. It can be typically have the following advantages and disadvantages:

Advantages

- reduced cost
- overcome skills shortages
- outsourcing can bring flexibility
- focus on their core skills and activities
- risks is not direct management control over providing the services

Disadvantages

- Dependency on supplier for the quality of service provision
- A risk of loss of confidentiality
- Difficulties in agreeing and enforcing contract terms
- The length of contract (the risk of being 'local in')
- Lost in-house expertise and knowledge
- A loss of competitive advantage
- Outsourcing might be seen by management as a way of off-loading problems rather than as a way of managing

Off shoring is the outsourcing of a business process to another country. For example, Apple offshore the assembly of the iPhone to China because, even with transport delays, production is still quicker than having the unit assembled in the US. But many organisations are reversing the trend (moving to in-shorting) as political and social pressure is building to protect domestic jobs.

Strategic alliances

Strategic alliances can take many forms, from loose informal agreements, partnerships and formal joint ventures to contracting out services to outside suppliers within a boundaryless organisation.

- Strategic alliances are co-operative business activities, formed by two or more separate organisations for strategic purposes,
- Ownership, operational responsibilities, financial risks and rewards are allocated to each member, while preserving their separate identity and autonomy.
- Strategic alliances are long-term collaborations brings together the strengths of two or more organisations to achieve strategic goals.
- Alliances can also help result in improved access to information and technology.
- Strategic alliances may be used to extend an organisation's reach without increasing its size.

Networks

- Networks of experts which come together for a particular project or purpose, either on a short or long-term basis.
- Teleworking, where individuals are bases in different locations but work together through the use of information technology.
- One-stop-shops, where a group of organisations are co-ordinated centrally with the aim of providing a comprehensive and seamless service.
- Service networks, where the members of the network provide services to customers through any other members of the network.

Shared services

A shared service refers to the centralisation of a service (or services) that has previously been carried out remotely at each business unit. Examples: areas of IT and accounting.

Shared services will still be carried out within the organisation and will not require the use of a third party external organisation.

Shared services go beyond a simple 'back officing' of common services. The shared services is typically treated as a separate and discrete business unit its services are charged to other business units at arm's length prices.

The **POPIT model** will play a key role in moving to a shared service system.

Business process change

Harmon's process-strategy matrix

According to Paul Harmon a process-strategy matrix is a matrix formed by an estimate of:

- the **strategic importance** of a process on the horizontal axis

- the process **complexity** and dynamics on the vertical axis

The matrix can be used to determine how to manage individual processes.

	Strategic importance	
	Low	**High**
High	Outsource	Undertake process improvement
Complexity		
Low	Minimum effort	Automate

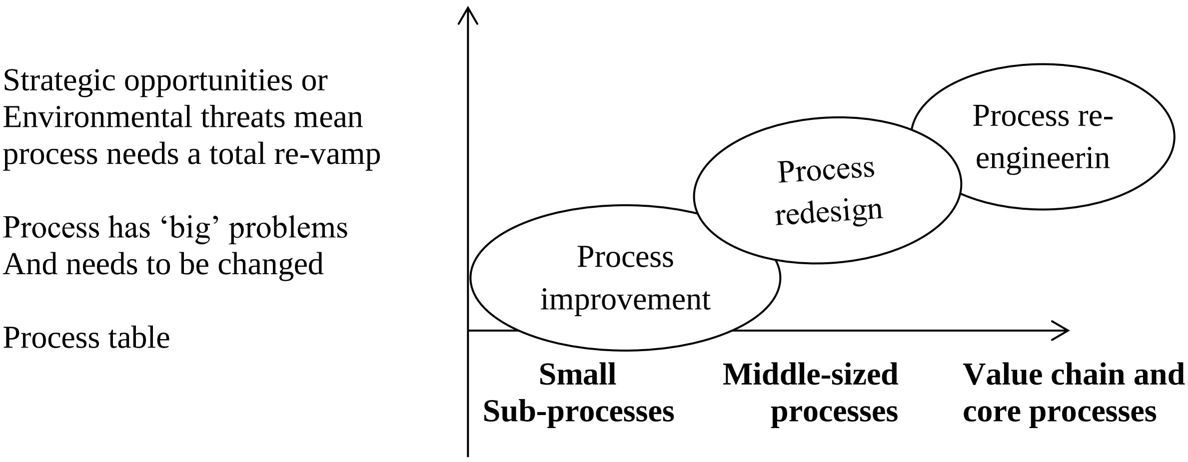
Further explanation on Harmon's matrix

	Strategic importance	
	Low	**High**
High **Process Complexity Dynamics**	Complex processes but not part of company's core competency • outsource	Complex dynamic processes of high value and strategic importance. They provide competitive advantage • Undertake process improvement effort that focuses on people.
Low	Straightforward, static commondity processes • use automated ERP type of application and / or outsource • use minimum resources necessary for efficient functioning	Straightforward, static and valuable Automate to gain efficiency
	Must be done but adds little value to products or services	**Very important to success, high value added to products or service**

2 Improving the processes of an organisation

Process redesign often called Business Process Re-engineering or Redesign (BPR), Business Process Management (BPM) or Business Process Improvement (BPI) takes a 'clean sheet' approach to the process which is usually either broken, or so slow that it is no longer competitive in delivering the company's value to its customer.

The range (or levels) of opportunities include the following:



- if a process is relatively stable and the goal is to make incremental improvements, then the term 'process improvement' is used.
- at the other extreme if a major (core) process needs radical redesigning, then the term 'process re-engineering' is used.
- the term 'process redesign' is used for any processes that fall between these two extremes.

Typical causes of problems in processes

- activities are unnecessary
- activities are in the wrong order
- activities are in the wrong swim lane
- activities are missing
- activities take too long

Typical solutions in processes

- removing swim lanes
- removing unnecessary activities
- combining job roles
- combining activities
- reducing handovers between swim lanes
- changing the order of activities
- outsourcing activities

Business process redesign methodology

Process redesign will need to be managed as a formal project. Harmon recommends a five-stage generic business process redesign methodology:

1	Planning a process redesign effort	• Identity goals • Define scope • Identify personnel • Devise a general plan for the redesign
2	Analysis of an existing process	• Document workflow • Identify problems • Devise a general plan for the redesign
3	Design of a new or improved process	• Explore alternatives and choose best redesign to achieve goals
4	Development of resources for an improved process	• Make products better, easier to manufacture and maintain • Redesign managerial and supervisory jobs and develop measurement system to monitor new process • Redesign jobs, work environment and incentive system' develop training; hire new employees if necessary
5	Managing the implementation of the new process	• Integrate and test • Train employees, arrange management • Maintain process and modify as needed

Range of process redesign patterns

- Re-engineering – start with a clean sheet of paper and question all assumptions.
- Value-add analysis – try to eliminate all non-value-adding activities. Porter's value chain model covered in chapter 5 may be particularly useful here.
- Simplifaction – try to simplify the flow of the process, eliminating duplication and redundancy.
- Gaps and disconnects – a process redesign pattern that focuses on checking the handoffs between departments and functional groups in order to assure that flows across departmental lines are smooth and effective.

3 Software solutions

Establishing business information needs

Technique	Suitability
• Interviewing	• Standard technique for most scenarios
• Written questions	• Where people are not available for interview
• Questionnaires	• Where the user population is too large to interview • Generally unsuitable due to superficial nature of questions and lack of interaction
• Observation	• Particularly useful if carried out before interviewing
• Document analysis of existing	• Good source of design and analysis material
• Workshops	• Useful for resolving conflicts and for new processes where high uncertainty exists
• Protocol analysis – a mixture of interview and observation	• Ensures all aspects of the process are considered and none 'taken for granted' by users
• Prototyping	• Where requirements are unclear • Helps users reassess their desired functionality

Using generic software solutions

The advantages and disadvantages of generic solutions are as follows:

Advantages	Disadvantages
• They are generally cheaper to buy than bespoke solutions are to develop • They are likely to be available almost immediately • Any system bugs should have been discovered by the vendors before sale • Good packages are likely to come with good training programs and excellent documentation and on-screen help facilities • New updated versions of the software are likely to be available on a regular basis • The experience of a great number of users with similar needs to those in the organisation has been incorporated into the design of the package	• They do not fit precisely the needs of the organisation – the users may need to compromise what they want with what is available • The organisation is dependent upon an outside supplier for the maintenance of the software; many software suppliers are larger than most of their customers, and are the therefore difficult to influence • Different packages used by the organisation may have incompatible data structures • Using the same packages as rival organisations removes the opportunity of using IS for competitive advantage

• Different packages will be available for different operating systems or data structures	

Evaluating and selecting a generic software solution

In evaluating different options, both the software and the supplier need to be assessed.

Choosing software

In evaluating the software the following factors should be assessed as a minimum:

- where the software will match the expected organisational and user **requirements**
- the level of **flexibility** in adapting the software as these requirements change
- the **competencies** of the organisation is using and exploiting the software
- the availability of **future** updates and ongoing support and maintenance
- the **compatibility** with existing hardware and software
- the provision of **training,** user manuals and / or online help
- the interface design and **user-friendliness** (referred to as the non-functional requirements)
- the **cost** of the software and the ease of implementation / transfer
- security and **controls** over access to the software

Choosing a supplier

Before tying the organisation into a particular supplier, the procurement manager should consider the following (as a minimum) for each prospective supplier:

- long-term **viability** (this could include obtaining records of financial performance and position)
- length of **time in business**
- **references** from previous customers
- **ethical** standards (this might include an assessment of the directors and any potential links to our own organisation)
- availability of **demonstrations**
- the ability to provide guarantees and **warranties** for non-compliance, later delivery, failure to meet functional and non-functional requirements etc.
- security and **controls**
- **copyright** (for bespoke solutions)
- **user base** (for generic solutions)
- **maintenance** and after-sales support

Solving problems in purchased software

- the provision of future updates,
- obtaining a tailored version of the software, or
- seeking a manual work-around

Systems development risks

- they fail to satisfy the user's real requirements: the system was specified incorrectly
- they do not provide the data processing or information for which they were designed, or to the quality expected
- the system was therefore designed and programmed incorrectly
- they cost much more to develop and run than expected. The system is therefore less efficient than expected

Implementation

- data migration – transferring data from the old system to the new
- training – training staff on the new system
- changeover – introducing the new system to the business operations

Data migration

Some of the stages include:

- Planning
- Data mapping
- Manual input
- Testing the solution
- Implementing the solution

Training

Methods of training

- **External courses**
- **Internal courses**
- **Computer based training**

Changeover technique

- Parallel running
- Direct changeover
- Phased
- **Parallel running**
  This is when the new and the old system run side by side for a period of time. It is known as the high-cost low-risk approach.

- **Direct changeover**
  This approach is when the old system immediately finishes and the new takes over; confidence will be high in the new information. It is known as the high-risk low-cost approach.
- **Phased**
  This is when the new information system can be introduced part by part or stage by stage. It must be remembered that the phase can be either direct or parallel in each of the stage.

Generic software solutions and business process redesign

Competitive advantage

Firms seek to redesign processes to increase their competitive edge. By using generic software packages they may be able to match the best practice of competitors who also use the software, but are less likely to outperform the.

As opposed to the BPR approach explained in this chapter, the RTP (Enterprise Resource Planning) driven approach to software solutions occur in reverse order. In effect, businesses start with the solution and then modify processes.

CHAPTER 19

The role of information Technology

1 Information technology – the strategic context

Business strategy and information strategy

Link to strategic analysis

Porter suggested three ways in which IT in general can affect the competitive environment and an organisation's ability to compete. Though these points apply to IT in general, they are particularly important when considering ebusiness.

- The products offered having a uniqueness of brand, technical performance or design not available elsewhere.
- New businesses might become possible. For example, auction sites and photo album sites.
- The industry structure can be changed. For example, in the music business it can be argued that the large CD publishers have less power because music can be self-published on the internet.
- IT can provide an organisation with competitive advantage by providing new ways of operating. For example, airlines save money by encouraging internet bookings

It could lead to new strategic choices

IT can, for example, support new competitive strategies Porter identified three generic strategies for dealing with the competitive forces. The two basic strategies are overall cost leadership and differentiation. The third strategy – a focus strategy – concentrates on a particular segment of a product line or geographical market – a niche. If it is known which strategy an organisation is currently using to promote their products and/or services, it should be possible to define a role for IS to enhance that strategy.

How IT can play a role in generic strategies

- Overall **cost leadership** is about competing by offering products or services at low cost and value for money. The emphasis is on cost reduction. For example, driving down inventory levels, with the assistance of IT for supply chain planning and scheduling, can reduce costs. Sales forecasting software that can be fed into manufacturing resources planning applications can be used in shop floor planning and scheduling applications to increase efficiency.
- **Differentiation** is about showing that your product or service is different from those of your competitors through, e.g. brand image, customer service or design. A way of differentiating may be to make the ordering process as easy and flexible as possible. This can be done by providing online information services to identity the most appropriate product or service, followed up by a simple online ordering process. Where the

differentiation is by customisation, CAD (computer aided design) can reduce costs effectively.

- **Focus.** This strategy concentrates on a niche market, e.g. a particular buyer group, market, geographic area, segment or product line. The opportunities for IS/IT include providing access to customer information, trends and competitors so as to maximise competitive thrust and exclude competitors.

Finally, IT can play a role it putting **strategy into action.** For example, we have already seen in the previous chapter how IT can play a vital role in process redesign efforts.

2 EBusiness

The meaning and use of ebusiness

Ebusiness has been defined as the transformation of key business processes through the use of internet technologies.

Ecommerce is a subset of ebusiness. The most generic description of ecommerce is trading on the internet, buying and selling products and services online.

The categories of ebusiness

- **B2B** (business to business). For example, a supermarket IS system automatically placing orders into suppliers' IS systems.
- **B2C** (business to consumer). Selling over the internet – books, flights, music, etc.
- **C2B** (consumer to business). Some internet sites display a selection of suppliers' offerings from which the user can choose. A model that largely depends on the internet.
- **C2C** (consumer to consumer). Auction sites, such as ebay, putting consumers in touch with each other. Amazon does the same by offering secondhand books. This model largely depends on the internet.
- **'Buy side' ecommerce**: focuses on transactions between a purchasing organisation and its suppliers.
- **'Sell side' ecommerce:** focuses on transactions between a purchasing organisation and its customers.

The stages of ebusiness

Stage	Characteristics
1 Web presence	Static or dynamic webpage but no transactions are carried out. Would show information about the organisation, product, contact details, FAQs (Frequently Asked Questions). Faster updates are possible than with paper-based information and could be cheaper than paper-based catalogues.
Ecommerce	Buying and selling transactions using ecommerce. Might cut out middlemen, but there is probably no fundamental change in the nature of the business.
Integrated Ecommerce	Integrated ecommerce. For example, information can be gathered about each customer's buying habits. This can allow the organisation to target customers very precisely and to begin to predict demand.
Ebusiness	Ebusiness is now fundamental to the business strategy and may well determine business strategy

Benefits of ebusiness

- Most companies employ ebusiness to achieve the following:
- Cost reduction – e.g. lower overheads, cheaper procurement
- Increased revenue – e.g. online sales, better CRM
- Better information for control – e.g. monitoring website sales
- Increased visibility
- Enhanced customer service – e.g. via extranets
- Improved marketing – e.g. emailing customers with special offers
- Market penetration – e.g. even small suppliers can gain a global presence via the internet
- The combination of the above should be to enhance the company's competitive advantage

Barriers to ebusiness

Barriers to ebusiness can be seen in both the organisation itself and in its suppliers and customers. They include:

- technophobia
- security concerns
- setup costs
- running costs
- limited opportunities to exploit ebusiness
- limited IT resources in house
- customers not likely to be interested in ebusiness.

Intranets and External internets

Intranets are internal internets. They exist inside the organisation only, using website and browser technology to display information.

Commonly they contain: information about customers

- information about products
- information about competitors
- news/updates
- procedure manuals

However, there's no reason why accounting information cannot be delivered over intranets. Extranets are intranets that are connected to external intranets. For example, a supplier could give customers access to their order processing system so that orders can be laced and tracked. It is when these types of external connection are made that ebusiness cab gegin to produce spectacular results.

The advantages of intranets and the Internet

- Employees have ready access to vast sources of external data that can help to improve the quality of decision making.
- Organisations can advertise their goods and services on a website, and provide other information that helps to promote their image.
- Organisations can use the Internet to purchase goods or supplies, saving time and money.
- The Internet/intranet provides a means of operating an email system. Communication by email is fast and should remove the requirement for excessive quantities of paper. Using emails might also reduce the non-productive time spent by employees on the telephone.
- Intranets create the opportunity for more flexible organisation of work. For example, employees who are away from the office can access the organisation's IT system and files

through the Internet. Similarly, employees can work from their home but have full access to the organisation's systems.

There are disadvantage with using intranets and the Internet.

- Email systems can become inefficient if too many messages are sent and users have to look through large amounts of 'junk mail' to find messages of value.
- Emails can be disruptive, especially if a prompt appears on an individual's computer screen whenever a new message is received.
- Senders of emails often expect an immediate reply to their messages, and a delay in responding can create bad feelings and illwill.
- Employees might waste too much time looking for information on the Internet, when the value of the information is not worth the time spent looking for it.

Without suitable controls, employees might spend large amounts of time on the Internet or exchanging emails for their personal benefit, rather than in carrying out their work responsibilities.

The greatest problem with using intranets and the Internet, however, is the vulnerability of the organisation's IT system to:

- unauthorised access by hackers, including industrial spies
- the import of viruses in attachments to email messages and other malicious software

Making websites interactive

Search

- Online forms
- 'Members only' section to the site
- Interactive questionnaires/surveys/polls
- Animations
- Subscription email lists
- Links to other sites
- Downloadable files
- Contact Us
- Site map
- Text only version of the site
- Multilingual requirements
- Provision for printing and bookmarking

3 Informal Technology risks

Computer systems have unique risk and control issues that need to be addressed by business. As with any risk factor the company needs to make an assessment of the risks and decide on the appropriate level of control to reduce the risks to an acceptable level.

Risks to a computer system

- Dissatisfied employees might deliberately modify or destroy information in the system.
- A hacker or industrial spy might break into the system.
- Viruses or malicious software could be introduced.
- Accidental mistakes could be made on input to the system.
- Inadequate security of the hardware or data.
- Faults in the hardware system.

Information security

Risks to information security can be categorised as follows:

- Data protection legislation-improper use of that data. In the UK, for example, rights are given to 'data subjects' by the Data Protection Act.
- Risks Description
    - ✓ Risk of hardware – theft
    - ✓ Physical damage to hardware and computer media (disks, etc)-malicious damage. Poor operating conditions causing damage to equipment and files, natural disasters, such as fire and flooding.
    - ✓ Damage to data- data can be damaged by hackers into the system, viruses, program faults. Program might be altered by a hacker or computer fraudster.
    - ✓ Operational mistakes
    - ✓ Fraud and industrial espionage
    - ✓ Erroneous input

4. Controls in an information systems environment

To combat the types or risks discussed above companies will put in place control procedures.

Alternative control classification

- **Security controls:** controls designed to ensure the prevention of unauthorised access, modification or destruction of stored data.
- **Integrity controls:** controls to ensure that the data are accurate, consistent and free from accidental corruption.
- **Contingency controls:** in the event that security or integrity controls fail there must be a backup facility and a contingency plan to restore business operations as quickly as possible.

General controls

- **Personnel controls**

Recruitment, training and supervision needs to be in place to ensure the competency of those responsible for programming and data entry.

- **Logical access controls**

Security over access is often based on a logical access system. This is illustrated by the following diagram: Passwords and user names are a way of identifying who is authorised to access the system.

- **Access logging**

The system will produce regular including a system access report and various predetermined exception reports. The effectiveness of these reports is determined by:

- The frequency of report production.
- The follow up of detected breaches in security

- **Audit trail**

An audit trail consists of a record or series of records that allows the processing of a transaction or an amendment by a computer or clerical system to be identified accurately, as well as verifying the authenticity of the transaction or amendment, including the identity of the individuals who initiated and authorised it. Audit trails are also used to recore customer activity in ecommerce on a company's website. The audit trail records the customer's initial access to the website, and then each subsequent activity (purchasing and payment, confirmation of order and delivery of the product). The audit trail can be used to deal with any subsequent enquiry or complaint from the customer. In some cases, 'audit trails' can be used to track down hackers into a system. A hacker might sometimes unknowingly leave a trail of where he came from, for example through records in the activity log of the hacker's Internet service provider.

- **Facility controls**
    - ✓ **Physical access**

There are various basic categories of controlling access to sensitive areas. These include:

- security guards in buildings
- working areas to which access is through a locked door or a door with an ID card entry system
- closed circuit TV
- doors automatically locked in the event of a security alarm.
- disks should not be left lying around on desks and working surfaces
- computer printout and disks should be shredded

✓ **Location of IT facilities**

It is imperative that the location of the system is considered, and hence all equipment is located so as to protect against

- Fire
- Flood
- Smoke
- Food
- Drinks
- Power Failure
- Environment

- Business continuity planning (disaster recovery planning)
- System backups

Application controls

These are controls to ensure that data are correctly input, processed and correctly maintained, and only distributed to authorised personnel.

Input controls:

- Checking and authorizing source documents manually.
- The use of batch controls.
- Pre-numbered forms.

Processing controls:

- Computer verification and validation checks.
- Error detection controls such as
- Control totals
- Balancing.

Output controls:

- Monitoring of control logs.
- Physical checking of output.

Software controls

Software control prevents making or installing unauthorized copies of software. Illegal software is more likely to fail, comes without warranties or support, can place systems at risk of viruses and the use of illegal software can result in significant financial penalties.

Software can be controlled by:

- Buying only from reputable dealers.
- Ensuring that the original disks come with the software.
- Ensuring that licences are received for all software.
- Retaining all original disks and documentation.

Network controls

The increase in popularity of the LAN (local area network) has brought concerns in relation to system security.

The main areas of concern are:

- Tapping into cables
- Unauthorised log in
- Computer viruses
- File copying
- File server security.

Controls

Controls must exist to prevent unauthorized access to data transmitted over networks and to secure the integrity of data.

Methods include:

- Firewalls
- Flow
- Data encryption
- Virus protection.

CHAPTER 20

Using IT successfully

Supply chain management (SCM)

Many businesses prosper or fail depending on the success of their relationship with their suppliers and with those who they supply. Businesses that rely on other businesses to this extent are in what is called a supply chain – each supplying each other right up to the final link in the chain, the consumer. The internet can help make this relationship work more effectively and efficiently.

A supply chain encompasses all activities and information flows necessary for the transformation of goods from the origin of the raw material to when the product is finally consumed or discarded.

This typically involves distribution of the product from the supplier to the manufacture to the wholesaler to the retailer and to the final consumer, otherwise known as nodes in the supply chain.

The transformation of product from node to node includes activities such as: While each firm can be competitive through improvements to its internal practices, ultimately the ability to do business effectively depends on the efficient functioning of the entire supply chain

- production planning
- purchasing
- materials management
- distribution
- customer service
- forecasting

Obviously, if e-business capability is present in all members of the supply chain, management of the chain is becoming more feasible: selling, delivering, ordering, designing and manufacturing can all be linked electronically permitting:

- cost savings
- time savings
- faster innovation
- better marketing
- better quality

<u>Managing the chain</u>

Active management of supply chain activities aims to maximize customer value and achieve a sustainable competitive advantage.

Managing the chain primarily therefore concentrates on managing the movement of the

- materials/inventory
- information
- funds

Inventory control

Amongst other things, this will include a consideration of:

- Number, location and size of warehouses and distribution centres
- Production scheduling (including life cycle management to ensure that new products can be successfully integrated into the chain)
- A transportation strategy (in terms of routes, timing etc.)

Information management

The key elements of information required for successful supply chain management include:

- potential levels of end-user and customer demand
- daily production and distribution plans
- resource availability and utilisation

fund management

for the system to work it needs to be sufficiently liquid at all nodes to ensure that bottlenecks are avoided and supply can be sustained. There also needs to be a strong relationship of trust between each party in the chain.

Importance of Information Technology

IT plays an obvious role in providing, storing, managing and interrogating the information management part of supply chain management. But IT can provide aid for all of the areas that require consideration through systems such as eprocurement and customer relationship management (covered in the next chapter), and there will also links to other areas of the syllabus such as BPR, project management, organisational structure etc.

Push and pull supply chain models

One key element in supply chain management is choosing between having a ‘push’ or a ‘pull’ model.

Push model

- Products are built, distributed, and ready for the customer demand.
- Product design is led by the manufacturer.

- Product quality is often determined by raw material suppliers and component manufacturers.
- There is little product personalisation to customers.
- Low setup costs and economies of scale are possible.
- Inventories are built up waiting for customers to demand them (a push system is sometimes referred to as a Make to Stock (MTS system)).

Pull model

- Planning for a product starts when the customer places the order and creates firm demand.
- Product design is often customer led (a pull system is sometimes referred to as a Make to Order (MTO system)).
- Personalisation of the product by the customer is possible.
- Inventory levels are minimized (systems such as JIT and TQM can be used).
- Lead times can be much higher.
- Setup costs are higher and economies of scale are not always possible.

The pull business model is less product centric and more directly focused on the individual consumer – a more marketing oriented approach.

- In the pull model, customers use electronic connections to pull whatever they need out of the system.
- Electronic supply chain connectivity gives end customers the opportunity to give direction to suppliers, for example, about the precise specifications of the products they want.
- Ultimately, customers have a direct voice in the functioning of the supply chain.

Upstream SCM

The key activity of upstream SCM is e-procurement.

Electronic Procurement (also known as e procurement) is the business to business to business purchase and sale of supplies and services over the internet. Its overall goal is to streamline the purchasing process in order to reduce costs, increase speed and allow managers to focus on other strategic matters. An important part of many B2B sites, e-procurement is also sometimes referred to by other terms, such as supplier exchange.

Eprocurement

is the term used to describe the electronic methods used in every stage of the procurement process, from identification of requirement through to payment. It can be broken down into the stages **of e-sourcing, e-purchasing, and e-payment.**

Esourcing: covers electronic methods for finding new suppliers and establishing contracts. Issuing electronic invitations to tender and requests for quotations reduces:

- administration overheads
- potentially costly errors, as the rekeying of information is minimized
- the time to respond

Epurchasing

- electronic categories for core/standard items
- recurring requisitions/shopping lists for regularly purchased items. The standard shopping lists form the basis of regular orders and the lists can have items added ore deleted for each specific order
- electronic purchase orders despatched automatically through an extranet to suppliers
- detailed management information reporting capabilities.

Epayment: includes tools such as electronic invoicing and electronic funds transfers. Again, e-payment can make the payment processes more efficient for both the purchaser and supplier, reducing costs and errors that can occur as result of information being transferred manually from and into their respective accounting systems. These efficiency savings can result in cost reductions to be shared by both parties.

The benefits of e-procurement

- Labour costs will be greatly reduced.
- Inventory holding costs will be reduced. Not only should overstocking be less likely, but if orders are cheap to place and process, they can be placed much more frequently, so average inventories can be lower.
- Production and sales should be higher as there will be fewer stockouts because of more accurate monitoring of demand and greater ordering accuracy
  Other benefits include the following
- The firm may benefit from a much wider choice of suppliers rather than relying on local ones.
- Greater financial transparency and accountability
- Greater control over inventories
- Quicker ordering, making it easier to operate lean or JiT manufacturing systems
- Fewer errors in terms of ordering unnecessary items, mispricing items, overpaying for items, using an incorrect supplier etc.
- There are also considerable benefits to the suppliers concerned, such as reduced ordering costs, reduced paperwork and improved cash flow, that should strengthen the relationship between the firm and its suppliers

Potential risks of e-procurement

There are some risks associated with e-procurement. These are:

Technology risks: there is a risk that the system (whether software or hardware) will not function correctly.

- **Organizational risks:** Staff might be reluctant to accept the new procurement methods and may become concerned over possible redundancies.
- **No cost savings realised:** As with all IS/IT projects, it is very difficult to predict all the benefits that can arise. Tangible benefits (such as might arise if fewer staff have to be employed) are relatively easy to forecast. However, intangible benefits (such as better customer service giving rise to an improved reputation) are very difficult to estimate with any accuracy.
- The buying company can become entrenched with existing, approved suppliers and there may be disincentives to find alternative, cheaper sources of supplies.

<u>Restructuring the supply chain</u>

In an earlier chapter we looked at strategic choices of outsourcing, vertical integration and strategic alliances, where the key issues of cost, quality and control were highlighted. These are still relevant for online businesses as much as for conventional 'bricks and mortar' organisations. All organisations must decide between:

- vertical integration – manufacturing in-house
- virtual integration – the majority of supply chain activities are undertaken by third parties
- virtual disintegration (disaggregation) – in between these two extremes

However, internet technology allows more efficient and cheaper communications within the chosen structure and may make virtual integration preferred to vertical integration.

Downstream SCM

Downstream supply change management is about managing relationships with both customers and consumers, as well as any other intermediaries along the way.

Examples of downstream supply chain management actions are:

- providing displays for retailers
- creating a website for end users
- creating user forums on websites
- determining which retailers and distributors to use
- use of different logistical method/providers
- changes to finished goods inventory policies
- setting recommended retail prices
- giving retail exclusivity rights

- forward integration

	Advantages	Disadvantages
1	can ties customers / increase switching costs	can be expensive to implement
2	can improve customer loyalty and retention	as a differentiation strategy it is easily copied
3	can increase market visibility	it relies on suppliers willingness to adapt to customer needs (often needs corresponding upstream management)
4	provides better information on customer needs, tastes etc.	the organisation might become reactive rather than proactive to customer needs
5	product failure rates can be reduced	forward integration can increase business risk and exit barriers
6	can facilitate pull supply chain management	must ensure that forum / website users are representative of all users
7	more regular and better communication with customers (e.g. can provide software/product updates etc.)	requires skills and experience for the benefits to be fully realised
8	gives users a voice	there is a risk of loss focus on core competences and activities

Dealing with intermediaries

A typical downstream for a manufacturer might involve selling to distributors, who then sell on to retailers, who in turn sell on to end users. Distributors and retailers are therefore intermediaries between the manufacturer and the consumer of the product. One element of supply chain management is to manage intermediaries.

- Ecommerce can lead to **disintermediation**. In this process intermediate organisations (middlemen) can be taken out of the supply chain.
- The process of **reintermediation** is also found, i.e. new intermediaries are introduced to the value chain, or at least to some aspects of it.
- **Countermediation** is where established firms create their own new intermediaries to compete with established intermediaries.

Examples

An example of **disintermediation** is seen in the travel industry where travel agents have been cut out of many transactions as the public can book directly with hotels, airlines and rail companies.

The travel industry also gives an example of **reintermediation.** Companies like lastminute.com and expedia.com are like new travel agents, presenting a wide choice of products and services.

An example of **countermediation** is Opodo.com, set up by a collaboration of European airlines to encourage customers to book flights directly with rather than using cost comparison intermediaries such as lastminute.com.

Using Big Data to information and implement business strategy

The ability of organisations to extract valuable information from Big Data is becoming a strategic capability. Like any capability, it requires investments in technologies, processes and governance.

Laney suggested that Big Data has the following characteristics, known as the 3V's:

- Volume – there is lots of it
- Velocity – it is generated very quickly
- Variety – it can take many varied forms

Volume

Big Data is characterised by its sheer volume. IBM believe that we create over 2.5 quintillion bytes of data every day. If the average PC can hold 100 gigabytes of data on its hard drive, there is enough Big Data created every day to completely fill 25 million PCs. Per day. For example, there are over 5 billion Facebook status likes per day. Facebook has to store this data on servers, and businesses would like to use and interpret these links to fin patterns.

So there is already a large volume of Big Data out there and it's only going to get bigger. The University of London's (UK) Big Data Institute believes that Big Data will double in size every two years. On top of that, UCL believes that currently less than 0.5% of the data that exists is ever analysed.

But this volume of Big Data causes problems for businesses. In order to perform meaningful analysis of this volume of data organisations will require new skill sets, large investments and a deliberate focus on Big Data. It is also likely that organisations will have to collaborate and share databases on Big Data. For example, the World Health Organisation has used mobile phone data held by service providers in Kenya to match human travel patterns to the spread of malaria (which it holds on its own database).

Velocity

The problem is worsened by the speed at which Big Data is created. The UK magazine, Baseline, reports that there are over 570 new websites created every minute. It also reports the commonly held belief that 90% of the world's data that is in existence has been created in the last two years.

Big Data is created quickly and moves around quickly. There are 300 hours of new content uploaded and shared to You Tube every minute, for example. For businesses wishing to exploit Big Data, they will have to obtain the information quickly, analyse it quickly and exploit it quickly. If, for example, there is a road crash or traffic build up on a particular major road, providers of satellite navigation systems for roads will want to get that information as quickly as possible (by, for example, measuring the average road speed for vehicles on a particular road), assess whether the cause is a temporary one, and then suggest an alternative route for road users. The more quickly that this can be done then the better the navigation system, and users of the system will be much more satisfied with its use.

Software systems will play a significant role in dealing with the volume and velocity of Big Data. New systems such as in-memory analytics mean that the analysis can happen in real time without the need to even store the data onto disks on computer servers.

Variety

Big Data is also characterised by its variety. Consider the data that might exist and be stored about yourself. The types and sources of Big Data are many fold.

These types are often subdivided into two catagories:

- Structured data
  Structure data resides in a fixed field within a record or file (such as a database or spreadsheet). Your banking transactions, your contact list or your past store purchases are therefore likely to be stored as structured data. This type purchases are therefore likely to be stored as structured data. This type of data is easier to access and analyse, as long as the model is well designed (for example, past store purchases on a store card may be less useful if the file does not record quantity, timing and value).
- Unstructured data
  The vast majority of Big Data is unstructured. Fields or sizes and includes data such as your personal interests, your photographs and videos, your likes and dislikes etc.

Using Big Data strategically

There are many ways that Big Data can be used strategically, based on common data analysis techniques.

Predictive modelling can predict user behavior based on their previous business transactions and preferences. This can facilitate new product or new market development.

Cluster analysis can be used to segment customers into groups based on similar attributes. Once these groups are discovered, managers can perform targeted actions such as customising marketing messages and cross-selling to each unique group. Another popular use case is to predict what group of users may "drop out". Armed with this information, managers can proactively devise strategies to retain this user segment and lower the churn rate.

Social analysis often involves metrics such as the number of video views and the number of followers or community members. This can allow content to be updated, removed or promoted depending on changes in these metrics.

Engagement measures the level of activity and interaction among platform members, such as the frequency of user-generated content. For example, Foursquare have begun to provide 'rewards' (such as a free coffee) to those users who check in and have the greatest number of connections (number of Twitter followers, for example). This can spread brand awareness and possibly cut marketing costs so that they are better aimed at the most influential users.

Reach measures the extent to which content is disseminated to other users across social platforms. Reach can be measured with variables such as the number of retweets on Twitter and shared likes on Facebook. Products or marketing campaigns with a poor reach can be changed or removed from the business portfolio.

Decision scientists explore Big Data as a way to conduct "field research" and to test hypotheses. Big Data is therefore used prior to strategy implementation and will influence strategic choice.

There is now a general consensus that data is a most valuable asset that, when farmed in the right way, will deliver organisations increased opportunities and insights to provide a stronger competitive advantage in existing markets, and to find and develop new products and markets.

Disruptive technology

Disruptive technology relates to instances where technology is used to fundamentally change and 'disrupt' the existing business model in an industry.

An example of a disruptor

An example of a disruptor is the passenger service Uber which created a business model using technology which avoided the need for licensed drivers, a vehicle fleet, local booking services etc. Instead, customers use their internet connected device to hail a ride and all payments are handled by a smartphone app.

Uber has disrupted the existing business model for traditional passenger services. Uber was set up in San Francisco in the United States and its initial key competitor was the Yellow Cab Co-operative, but whilst Uber has grown to a business worth over $60bn, the Yellow Cab Co-operative has since filed for bankruptcy.

The key reason for the growth of new disruptive businesses is from technology. Not only from the technology that they employ in order to cut costs and improve efficiency, but also in the access that consumers now have to technology in the modern on-demand economy. For example, many disruptive businesses rely on smartphone applications or have internet-only based transactions.

The two largest growth sectors for disruptive technology are in health services and financial services. Financial technology (commonly known as Fintech) is, for example, completely disrupting the traditional banking sector – long seen as a highly technical, highly regulated industry dominated by giant banks.

Fintech businesses exist which can provide investment advice, offer banking services, transfer money internationally, provide mortgages and loans, exchange currency etc. These are typically big earners for traditional financial institutions. Goldman Sachs estimates that upstarts for traditional financial institutions. Goldman Sachs estimates that upstarts could steal up to $4.7 trillion in annual revenue, and $470 billion in profit, from established financial services companies.

Here is an extract from Betterment's mobile app description:

Why we're here

Betterment is an online financial advisor with one purpose: to help you make the most of your money. We're taking investment strategies that have worked for decades and using technology to make them more efficient. Our goal: to increase your long-term returns.

What we do for you

We make tailored recommendations, from how much to invest to how much risk to take on in your portfolio. Then, we invest your money in a globally diversified portfolio of low-cost ETFs and help lower taxes in ways many traditional investment services can't match.

Seek higher returns:

- Automated portfolio management
- Globally diversified portfolio of ETFs
- Tax efficient investing features, like tax loss harvesting and asset location

Get a better investing experience;

- Sync your external investments
- Customer support 7 days per week
- Access to CFP® professionals and licensed financial experts

Invest and save with transparency:

- Low-cost, straightforward pricing plans
- Low fund fees
- No trading or rebalancing fees

The advantages that Fintechs have are:

- better use of data – providing better understanding of their customer and giving customers a wider choice
- a frictionless customer experience using elements such as smartphone apps to provide a broad and efficient range of services
- more personalization of products/services to individual customers
- the lack of a physical presence (with associated overheads and operating costs)
- access to cheap capital to fund growth – much like when internet based businesses first came to prominence in the 1990's, investors want to get in on the growth potential that Fintechs offer. This gives Fintechs a wide scope for raising cheap finance in order to fund their future expansion.

Cloud and mobile computing

Cloud and mobile computing is computing based on the internet. It avoids the needs for software, applications, servers and services stored on physical computers. Instead it stores these with cloud service providers who store these things on the internet and grant access to authorised users.

Benefits of cloud and mobile computing

- Sharing data
- On-demand self-service
- Flexibility
- Collaboration
- More competitive
- Easier scaling
- Reduced maintenance
- Back-ups
- Disaster recovery
- Better security

Risks of cloud and mobile computing

- Reliance on the service provider
- Regulatory risks
- Unauthorized access of business and customer data

Software solutions

Establishing business information needs

Various methods are available for establishing business information needs, including the following:

Technique	Suitability
• Interviewing	• Standard technique for most scenarios.
• Written questions	• Where people are not available for interview.
• Questionnaires	• Where the user population is too large to interview • Generally unsuitable due to superficial nature of questions and lack of interaction.
• Obligation	• Particularly useful if carried out before interviewing.
• Document analysis of existing processes	• Good source useful if carried out before interviewing.
• Workshops	• Useful for resolving conflicts and for new processes where high uncertainty exists.
• Protocol analysis – a mixture of interview and observation	• Ensures all aspects of the process are considered and none 'taken for granted' by users.
• Prototyping	• Where requirements are unclear. • Helps users reassess their desired functionality.

Using generic software solutions

There are various ways to produce a software solution.

- Purchase a standard ('generic) software package and:
  - Use this without any modification
  - Make suitable amendments to customise this for the orgainisation's specific requirements
  - Add company specific modules as necessary.
- Pay for a bespoke system to be developed using existing hardware.

The advantages and disadvantages of generic solutions are as follows:

Advantages	Disadvantages
• They are generally cheaper to buy than bespoke solutions are to develop. • They are likely to be available almost immediately. • Any system bugs should have been discovered by the vendors before sale. • Good packages are likely to come with good training programs and excellent	• They do not fit precisely the needs of the organisation – the users may need to compromise what they want with what is available. • The organisation is dependent upon an outside supplier for the maintenance of the software; many software suppliers are larger than most of their customers, and are therefore difficult to influence.

documentation and on-screen help facilities. • New updated versions of the software are likely to be available on a regular basis. • The experience of a great number of users with similar needs to those in the organisation has been incorporated into the design of the package. • Different packages will be available for different operating systems or data structures.	• Different packages used by the organisation may have incompatible data structures. • Using the same packages as rival organisations removes the opportunity of using IS for competitive advantage.

Choosing software and a supplier

Choosing software

When evaluating software the following factors should be assessed as a minimum;

- whether the software will match the expected organizational and user **requirements**
- the level of **flexibility** in adapting the software as these requirements change
- the **competencies** of the organisation in using and exploiting the software
- the availability of **future** updates and ongoing support and maintenance
- the **compatibility** with existing hardware and software
- the provision of **training,** user manuals and/or online help
- the interface design and **user-friendliness** (referred to as the non-functional requirements)
- the **cost** of the software and the ease of implementation/transfer
- security and **controls** over access to the software

Choosing a supplier

Before tying the organisation into a particular supplier, the procurement manager should consider the following (as a minimum) for each prospective supplier:

- long-term **viability** (this could include obtaining records of financial performance and position)
- length of **time in business**
- **references** from previous customers
- **ethical** standards (this might include an assessment of the directors and any potential links to our own organisation)
- availability to **demonstrations**
- the ability to provide guarantees and **warranties** for non-compliance, later delivery, failure to meet functional and non-functional requirements etc.
- security and **controls**
- **copyright** (for bespoke solutions)

- **user base** (for generic solutions)
- **maintenance** and after-sales support

Implementation

Implementing software solutions involves three key elements:

- data migration – transferring data from the old system to the new
- training – training staff on the new system
- changeover – introduction the new system to the business operations.

Data migration

It is vital to consider the stages that will be addressed during the migration process. Some of the stages include:

- Planning
- Data mapping
- Manual input
- Testing the solution
- Implementing the solution.

Stages in data migration

It is vital to consider the stages that will be addressed during the migration process. Some of the stages include:

- **Planning** – the organisation may need to create a Steering Committee that has representatives from a number of areas of the organisation including payroll, personnel, etc.; they may be from various levels, e.g. operational, tactical and strategic.
- **Data mapping –** this is the stage when the data is moved from one system into the field heading and file structures of the new system. An evaluation will need to take place of the structures within the new allocation for field headings is consistent.
- **Manual input** – there may be a requirement to enter some of the data manually from the old format to the new. This will require the organisation to consider the method of manual input as there are many issues with this type of transfer such as the type of input method, e.g. keyboard or scanner. The use of a keyboard, for example, greatly increases the chances of transposition errors that will reduce the quality of the input made.
- **Testing the solution –** there will need to be a period of testing after the conversion process to ensure that all of the data is accurate and that the system is running properly. A test environment will have to be created by the team to ensure that all the outputs from the tests made are accurate; this may include test plans and scripts for the conversion software.

- **Implementing the solution –** once the file conversion has been tested and accepted it can be run on the live data. Procedures will have to be specified to test that records are accurately converted.

Training

Training and a strategy for training are crucial. In order for this to be successful and resources not to be wasted it is vital that there is clarity about a number of issues.

Methods of training

- **External courses** – users go to the providers' premises to enable them to obtain the knowledge and the skills to use the new information system.
- **Internal courses** – the organisation runs a course in-house relating to the use of the information system. The course can be conducted by the internal training or IS department or an external provider my come into the company to run the course.
- **Computer-based training** – as an alternative the staff may be trained using a software tutorial that is often supplied with the original software purchase. The tutorial can be quickly installed onto the PC.

Changeover techniques

- Parallel running.
- Direct changeover.
- Phased.

CHAPTER 21

E Marketing

1. Stages in the marketing process

(1) **Market analysis** – used to identify gaps and opportunities in a business' environment (as explored in chapter 2).

(2) **Customer analysis** – examining customers so that potential customers can be divided into segments with similar purchasing characteristics.

(3) **Market research** – determining characteristics of each segment such as size, potential, level of competition, unmet needs etc.

(4) **Targeting** – deciding which segments to target (again, chapter 2 techniques such as PESTEL, 5 forces and forecasting would be used here).

(5) **Marketing mix strategies** – developing a unique marketing mix for each segment in order to exploit it properly.

Material	**Customer analysis**
Market analysis helps identify the appropriate marketing strategy	There are three sets of strategic question that are used to analyse customers – segmentation, motivation and unmet needs.
Appraisal and understanding of the present situation. Product life cycle, strength of competition, market segmentation, anticipated threats and opportunities, customer profile	Segmentation : Traditional segmentation focuses: geographic variables, demographic variables, psychographic variables, psychographic variables
Definition of objectives of profit, turnover, product image, market share and market position by segment	Motivation – concerns the customers' selection and use of their favourite brands, the elements of the product or service that they value most, the customers' objectives and the changes that are occurring in customer motivation.
Evaluation of the marketing strategies available to meet these objectives,	Customer lifecycle segmentation model (1) First time visitor (2) Return visitor (3) Newly registered visitor (4) Registered visitor (5) Have made one or more purchases (6) Have purchased before but now inactive (7) Have purchased before and are still active and responsive
Definition of control methods to check progress against objectives and provide early warning, thereby enabling the marketing strategies to be adjusted.	Unmet needs – considers why some customers are dissatisfied and some are changing brands or suppliers. The analysis looks at the needs not being met that the customer is aware of.
There are **two purposes** of the analysis: • to identify gaps in the market where consumer needs are not being satisfied	

• to look for opportunities that the organisation can benefit from, in terms of sales or development of new products or services.	

Customer and markets

It would be virtually impossible to provide one single product that would satisfy all people in all markets, an organisation can tailor its marketing approach with a specific product and go for:

- **undifferentiated marketing** – one product and one market with no attempt to segment the market, e.g. sugar is a product that is marketed in a relatively undifferentiated way
- **differentiated marketing** – the market is segmented with products being developed to appeal to the needs of buyers in the different segments, e.g. Toyota offers a wide range of different types of vehicle (sports car, 4x4, estate) in response to differing customer needs
- **niche or target marketing** – specialising in one or two of the identified markets only, e.g. Ferrari only make expensive luxury sports cars.

2. Marketing mix strategies

The marketing mix is the set of controllable variables that the firm can use to influence the buyers' responses (Kotler).

The original 4Ps model

Product	Price	Promotion	Place
• Brand name • Packaging • Features • Options • Quality • Warranty • Service • Style appreal	• Level • Discounts • Allowances • Payment terms • Delivery options	• Sales promotion • Personal selling • Publicity • Advertising	• Distribution channels • Distribution coverage • Outlet locations • Sales territories • Inventory levels • Inventory locations

Emarketing: the 7Ps

4 Ps plus additional 3 Ps

- **People/participants** (for example, having adequately trained staff and support services)
- **Process** (for example, payment and delivery processes) and
- **Physical evidence** (for example, website layout and navigation)

The additional 3Ps are particularly relevant to the marketing of services.

Pricing should be determined with reference to four factors:

- **Cost** (i.e. we should ensure that all costs are coverd).
- **Customers** (we should consider how much customers are willing to pay).
- **Competitors** (we should consider how much competitors are / will be charging).
- **Corporate objective** (we should consider what we are aiming to achieve – for example, a low price might be necessary when we are trying to break into a market).

pricing objective: different objectives that a business may be aiming to achieve with its pricing strategy:

survival – this is a break even requirement. (e.g. a recession).

profit – in the longer term, businesses will hope to achieve a level of profit that satisfies their longer term objectives.

return on investment – a business may have a ROI target that it needs to satisfy and this could be used to determine the price.

- **market share** – often with new products and markets the initial objective is to achieve a level of market share. This may mean that prices are set below those of rivals' in order to win customers away from rivals.
- **cash flow** – if a business has cash flow problems it might price products in order to bring in cash to the business more quickly (e.g. by offering settlement discounts).
- **status quo** – the business may pursue a strategy of non-price competition (e.g. cola companies generally use this approach) in order to maintain an existing (often mature) position.
- **product quality** – price is often used as an indicator of quality. So a business who wants to promote the quality of their product might use a higher selling than that of rivals.

Practical pricing methods

- **Penetration pricing** – a low price is set to gain market share.
- **Perceived quality (or prestige) pricing** – a high price is set to reflect/create an image of high quality.
- **Periodic discounting** – this is a temporary production in prices for a limited period such as a 'Holiday Sale'.
- **Price discrimination** – different prices are set for the same product in different markets. e.g. peak/off-peak rail fares.
- **Going rate pricing** – prices are set to match competitors.

- **Price skimming** – high prices are set when a new product is launched. Later the price is dropped to increase demand one the customers who are willing to pay more have been 'skimmed off'.
- **Negotiated pricing** – the price is established through bargaining between the seller and the customer.
- **Loss leaders** – one product may be sold at a loss with the expectation that customers will then go on and buy other more profitable products.
- **Captive product pricing** – this is used where customers must buy two products. The first is cheap to attract customers but the second is expensive, once they are captive.
- **Bait pricing** – this is also used by companies with wide product ranges, but often the lowest priced model is advertised in the hope to attract customers to the line and hope that they will actually decide to buy a higher priced item from the range.
- **Bundle pricing** – two or more products, usually complementary, are packaged together and sold for one price.
- **Cost plus pricing** – the cost per unit is calculated and then a mark-up added.

Cost based pricing

Cost based pricing is often inappropriate for businesses – it ignores customers, competitors, and corporate objectives. However, it may occasional prove useful for businesses – for example, in times of rapid inflation or when demanded by a particular, powerful customer.

- ✓ Full cost plus
- ✓ Marginal cost plus
- ✓ Target ROI (Return on Investment)

Relevant cost pricing

In calculating which costs are relevant, three criteria must be satisfied:

- the cost (s) must be **incurred in the future,**
- only the **incremental cost (s)** should be included, and
- the **cash impact** only of the cost (s) should be included.

4 Pricing in economics

Pricing in economics is based on assumptions about demand and supply and the interaction between these two factors. From a marketing perspective demand will be more important than supply.

Profit maximisation in economics

Marginal revenue = marginal cost

It assumes that a number of variables remain unchanged:

- the business environment
- the buyer's needs
- the buyer's ability to pay
- the marketing mix.

Demand based Pricing

The elasticity of demand

The relationship price and demand is also affected by the elasticity of demand for the product.

This is calculated as follows;

$$\text{Price elasticity of demand} = \frac{\%\ change\ \ in\ quantity\ demanded}{\%\ change\ in\ price}$$

Demand is likely to be less elastic when:

- There are few or no substitutes or competitors.
- Buyers do not readily notice the high price.
- Buyers are slow to change their buying habits and search for lower prices.
- Buyers think the higher prices are justified by quality differences and/or normal inflation.

5 E-mrketing: the 6Is

Interactivity	• Traditional media are mainly 'push' media – the marketing message is broadcast form 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.
Intelligence	• The internet can be used as a low cost method of collecting marketing information about customer perceptions of products and services. • The website 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.
Individualisation	• Communications can be tailored to the individual, unlike traiditional media where the same message is broadcast to everyone. • Personalisation is an important aspect of CRM and mass customization, e.g. every customer who visits a particular site is profiled so that when they next visit information relevant to their product, interest will be displayed.

Integration	• The internet can be used as an integrated communications tool, e.g. it enables customers to respond to offers and promotions publicized in other media; • It can have a direct response or call back facility built in; • It can be used to support the buying decision, even if the purchase does not go through the internet – with web specific phone numbers on websites.
Industry structure	The relationship between a company and its channel partners can be dramatically altered by the opportunities available on the internet. For example, disintermediation and reintermediation
Independence of location	• Electronic media gives the possibility of communicating globally – giving opportunities of selling into markets that may not have been previously accessible.

6. E branding

A brand is a name, symbol, term, mark or design that enables customers to identify and distinguish the products of one supplier from those offered competitors.

E branding

It has become more and more important as companies decide to offer their services and products online. Website design, corporate branding, ecommerce and search engine optimization are critical components in building a company's ebranding.

E branding strategies

Carry out exactly the same branding on the website as in other places.

Offer a slightly amended product or service, still connected to the original brand. The slight differentiation is often signaled by putting the word 'Online' after the original brand name.

Form a partnership with an existing brand.

Create an entirely new brand, perhaps to emphasise a more modern, flexible approach. This has been common with financial institutions such as HBOS and IF. HBOS runs a conventional banking operation and IF is its direct finance operations that makes high use of the internet.

7. Customer relationship management (CRM)

The objective of CRM is **to increase customer loyalty** in order to increase profitability and is thus a key aspect of ebusiness.

Definitions

- CRM is an approach to building and sustaining long term business with customers.

- eCRM is the use of digital communications technology to maximise sales to existing customers and encourage continued usage of online services.

The customer lifecycle

(1) Customer selection – defining what type of customer is being targeted

- Who are we targeting?
- What is their value?
- Where do we reach them?

(2) **Customer acquisition** - forming relationships with new customers

- Need to target the right segments.
- Try to minimise acquisition costs. Methods include traditional offline techniques (e.g. advertising, direct mail) and online technique (e.g. search engine marketing, online PR, online partnerships, interactive adverts, opt-in email, and viral marketing).
- Service quality is key here.
- Choice of distribution channel also very important.

Customer retention – keeping existing customers.

- Emphasis on understanding customer needs better to ensue better customer satisfaction.
- Use offers to reward extended website usage.
- Ensure ongoing service quality right by focusing on tangibles, reliability, responsibility, responsiveness, assurance and empathy. – Emphasis on understanding customer needs better

Customer extension (or 'customer development') – increasing the range of products bought by the customer.

- "Resell" similar products to previous sales.
- "Cross sell" closely related products.
- "Upsell" more expensive products.

CRM aims to extend marketing over all four stages and build a lasting relationship with customers which creates loyalty and keeps them coming back for more.

Comparison with transaction marketing

Transactional marketing	**Relationship marketing**
Orientation to single sales	Orientation to customer retention
Discontinuous customer contact	Continuous customer contact
Focus on product features	Focus on customer value
Short time scale	Long time scale

Little emphasis on customer service	High emphasis on customer service
Limited commitment to meeting customer expectations	High commitment to meeting customer expectations

Customers of large organisations rarely speak to a specific named individual. This is especially so if the organisation uses a call centre approach to handle customers' calls. It is, however, important that the customer feels he or she is getting a good service, where the organisation knows about previous sales, customer preferences, previous problems and previous conversations. Typically, a CRM will show the following information onscreen to employees dealing with customers.

- The customer's name, address, telephone number, email and, if applicable, web address.
- Current debtor's ledger balance.
- If the customer is an organisation. Named individuals employed by the customer with whom the organisation deals, together with their job titles and authority levels.
- Some additional information about customer's employees, for example that person is a technical expert, or previously worked for a certain company, or does not like to be contracted before 2 pm.
- Summaries of previous conversations with the customer.
- Details of previous sale to the customer – description of goods/services and value.
- Diary entries to remind the organisation to carry out agreed tasks for the customer.

It is immensely valuable to have this information available when dealing with customers, both to talk intelligently to the customer, and identify sales opportunities that might arise during the conversation. CRM packages therefore allow organisations to have much more informed, professional and, it is hoped, profitable relationship with customers.

CHAPTER 22

Project management – the business case

1 Project Features

A project can be defined simply as an activity, which has a start, middle and end, and consumes resources. It will:

- have a specific objective
- have a defined start and end date (timescale)
- consume resources (people, equipment and finance)
- have cost constraints that must be clearly defined and understood to ensure the project remains viable
- require organisaton

2 Process redesign, e-business and systems development as projects

A project differs from 'ordinary work' that is ongoing and has a mixture of many recurring tasks and more general goals and objectives. Although some projects may be initiate on ad-hoc basis, it is more common for them to be an implementation tool for the strategic plan of the organisation.

Projects are fundamental to other aspects of the syllabus such as business process change and IT development.

3 Stages in the project life cycle

Every project is different, but each will include at least the following five stages:

- initiation
- planning
- execution
- control
- completion

Project initiation – building the business case

This chapter focuses on project initiation. It examines the contents of a business case document, it assesses what benefits might be derived from a project and how these benefits should be managed, it assesses potential project costs, and it finishes by matching up the project cost and benefits in project appraisal techniques.

Reasons for buildings a business case:

- to obtain funding for the project
- to compete with other projects for resources

- to improve planning
- to improve project management

4 Contents of a business case

Organisations who have performed many projects will often have developed their own method of presenting a business case. However, they are likely to have the following key elements in common:

- an assessment of current strategic position
- the constraints that are likely to exist for any project
- the risks that might arise for the project and how these will be managed
- an assessment of the benefits and costs of performing the project and how these will be managed

The formal business case document

1) Introduction
2) Executive summary
3) Description of current situation
4) Options considered
5) Analysis of costs and benefits
6) Impact assessment
7) Risk assessment
8) Recommendations
9) Appendices

Project constraints

There are three key project constraints:

- cost
- time and
- scope

Risk analysis

Risk is defined as 'the chance of exposure to the adverse consequences of future events'. A risk is anything that will have a negative impact on any one or all of the primary project constraints – Time, Scope and Cost.

All projects include some risk.

- Cost over-run
- Missed deadlines

- Poor quality
- Disappointed customers
- Business disruption

Risk can results in four types of consequences;

- benefits are delayed or reduced
- timeframes are extended
- outlays are advanced or increased
- output quality (fitness for purpose) is reduced

In order to avoid these consequences, a project manager should add two elements to his/her business case:

- a risk assessment – explaining the type of scale of risks that might occur
- a risk management plan – explaining how these risks will be managed in order to ensure project success

Risk assessment

Risks can be analysed and evaluated according to:

- the likelihood that they will occur, and
- the impact that they could have on the project

Risk management

This in turn can lead to plans on how each risk should be managed:

Impact \ **Likelihood**	**Low**	**High**
Low	**Accept**	**Reduce**
High	**Transfer**	**Avoid**

6. Project benefits

In order to make a business case on the basis of these benefits, the scale of the benefits should be assessed. The benefits can often be classified along the following scale:

1) Observable
2) Measureable
3) Quantifiable
4) Financial

(1) Observable

- ✓ Intangible benefits
- ✓ Benefits aren't measureable

(2) Measurable

- ✓ A measure may exist for this type of benefit cannot specify where it will post project.
- ✓ If it is deemed too difficult or expensive to measure the increase in performance, then the benefit should be related to and observable benefit.

(3) Quantifiable

- ✓ These benefits should be forecast able in terms of the benefit that should result from the changes
- ✓ This means that their impact can be estimated before the project commences.

(4) Financial

- ✓ These benefits can be given a financial value – either in terms of a cost reduction or a revenue increase.

7. Benefits management

'The purpose of the benefits management process is to improve the identification of achievable benefits and to ensure that decisions and actions taken over the life of the investment lead to realising all the feasible benefits.'

The benefits management process

Ward and Daniel suggest the following stage to ensure that the benefits management process realises the maximum set of benefits from the project:

1) Identify and structure benefits
2) Plan benefits realization
3) Execute benefits plan
4) Review and evaluate results

5) Establish potential for further benefits

Identify and structure benefits

Potential benefits from projects have already been discussed in this chapter. The key element at this stage is to quantify the benefits, establish ownership of them, determine the impact on stakeholders and consider their impact on the business case.

Planning benefits realization

It is important that all benefits are identified, responsibility is clear and the likely value of the benefit is quantified. The current level of performance should be used as a starting position (baseline), and then performance measure should be identified which can identify progress towards achieving the perceived improvement in performance/value of the benefit.

At this stage a benefit dependency network would be created (covered later in the syllabus).

Executing the benefits plan

The plan then needs to be put into action. Interim targets should be monitored and assessed and remedial action may have to be taken when these target are not being met.

Further benefits may also be identified and a decision has to be taken on whether or not to pursue these.

Reviewing and evaluating the results

One important element of this will involve a Post Implementation Review.

The evaluation should involve all those who have responsibility for delivering benefits. It should focus on what has been achieved, identify reasons for the lack of any benefit deliveries and identify further action needed to deliver what has not been achieved.

Establishing the potential for further benefits

Some benefits only become apparent when the project has been implemented and the associated business changes have been made. So the potential for these further benefits needs to be assessed and analysed.

Benefits ownership

A benefit owner should be assigned to each benefit. Ideally it should be someone who gains as advantage from the benefit and is therefore motivated to ensure that the benefit is realized.

It may occasionally be necessary to have more than one benefit owner for each benefit, but this group should be kept as small as possible.

A change owner will be appointed for each enabling and business change. It will be their job to ensure that the change is successfully achieved. For example, if an enabling change is to train staff in new production techniques, then perhaps an HR manager will be given ownership of this change and responsibility for its success or failure.

Benefits and change owners should have the power to effect the achievement of either benefits of change. Benefit owners might need to have the power to add extra resources to the project, whilst change owners may have to use their influence to overcome problems. Therefore, the owner will often hold senior positions in the organisation.

However, this does not always have to be the case. For simple projects where there is significant past experience, middle managers might play some ownership roles – particularly as change owners.

9. Project costs

In order to properly assess a project the potential benefits need to be measured against the potential costs. Typical project costs might be:

- capital investment costs
- development costs
- centrally allocated costs/infrastructure costs
- external consultancy costs
- resource costs
- quality costs
- flexibility costs
- disruption costs

10. Project Appraisal

- accounting rate of return (ARR)
- payback period
- net present value (NPV)
- internal rate of return (IRR)

Regardless of the method used, it will be important that only financial costs and benefits are included in the appraisal. Often, as explained earlier, project managers will attempt to 'upscale' other benefits (such as measurable or quantifiable ones) into financial benefits and the accountant may have to remove these in order to get a true reading of the financial impact of the project.

Project management II – Managing the project to its conclusion

Importance of a project plan

A project plan aims to ensure that the project objectives are achieved within the constraints of quality, cost and time. Planning is essential – it helps to:

- communicate what has to be done, when and by whom
- encourage forward thinking
- provide the measures of success for the project
- make clear the commitment of time, resource (people and equipment), and money required for the project
- determine if targets are achievable
- identify the activities the resources need to undertake

Project Initiation Document (PID)

The PID is a formal, detailed document which contains planning information extracted form other sources such as

- Business case
- The dissemination plan
- The risk assessments
- Gantt charts, etc

Typical contents might include;

- a purpose statement (project drivers)
- project and investment objectives
- a scope statement
- project deliverables (part of the product breakdown structure, explained later)
- cost and time estimates
- benefit and change owners
- chain of command
- team responsibilities
- project gateway, performance measure and results (updated regularly)

Details on the contents of a project plan

(1) Overview of the project

- Background to the project – a summary of the background to the project (and how it builds on previous work) (and why it is important)
- Aims and objectives – a list of the broad aim or purpose of the project, and the specific objectives you intend to achieve.
- Overall approach – a description of the overall approach you will take to achieve the objectives outlined above, including:
    - strategy and/or methodology and how the work will be structured

  - important issues to be addressed
  - scope and boundaries of the work
  - link to critical success factors
- Project outputs – a list of the tangible deliverables (including reports).
- Project outcomes – a list of the outcomes you envisage and what change they will stimulate or enable.
- Stakeholder analysis using Mendelow's power-interest matrix.
- Risk analysis – a list of the factors that could pose a risk to the project's success and an assessment of their likelihood and severity.
- Standards – a list of the standards the project will use.
- Intellectual property rights – an indication of who will own the intellectual property.

(2) Project resources part project management framework including:

- organisation
- reporting relationships
- decision process
- the role of any local management committee

(3) Detailed part of the plan will outline:

- the project deliverables and reports
- when they are due
- the phasing of the work and any dependencies
  contain a Gantt chart, diagram, or flowchart

(4) Evaluation plan evaluate the quality of the project outputs and the success of the project.

(5) Dissemination plan share outcomes and learning with stakeholders.

The exit and sustainability plans explain what will happen to project outputs at the end of the project (including knowledge and learning).

Team members

A team member is selected to join the core team because of their specialist knowledge or expertise. They are usually drawn from a functional department and therefore have a further responsibility in representing that department. Some of the roles taken on by team members in organisations include:

- Specialist or technical expert – brings specialist knowledge and advice to the term.
- Representative – as part of the core team, the member represents their 'home' department and as part of the project team communicates the project team's views and decisions when back in their 'home' department.

- Monitor – will monitor their progress against the plan appropriately and regularly.
- Change manager – as changes are identified, will ensure that the full implications have been assessed before the changes are agreed and implemented.
- Problem solver – will be faced with many problems during any project and will be required to solve them by drawing on the resources of the project team and their 'home' department and through the use of problem-solving techniques.

Project sponsor

The project sponsor or project facilitator will normally be a senior member of the management team.

- They are often chosen as the person with the most to gain from the success of the project and the most to lose from the failure of it.
- Their job is to direct the project, and allow the project manager to manage the project.

Typical roles of a project sponsor

The roles taken on the project sponsors in organisations include:

- gatekeeper – choosing the right projects for the business means ensuring that only projects that support the business strategy are started and that they are of sufficiently high priority and have clear terms of reference
- sponsor and monitor – steering the project by requesting regular meetings with the project leader and giving advice and guidance
- supporter and coach – provides practical support for the project leader, especially if they are taking on a project that is larger or more significant than they have handled before
- decision-maker – if decisions are required that are outside the scope of the project then the project sponsor will make the decision on behalf of the organisation
- champion or advocate – involves informal communication with other senior managers to ensure that they continue to have an objective view of the importance of their project in relation to other projects within the business
- problem solver – when the team faces problems that it is solve or does not have the skills or experience to solve
- resource negotiator – a project's success will depend on the availability of the right resource at the right time. In cross-functional projects the sponsor may provide assistance in negotiating resources around the company

The project manager

The project manager is the person appointed by the organisation to lead the team, and mange it on a day-to-day basis. Primarily the project manager's responsibility is to deliver the project and to ensure that effectiveness and efficiency are achieved across the entire project.

Typical roles of a project manager

Some of the roles taken on by project managers in organisation include:

- Team leader – will spend time building the team, motivating individuals and ensuring that the project has a clear purpose and that every core team member understands that purpose.
- Planner and co-ordinator – will ensure that the team creates a realistic plan and will often consolidate the individual team member's plans into a full project plan. They will then co-ordinate the activities of the team to meet that plan and deal with changes in a systematic way.
- Task manager – involves clarifying the goals of the project and ensuring that every action is moving the project towards those goals.
- Communicator and relationship manager – will take the lead in proactively communicating the project in an appropriate way to all the stakeholders and manage the relationship with key stakeholders to ensure their needs are being met.
- Problem solver – will be faced with many problems during any project and will be required to solve them through team problem-solving techniques.
- Monitor and change manager – will put controls in place to ensure the project progresses against the plan and is monitored appropriately and regularly.
- Budget manager – will involves setting up the budget and then monitoring its use to ensure the best use of resources.
- Meeting manager – most project teams only meet as a team during project meetings so it is very important that each meeting is well managed.

While there are clearly overlaps, there are some important differences between a project manager and a 'normal' line manager:

- line mangers are usually specialists whereas project managers are often generalists.
- Line managers operate close to the technical tasks in their departments, whereas project managers may have to oversee work in many different areas
- Line managers exercise direct supervisory authority, whereas project managers facilitate rather than supervise team members.

Problems faced by project managers

Typical problems face by a project manager will include:

- managing staff who are assigned to the project part-time and have responsibilities in their 'home' departments
- managing the relationship with the departmental managers who have staff on the project team

- managing the size of the team given variable resource requirements throughout the project life cycle
- dealing with specialists in areas where the manager is not an expert

Monitoring the project

The purpose of the project monitoring, reviewing the controlling process is to track all major project variables and to ensure the team is making satisfactory progress to the project goals.

Performance measurements can include:

- Expenditure (cost)
- Schedule (time) performance – avoiding schedule slippage is a key objective
- Scope measures – both product scope and project scope
- Functional quality
- Technical quality performance
- Issue management performance
- Client satisfaction measures

Project gateways

This process is aided by specific project gateways. This will be review points that are planned for critical points in the project. The reviews will also ensure that the business case which justified the project is still valid at this stage.

If problems are identified then project control measures and corrective action will be necessary.

Threat identification

The following can threaten the success of a project. Identifying these in advance can help reduce the risk of slippage and other potential problems:

- Poor management
- Poor planning
- Lack of control mechanisms
- Unrealistic deadlines
- Insufficient budget
- Moving targets

Project control

- controlling the project means:
- taking early corrective action when needed
- balancing project effort
- looking for where effort can be reduced

- making changes early rather than late

examples of corrective action include:

- 'fast tracking' – a project management technique used to ensure that projects are completed within the shortest time possible, often by doing some activities in parallel that would normally be done is sequence (such as design and construction)
- 'crashing' – project crashing is a method for shortening the project duration by reducing the time of one or more of the critical project activities to less than its normal activity time. The object of crashing is to reduce project duration while minimizing the cost of crashing
- adding additional resources (people, money, time, etc.)
- scope reduction
- adopting higher risk but potentially more efficient approaches
- employee motivation

5 Project completion

A Post Project Review (PPR)

This happens at the end of the project and allows the project team to move on to other projects. It can often be the last stage of the project, with the review culminating in the sign-off of the project and the formal dissolution of the project team. The focus of the post-project review is on the conduct of the project itself, not the product it has delivered. The aim is to identify and understand what went well and what went badly in the project and to feed lessons learned back into the project management standards with the aim of improving subsequent project management in the organisation.

It typically involves:

- disbanding the team and 'typing up loose ends'
- performance review
- determination of lessons learnt
- formal closure by the steering committee

Post Implementation Review (PIR)

A PIR is an essential component of the benefits management process. A post-implementation review focuses on the product delivered by the project. It usually takes place a specified time after the project has been delivered. This allows the actual users of the product an opportunity to use and experience the product or service and to feedback their observations into a formal review. The post-implementation review will focus on the product's fitness for purpose. The review will not only discuss strategies for fixing or addressing identified faults, but it will also make recommendations on how to avoid these faults in the future. In this instance these lessons learned are fed back into the product production process. Without a PIR, a business cannot demonstrate that its investment in the project was worthwhile.

PRIs can sometimes be an on-going element of project management that may be used at project gateways to examine changes implemented to date.

Comparing the PPR and PIR

For most projects, a PIR is undertaken when the there has been sufficient time to demonstrate the business benefits of the new project. For a major programme of the change there may be several PIRs over time. The review will normally involve the project manager, senior management representatives and, where used, internal benefits management experts.

The PPR and PIR are related but have different objectives. The PPR is a one-off exercise at the end of a project with the key objective of learning lessons and feeding them into the organisation's project management processes and procedures for the benefit of future projects.

The objective of the PIR is to ensure that the maximum benefit is obtained for the organisation through the new project, and to make recommendations if the benefits are not obtained. Every project is different, but it is typical to perform a PIR two to twelve months after completion of the project.

The PPR focuses on the performance of the project, whilst the PIR focuses on the performance of the product of the project.

A PIR would typically involve the following analysis:

- the achievement (to date) of business case objectives (effectively a gap analysis)
- costs and benefits to date against forecast
- areas for further development consistency of the project with the overall business strategy
- the effectiveness of revised business operations (functions, processes, staff numbers etc.)
- stakeholder satisfaction (both internal and external)

Benefits realization review

A benefits realisation review is vital because a project cannot be said to be successful until management is assured that all the benefits promised at the evaluation stage can be shown to have been subsequently realised.

Ward and Daniel identify a number of elements of a benefits review:

- to determine and confirm which planned benefits have been achieved
- to identify which expected benefits have not been achieved and to decide if remedial action can be taken to still obtain them or if they have to be foregone

- to identify any unexpected benefits that have been achieved and any unexpected 'disbenefits' that have resulted
- to understand the reasons why certain types of benefits were or were not achieved and provide lessons for future projects
- to understand how to improve the organisation's benefits management process for all projects.

A necessary part of this process will that each benefits owner should prepare a statement detailing and evidencing the extent to which the benefit was achieved or reasons for its failure.

Reasons why change fails to deliver benefits

- vision and objectives either not clear or shared and owned
- benefits/outcomes not adequately owned, tracked and reported
- portfolio of programmes not all aligned to organisation's mission or strategy
- business change ignored or undervalued
- projects/programmes seen as delivering a capability rather than benefits
- making the right investment decision; to make the right investment decision we first need a clear understanding of what needs to be done and why it needs to be done now.

Lessons learnt review

6. Project management software

The planning and control of the project will be assisted through the use of appropriate software. The type of output produced by the package will very depending upon the package being used e.g. Fast PLAN and Win project.

Planning:

- The ability to create multiple network diagrams.
- The ability to create multiple Gantt charts.
- The ability to aid in the creation of the PID.

Estimating:

- The ability to consider alternative resource allocation.
- The ability to create and allocate project budgets.
- The ability to allocate time across multiple tasks.

Monitoring:

- Network links to all project team members.
- A central store for all project results and documentation.
- Automatic comparison to the plan, and plan revision.

Reporting

- Access to team members.
- Ability to create technical documents.
- Ability to create end of stage reports.

Advantages:

- Improved planning and control.
- Improved communication.
- Improved quality of systems developed.

CHAPTER 23

Financial analysis

1 The relationship between strategy and finance

Strategic choice and financial analysis

For example, the role of finance plays a key role in making strategic choices. In applying Johnson, Scholes and Whittington's strategy evaluation tests a decision maker might have the following financial concerns and the therefore carry out accompanying financial analysis.

Aspect	Key concern	Financial analysis
Acceptability	Achieving acceptable returns to shareholders	• Cash flow forecasts to ensure dividend growth requirements can be met • NPV • ROCE • Valuation of real options • Cost-benefit analysis • Ratio analysis (e.g. dividend yield, growth)
	Risk	• Sensitivity • Breakeven • Ratio analysis (e.g. gearing, dividend cover)
Feasibility	Resources	• Cash flow forecast to identify funding needs • Ability to raise finance needed • Working capital implications • Foreign exchange implications
Suitability	Getting the best returns from alternatives	• Return on Investment • Comparison of alternatives

		• Profit margins

There are two key funding decisions for management to consider:

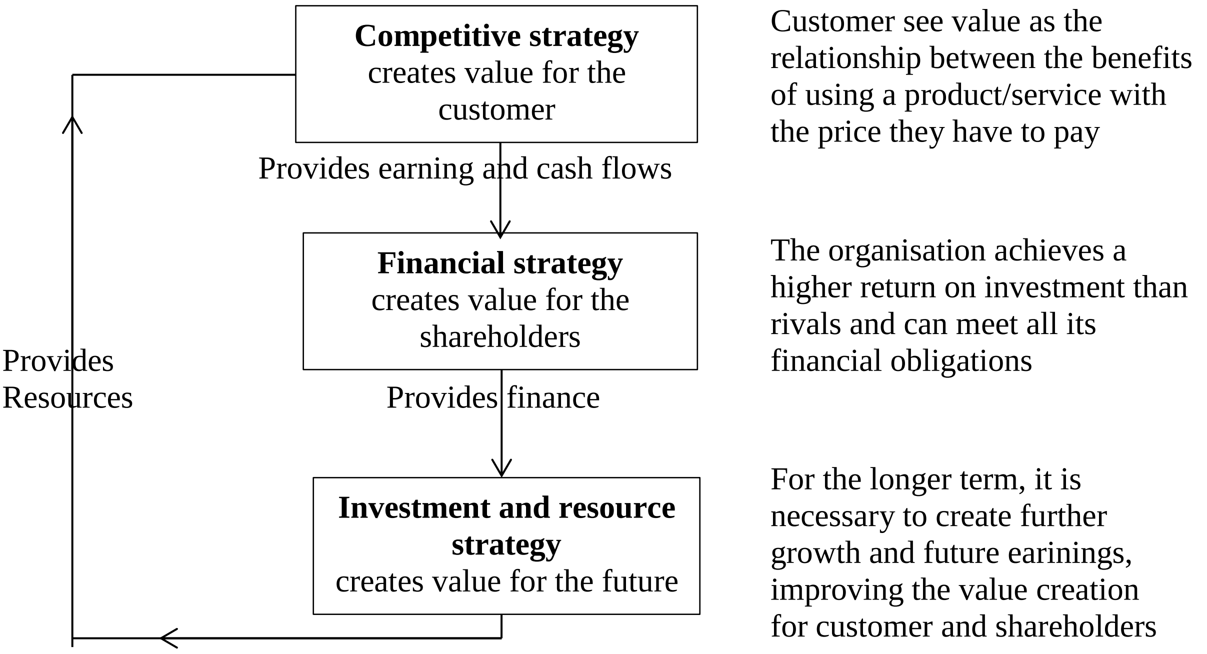
- where should funding be allocated?
- how should the funding be raised?

The accountant can now be expected to be involved in areas such as:

- Gaining competitive advantage in capital markets.
- Forward-looking decision support, sensitivity and scenario planning.
- Providing quantitative and qualitative analysis.
- Finding areas for cost efficiency.
- Improving the quality of information and decision making.

2 Managing for value

Traditionally, financial managers focused on the achievement of short-term financial targets such as profit margins, earnings per share, cost per unit etc. Managing for value aims to take a much broader, longer-term view in order to ensure that shareholder value (in terms of dividends received and increases in the capital value of shares) is maximized. There is a greater focus on value creation than there is on profits.Value creation is achieved using three key elements of strategic management, as shown below:



Therefore, financial strategy has three key elements with respect to value creation:

- recognizing (and accounting for) a cost of capital and aiming to maximise returns against this
- managing a company's finances to ensure a minimisation of that cost of capital
- allocating capital to the areas where it is likely to generate the best return for shareholders

Managing for value would examine the strategic decision from a financial perspective and ask questions such as:

- How will achieve a reasonable payback on the acquisition price?
- What is the most we are willing to pay before we willing to pay before we walk away?
- What investments will we need to make beyond pure purchase price?
- How dependent are we on "synergies" to make the acquisition work?
- Can we structure the deal more creatively to reduce our risk of overpaying?

So managing for value aims to ensure that the corporate or business level strategy is in line with the financial strategy and that all three to create value for shareholders.

However, we should be aware that not-for-profit (NFP) organisations are not concerned about shareholder wealth and their financial strategy has a much different focus.

3 Not-for-profit organisations

Financial objectives of 'not-for-profit' organisations

Since the services provided are limited primarily by the funds available, their financial aim is:

- to raise the maximum possible sum each year (net of fund-raising expenses)
- to spend this sum as effectively as possible on the target group (with the minimum of administration costs)

Value management in NFPs

An alternative strategy model developed for use with government organisations focuses the attention of managers on three key issues:

- public value to be created
- sources of legitimacy and support for the organisation
- operational capacity to deliver the value

This focuses attention on social purpose and on the ways in which society as a whole might be mobilised to contribute to social purposes rather than on the financial objectives.

Funding strategies for NFPs

What most non-profit organisations need are their core costs covered.

Core costs are the expenditure budgets that are not connected with the levels of activity undertaken by an organisation.

They are:

- the costs that will always need to be funded, regardless of the number of projects and
- are usually fundamental to the organisation's survival, even if they cannot be directly associated with any specific outcome.

Core cost can be placed under three headings:

Management	• Cost associated with governance, board meetings, etc. • User engagement and consultation • Monitoring and evaluation • CEO and associated staff
Research and development	• Innovation – costs associated with developing new activities and ways of operating (before they attract funding) • Quality assurance • Staff training and development
Support service	• IT, telephone, postage and fax • Finance and audit • Income generation (including fundraising) • Marketing for the organisation) • Premises • Travel and subsistence • Personnel

An organisation can only look ahead with confidence when the fundamental core costs are securely funded.

Creating a core funding strategy has different forms at each stage of a non-profit-seeking organisation's evolution.

- Infancy – tends to be heavily dependent on one funding source, which can limit independence.
- Growth phase – in funded by a multitude of projects and many donsors it is prone to the pitfalls of mission creep (the expansion of a project or mission beyond its original goals, often after initial successes) and inefficiency.

- Maturity and maintenance – funding should be derived from a constantly changing mix of sources.

There are five main elements to core funding.

- Strategic funding – is funding from regular, reliable donors.
- Apportioning overheads into project budgets. Each project budget is expected to make a contribution towards overheads.
- Self-generated income – is where part of the core costs is funded by activities within its own control.
- Developmental funding – donor agree to invest in the transformation of an organisation's infrastructure for a defined period.

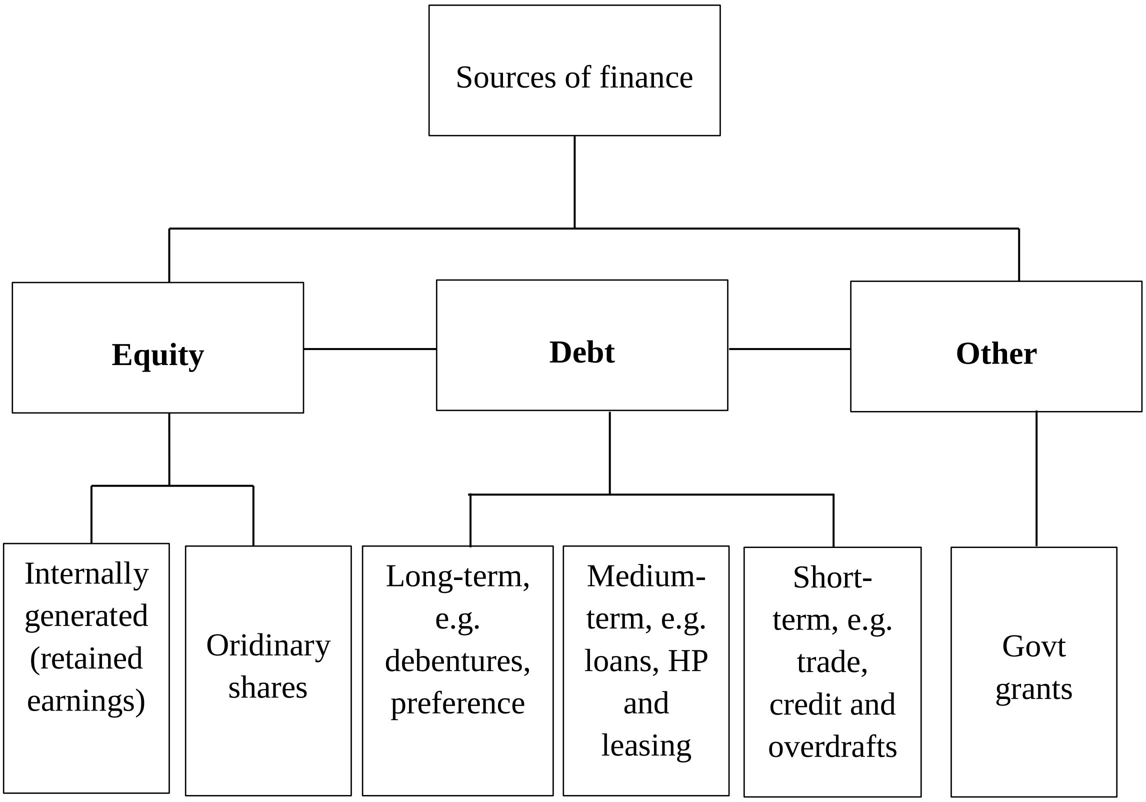
4 Funding strategies

Funding SBUs and strategic choice

Star • High growth • High business risk • Use some retained earnings and new equity from investors seeking growth • High reinvestment rate so medium devidends	**Problem child** • High growth • Very high business risk • Use equity from venture capital • Low or zero dividends in the short term
Cash cow • Low growth • Medium business risk • Use retained earnings (and debt if necessary) • Large net cash inflows to support dividens	**Dog** • Low growth • Low business risk • Use debt until divest • Zero reinvestment rate so high dividends

Alternative sources of finance

Financing was covered in detail in paper F9. A brief summary of alternatives and considerations are given here.



Key sources of internal finance

(1) Using retained profits
(2) Better working capital management

Factors to consider when choosing a financing package

- Cost
- Control
- Availability
- Gearing
- Security
- Cash flow
- Exit routes

5 Ratio analysis

Ratios

Ratio analysis is particularly useful for assessing whether a strategy is achieving its desired targets.

Forecast ratios

In an examination question you may be asked to assess the implications of a proposed financing package and/or strategy.

6 The role of cost and management accounting

Cost accounting is an approach to evaluating the overall costs that are associated with conducting business.

The role of cost accounting

Cost accounting has many roles in a business, including

- Inventory valuation
- To record costs
- To price products
- Decision making

Standard cost card

The standard cost card absorption rates

A typical standard cost card for a product might look as follows:

		$
Direct materials	(4 kg x $8/kg)	32
Direct labour	(3 hrs x $12/hr)	36
Variable overheads	(3 hrs x $4/hr)	12
Marginal production cost		80
Fixed overheads	(3 hrs x $5/hr)	15
Full (absorption) production cost		95
Profit per unit		25
Selling price		120

Review of overhead absorption procedure

- **Overhead allocation**

- **Overhead apportionment**
- **Overhead absorption**

Predetermined absorption rates

This **over or under-absorption** can be calculated as follows;

= (Budgeted overhead rate per unit x actual units) – Actual overheads incurred

Problems with standard costing in modern environments

- Products are often non-standard
- Standards can become quickly outdated
- Production is highly automated
- Often an ideal standard is used
- Modern environments are more concerned with continuous improvement
- Modern managers more detailed information
- More 'real time' performance measures are needed

7 Standard costing systems

There are three main ways to produce a standard cost card:

- marginal costing – this only includes variable production costs in the cost of production
- absorption (or full) costing – as seen above this involves including all overheads (including indirect ones) in the cost of production
- activity based costing (ABC) – this is an alternative to absorption costing that provides more details on indirect costs and a better allocation between products

Activity based costing – a solution for modern production environments

Modern producers have changed they ways in which they produce so that:

- much more machinery and computerised manufacturing systems
- smaller batch sizes
- less use of 'direct' labour

This has had the following **impact on production costs:**

- more indirect overheads (for example, insurance and depreciation of the machines and computers)
- less direct labour costs.

This means that the **traditional** methods of costing (marginal and absorption) produce **standard costs cards that are less useful** due to inaccurate product costs:

Activity based costing **(ABC) has been developed to solve some of the problems** that traditional costing methods create in these modern environments.

Cost drivers and cost pools

- A cost pool is an activity that consumes resources and for which overhead costs are identified and allocated. For each cost pool, there should be a cost driver.
- A cost driver is a unit of activity that consumes resources. An alternative definition of a cost driver is a factor influencing the level of cost.

When is ABC relevant?

- indirect costs are high relative to direct costs
- products or services are complex
- products or services are tailored to customer specifications
- some products or service are sold in large numbers but others are sold in small numbers

The implications of switching to ABC

The use of ABC has potentially significant commercial implications:

- Pricing can be based on more realistic cost data
- Sales strategy can be more soundly based
- Decision making can be improved
- Performance management can be improved

8 Decision making techniques

In this section we look at two areas:

- break even analysis
- marginal analysis

Contribution to sales ratios and breakeven points

Cost-Volume-Profit (CVP) analysis

CVP analysis makes use of the contribution concept in order to assess the following measures for a single product:

- contribution to sales (C/S) ratio
- breakeven point
- margin of safety

(Contribution = selling price less all variable costs)

C/S ratio

The C/S ratio of a product is the proportion of the selling price that contributes to fixed overheads and profits. It is comparable to the gross profit margin. The formula for calculating the C/S ratio of a product is as follows:

C/S ration = $\frac{\textit{Contribution per unit}}{\textit{Selling price per unit}}$ or $\frac{\textit{Total contribution}}{\textit{Total sales revenue}}$

The C/S ratio is sometimes referred to as the P/V (Profit / Volume) ratio.

Breakeven point

The breakeven point is the point at which neither a profit nor a loss is made.

- At the breakeven point the following situations occur,
  Total sales revenue = Total costs, i.e Profit = 0
  or
  Total contribution = Fixed costs, i,e. Profit = 0
- The following formula is used to calculated the breakeven point in terms of numbers of units sold.

  Breakeven point (in terms of numbers of units sold = $\frac{\textbf{Fixed costs}}{\textbf{Contribution per unit}}$
- It is also possible to calculate the breakeven point in terms of sales revenue using the C/S ratio. The equation is as follow:

  Breakeven point (in terms of sales revenue) = $\frac{\textbf{Fixed costs}}{\textbf{C/S ratio}}$

Margin of safety

The margin of safety is the amount by which anticipated sales (in units) can fall below budget before a business makes a loss. It can be calculated in terms of numbers of units or as a percentage of budgeted sales.

The following formulae are used to calculate the margin of safety:

Margin of safety

(in terms of units) = Budgeted sales – Breakeven point sales

$$\text{Margin of safety (as a \% of) budgeted sales} = \frac{\text{Budgeted sales} - \text{Breakeven sales}}{\text{Budgeted sales}} \times 100\%$$

Marginal analysis

Marginal analysis refers to situations where we use contribution to make decisions.

The key is that only costs which vary with the decision should be included in an analysis of the decision.

Marginal analysis can be used in four key areas of decision making:

- accepting/rejecting special contracts
- determining the most efficient use of resources
- make-or-buy decisions
- closing / continuation decisions

9 Dealing with risk in decision making

There are many ways in which risk can be dealt with in decision making. The most common technique is to attach probabilities to the potential range of outcomes and calculate expected values from this information.

Probabilities and expected values

Expected value formula

$EV = \Sigma px$

Decision trees and multi-stage decision problems

Drawing decision trees

In the exam it will be important that you can understand and interpret decision threes. You may also be expected to draw a simple decision tree.

Three-step method

Step 1: Draw the tree from left to right showing appropriate decisions and events/outcomes.

(This is known as the forward pass).

Symbols to use:

□ A square is used to represent a decision point. At a decision point the fecision marker has a choice of which course of action he wishes to undertake.

○ A circle is used at a chance outcome point. The branches from here are always subject to probabilities.

Label the tree and relevant cash inflow/outflows (discounted to present values) and probabilities associated with outcomes.

Step 2: Evaluate the tree from right to left carrying out these two actions:

Calculation an EV at each outcome point.

Choose the best option at each decision point.

(This is known as the backward pass)

Step 3: Recommend a course of action to management.

10 Budgeting

Purposes of budgeting

Budgets have several different purposes:

1) Planning
2) Control
3) Co-ordination
4) Communication
5) Motivation
6) Evaluation
7) Authorisation

Variance groups

Variances can be divided into three main groups:

- sales variances
- variable cost variances
    - material variances

  - labour variances
  - variable overhead variances
- fixed overhead variances

Variance investigation

Variances may also arise because of:

- poor budgeting
- poor recording of cost
- operational reasons (the key emphasis in exam questions)
- random factors

The controllability principle

Controllability means the extent to which a specific manager can control costs or revenues or any other item. The controllability principle is that a manager should only be made accountable and responsible for costs and revenues that he or she can control directly.

In variance reporting, this means that variances should be reported to the managers who are in a position to control the costs or revenues to which the variances relate.

CHAPTER 24

Strategic development and managing strategic change

Intended and planned strategies

Planned strategies

Rational approach involves the following steps

(1) Strategic analysis

(2) Strategic choice

(3) Strategic implementation

For intended strategies one would expect each stage to be completed before the next starts.

Henry Mintzberg made a distinction between deliberate strategy and emergent strategy.

An emergent strategy is a set of actions that is consistent over time, has not been stated in a formal plan and has developed or emerged outside the formal plan and between planning reviews.

Mintzberg and other are of the opinion that deliberate strategy focuses on control, while emergent strategy emphasises learning — there are many different ways that organisations can learn to add value to their product or service through areas such as process redesign and e-business.

2 Strategic drift

Strategic drift describes a situation where the organisation's strategy gradually, if imperceptibly, moves away from the forces at work in its environment.

Over time, organisations will have to deal with many different types of change and it is important that these changes are managed effectively.

Explanation of the stages in strategic drift

- The organisation takes a series of logical, incremental steps that were part of its plan to change ahead of the market and develop a competitive advantage.
- The rate of change in the market place speeds up, and the firm's incrementalist approach is not enough to maintain its advantage, and it is left behind.
- Faced with a stimulus for action, managers may seek to extend the market for their business, but may assume that it will be similar to their existing market, and therefore set about managing the new venture in much the same way as they have been used to.
- If this is not successful, strategy development is likely to go into a state of flux, with no clear direction, further damaging performance.
- Eventually transformational change is required if the demise of the organisation is to be avoided.

  Transformational change tends to occur when performance has fallen off significantly, i.e. in times of crisis.

3 Strategic change

Types of strategic change

Change can be classified by the extent of the change required, and the speed with which the change is to be achieved:

Speed of change / Extent of change	Transformation	Realignment
Incremental	**Evolution**	**Adaptation**
Big Bang	**Revolution**	**Reconstruction**

Further explanation

Explanation of the axes

Transformation	This entails changing an organisation's culture. It is a fundamental change that cannot be handled within the existing organisational paradigm.
Realignment	This does not involve a fundamental reappraisal of the central assumptions and beliefs.
Incremental change	This can take a long period of time, but results in a fundamentally different organisation once completed.
Big Bang change	This change is likely to be a forced, reactive transformation using simultaneous initiatives on many fronts, and often in a relatively short space of time.

4 Organisational culture

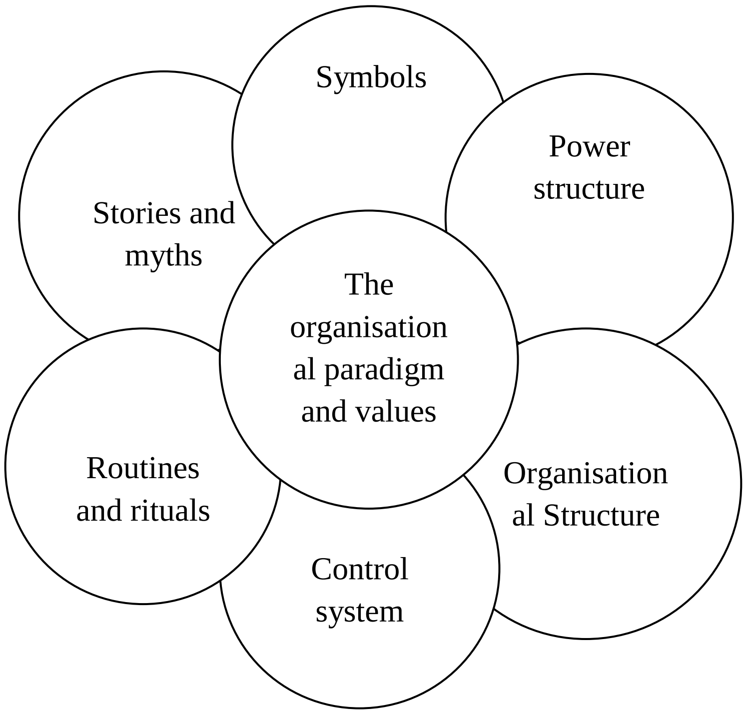
For change to be effective an organisation will often have to change its culture.

Culture is the set of values, guiding beliefs, understandings and ways of thinking that are shared by the members of an organisation and is taught to new members as correct. It represents the unwritten, feeling part of the organisation.

Culture is 'the way we do things around here' (Charles Handy).

Culture is a set of 'taken-for-granted' assumptions, views of the environment, behaviours and routines (Schein).

Cultural web



The culture web was devised by Gerry Johnson as part of his work to attempt to explain why firms often failed to adjust to environmental change as quickly as they needed to. He concluded that firms developed a way of understanding their organisation — called a paradigm — and found it difficult to think and act outside this paradigm if it were particularly strong.

The different elements of the cultural web

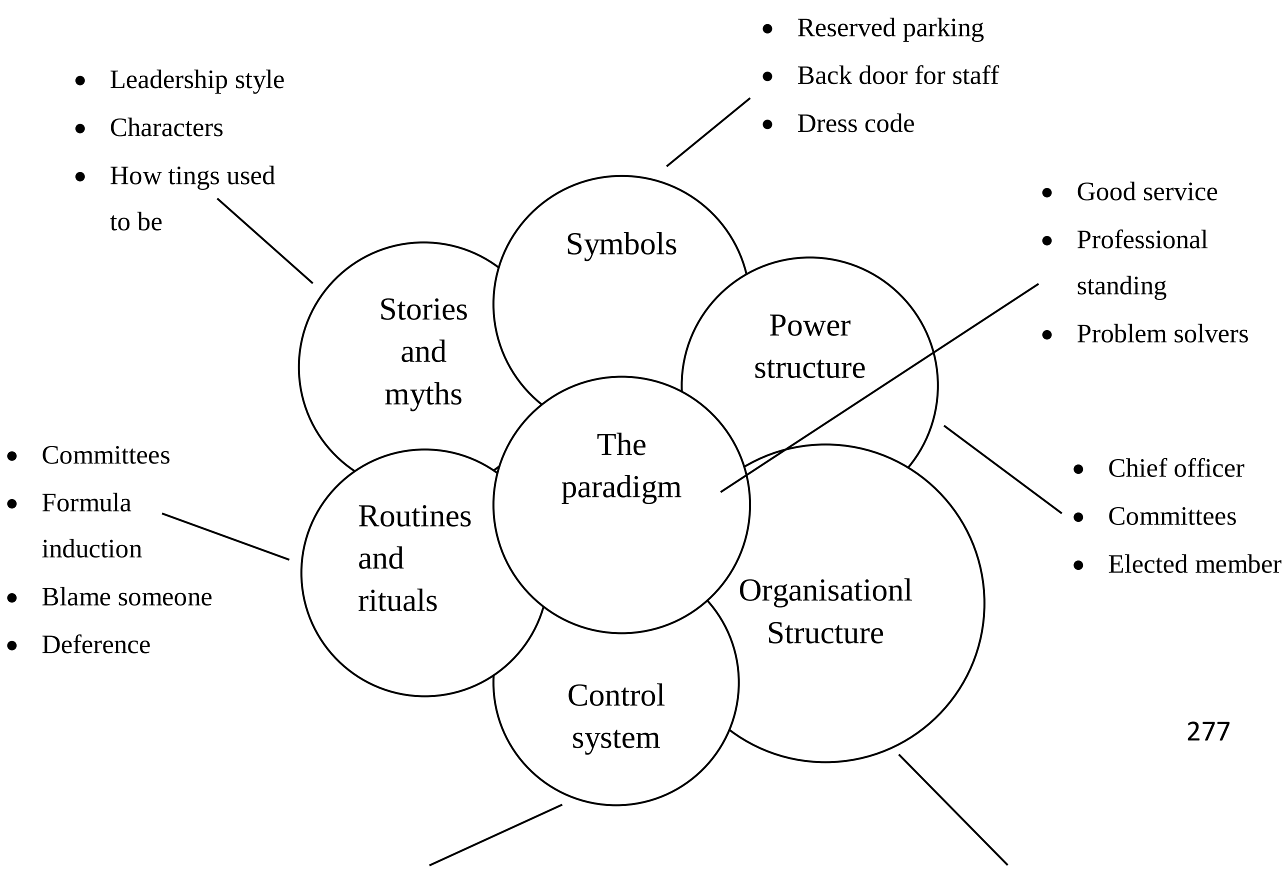
It is concerned with the manifestations of culture in the orgaisation and has six inter-related elements.

- Routines and rituals — routines are 'the way things are done around here' and may even demonstrate a beneficial competency. They can be the written or unwritten rules of the game within the organisation.

- Stories and myths — that employees tell one another and others about the organisation, its history and personalities; used to communicate traditions, standards and role models.
- Symbols — such as logos, offices, cars, titles, type of language and teminology commonly used become a shorthand representation of the nature of the organisation.
- Power structure — formal or informal power or influence by virtue of position, control of resources, who the person knows, or history. This may be based on management position and seniority but in some organisations power can be lodged with other levels or functions.
- Organisational structure — reflects the formal and informal roles, responsibilities, and relationships and ways in which the organisation works. Structure are likely to reflect power.

The cultural web in local government

A cultural web for a local government organisation could look like the following:



- Budgetary
- Service plan
- Complaints
- Contract compliance

- Functional
- Hierarchical
- Autocratic
- Devolved branches

5 Overcoming r

Resistance to change is the action taken by individuals and groups when they perceive that a change that is occurring is a threat to them.

Resistance is 'any attitude or behaviour that reflects a person's unwillingness to make or support a desired change'.

Reasons for resisting change

Job factors

- Fear of technological unemployment
- Fear of changes to working conditions
- Fear of demotion or reduced pay

Social factors

- Dislike need to break up current social environment
- Personal dislike of people implementing change
- Lack of consultation leading to rejection of change

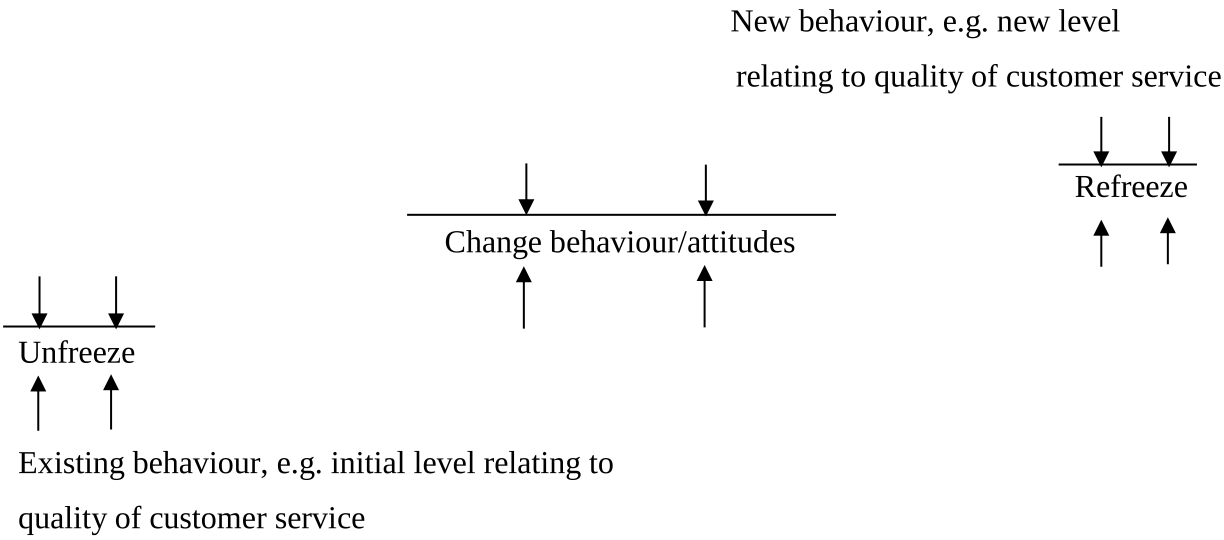
Personal factors

- Implied criticism of current working method
- Feel less valued
- Work becomes more monotonous

Resistance may take many forms, including active or passive, overt or covert, individual or organised, aggressive or timid. For each source of resistance, management need to provide an appropriate response.

Lewin's change process

The process of change, shown in the diagram below, includes unfreezing habits or standard operating procedures, changing to new patterns and refreezing to ensure lasting effects.

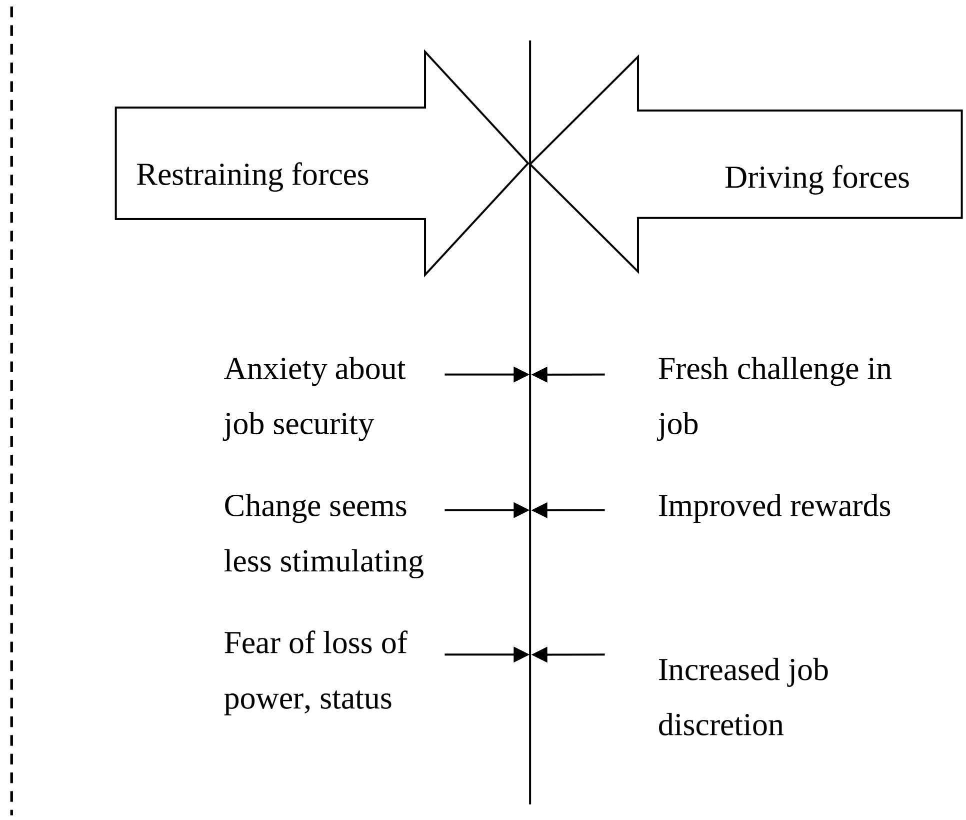


The process of change comprises three stages.

- Unfreezing — create the initial motivation to change by convincing staff of the undesirability of the present situation.
- The change process itself — mainly concerned with identifying what the new behaviour or norm should be. This stage will often involve new information being communicated and new attitudes, culture and concepts being adopted.
- Refreezing or stabilising the change — implying reinforcement of the new pattern of work or behaviour by rewards (praise, etc).

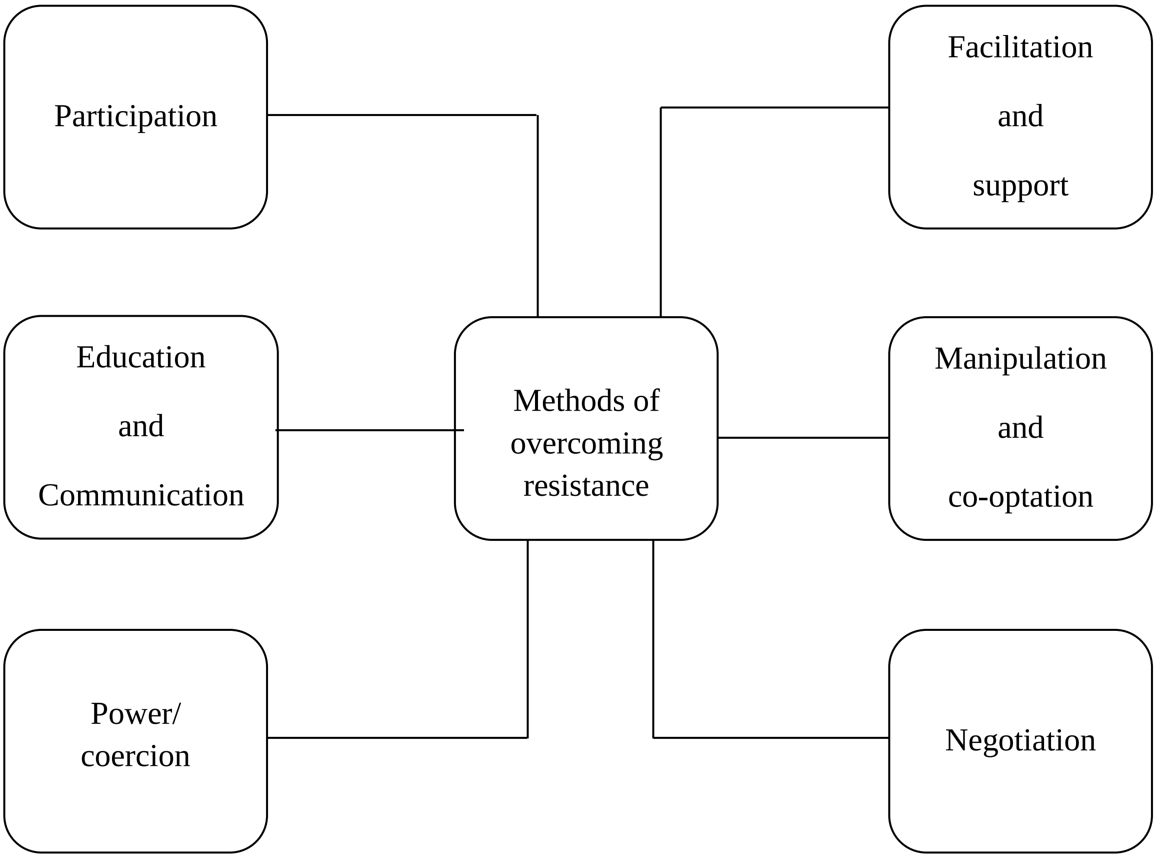
Force field analysis

Ideal state **Current state**



Leadership style

Kotter and Schlesinger set out the following change approaches to deal with resistance:



6 The context for change (Balogun and Hope Hailey)

For change to be successful, implementation efforts need to fit the organisational context. There is no simple 'off the shelf' approach that will work for all organisations. Balogun and Hope Hailey suggest that there are a number of **contextual features** that should be considered before an implementation approach (for example a style of leadership) for the change is determined:

- time
- scope
- preservation
- diversity
- capability

- capacity
- readiness
- power

Contextual features

- **Time** — is there time for longer term strategic development or does the firm have to reach quickly to a crisis?
- **Scope** — how much of the organisation will be affected? Is the change best described as realignment or transformation?
- **Preservation** — which aspects of working, culture, competences and people need to be retained?
- **Diversity** — the need to recognise that different departments (e.g., marketing and R & D) may have different sub-cultures.
- **Capability** — whether abilities exist to cope with the change. These can be on an individual, managerial or organisational level.
- **Capacity** — are resource (e.g. money, managerial time) available to invest in the change process?
- **Readiness** — are staff aware of the need for change and are they committed to that change?
- **Power** — how much authority and autonomy do change agents have to make proposed changes?